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Art. 2 – Objects

1. The objects of the foundation shall be to organise and maintain a documentation centre for the purpose of providing information about and explanations of national and international taxation and the application thereof, as well as promoting the study of taxation in general.
2. In the realisation of its objects the foundation shall strive to maintain good co-operation with its founder, the International Fiscal Association, hereinafter referred to as "I.F.A.", which set up the foundation as an independent entity.

Art. 3

1. The foundation shall endeavour to achieve its objects:
   a. by collecting and maintaining information concerning taxation whether in the form of a library with relevant books, periodicals

L'OBJET DU BUREAU

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

Art. 2 – Objets

1. La fondation a aussi bien pour objet d'organiser et de tenir à jour un centre de documentation permettant de fournir des informations et explications sur la fiscalité nationale et internationale et son application, que de promouvoir l'étude de la fiscalité en général.
2. Pour la réalisation de ces objets, la fondation devra chercher à entretenir une bonne coopération avec sa fondatrice, l'Association Fiscale Internationale, ci-après intitulée I.F.A. (International Fiscal Association), qui a créé la fondation comme entité indépendante.

Art. 3

1. La fondation s'efforcera pour la réalisation de ces objets:
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d. by publishing;
e. by offering co-operation in the publication of third parties;
f. by all other lawful means.

2. Within the framework of its objects the foundation shall be entitled to set up other legal entities and organisations or participate therein, whether on its own or together with others.

In close cooperation with the IFA, and with the aid of expert correspondents throughout the world, the IBFD acquires as much information as possible in the field of international and comparative tax law. The IBFD is thus able to supply data (but not advice) on specific tax problems. A fee, necessary for the maintenance and extension of the IBFD, is charged on a time/cost basis. The IBFD has published several series of monographs including "Selected Monographs on Taxation" (a joint venture with Harvard Law School, International Tax Program).

The IBFD publishes two other monthly journals: *European Taxation* on the tax systems in Europe, and the *International VAT Monitor* on VAT, sales tax and other, similar forms of indirect taxation. *Tax News Service,* published twice per month, provides world-wide information on the latest developments in international taxation.

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".

Other loose-leaf publications from the IBFD are: *Supplementary Service to European Taxation, African Tax Systems, Taxes and Investment in the Middle East, Taxes and Investment in Asia and the Pacific, Taxation in Latin America, Taxes and Investment in Canada,* the *Handbook on the 1989 U.S.–German Tax Convention.*

International tax data bases available from the IBFD are: the Tax Treaties Data Base on CD-ROM (approx. 1,100 treaties including protocols in English), the European Taxation Data Base on CD-ROM (comprehensive data base on taxation in Europe including legislation), the Data Base on Corporate Taxation and Cross Border Payments in OECD Countries (hard disk based, size approx. 4 Mb.), and the TNS On-line Data Base.

publiés dans ce domaine, les périodiques et autres publications, soit sous la forme d'une banque de données, soit sous une autre forme;
b. de fournir des informations et explications;
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e. d'offrir sa coopération dans la publication de tiers;
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Par une coopération étroite avec l'IFA et avec l'aide de correspondants à travers le monde, le BIDF rassemble toutes les données possibles en matière de droit fiscal international et comparé. De cette façon, le BIDF est à même de fournir des renseignements, mais non des avis, concernant des problèmes fiscaux spéciaux. Des honoraires, nécessaires au maintien et à l'expansion du BIDF, sont demandés en fonction du temps nécessaire et du coût. Le BIDF a publié un certain nombre de monographies dont des monographies sur la fiscalité (études réalisées en association avec Harvard Law School, International Tax Program).

Le BIDF publie également deux autres mensuels; à savoir: *European Taxation,* revue portant sur les systèmes fiscaux européens et l'*International VAT Monitor,* sur la TVA, les taxes sur le chiffre d'affaires et autres impositions comparables. *Tax News Service,* publication bi-mensuelle, donne des informations sur les derniers développements de la fiscalité de par le monde.

Guides to European Taxation, une publication sur 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".

Les autres publications sur feuilles mobiles sont les suivantes: *Supplementary Service to European Taxation, Systèmes Fiscaux Africains* (édition bilingue français-anglais), *Taxes and Investment in the Middle East, Taxes and Investment in Asia and the Pacific, Taxation in Latin America, Taxes and Investment in Canada,* the *Handbook on the 1989 U.S.–German Tax Convention.*

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The Association shall endeavour by all legal means to realise this aim: (a) by scientific research; (b) by holding congresses and conferences; (c) by publications; (d) by cooperation with all data collecting organisations, especially the International Bureau of Fiscal Documenta-

tion in Amsterdam; (e) by all other appropriate methods.

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tion Paper"; ces propositions étant toutefois beaucoup plus compliquées que celles contenues dans le "Consultative Document". On pense que la proposition de loi sur ce sujet sera publiée rapidement.

Rick Krever:

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Rick Krever:

Australien: Unterkapitalisierungsgesetzgebung *18*
Im Jahr 1987 schloss sich Australien dem exklusiven Kreis der OECD-Staaten an, die eine detaillierte Gesetzgebung hinsichtlich des Problemkreises der Unterkapitalisierung besitzen. Der Artikel analysiert die wichtigsten Elemente der australischen Bestimmungen und ihre Anwendung in der Praxis.

A.J. Easson und Jinyan Li:

Volksrepublik China: Der neueste Stand der Ausländerbesteuerung *26*
Es ist unzweifelbar verfrüht um jetzt die Effekte welche die neuesten tragischen Ereignisse auf Investitionen in China haben werden zu evaluieren. Potentielle Investoren werden vorsichtig sein und sie werden warten bis sie ein deutlicher Bild der Situation bekommen haben, bevor sie umfangreiche Geldbeträge in neue Projekten oder in die Erweiterung von bestehenden Projekten stecken werden. Trotzdem haben einige neue Entwicklungen stattgefunden welche einen Kommentar bedürfen. Dieser Artikel beschreibt einige Merkmale des Kooperative Gemeinschaftsunternehmen Gesetzes (Cooperative Joint Venture Law), den Steuerpflicht der chinesischen Inlandsteilnehmer eines Gemeinschaftsunternehmen, die Zuteilung von Devisen, Steuerabkommen, Probleme bezüglich Verrechnungspreisen, drei neue lokale Steuern und schliesslich die Vorschläge um die JVIT und die FEIT zu vereinheitlichen.

Montri Hongskrailers:

Thailand: Die wichtigsten Merkmale der Steueränderungen im Jahre 1989 ..... *30*
Während des vergangenen Jahres hat die thailändische Regierung verschiedene Dekrete verabschiedet, um die Bestimmungen der Steuergesetzgebung zu ändern. Die Änderungen betreffen insbesondere die Einkommensteuer. Der Artikel beschreibt die wichtigsten Merkmale des Notdekrets Nr. 15 von 1989 und die Königliche Dekrete Nrn. 199, 200, 201, 202 und 203.

Arthur J. Mann:

Steuerreform in Bolivien:1969-1989 ..... *32*
Die gründliche Revision des bolivianischen Steuersystems die in 1986 statt fund, wird zum heutigen Tage fortgesetzt. Die ehemalige Steuerstruktur wurde völlig abgeschafft und sie ist von einem integrierten System von 7 Steuern mit einer Mehrwertsteuer als Kern ersetzt worden. Dieser Artikel bescheibt die makro-ökonomischen Hintergründe dieser Steuerreform, die Steuerreform selbst und evaluiert die Änderungen der bolivianischen Steuergesetzgebung.

Veranstaltungskalender *36*

Roy Bahl:

Jamaica: Steuerreform: Eine Evaluation und eine Lehre *37*
Im Jahre 1986 wurde eine grundsätzliche Reform der Steuern vom Einkommen in Jamaika durchgeführt. Obwohl diese Reform erst seit kurzem ihren Einfluss ausübt, gibt es schon Indikationen, dass ihr Erfolg grösser als erwartet sein wird. Dieser Artikel beschreibt das Steuerreformprogramm, verschafft eine Evaluation ihres Erfolges und bietet eine bestimmte Lehre aus den praktischen Erfahrungen, die für Steuerreformer in anderen Entwicklungsländern von Nutzen sein könnten.

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UNITED STATES:

Current Capital Markets Issues*

John N. Bush & Peter J. Connors

I. INTRODUCTION

This article will review 4 subjects of interest in the capital markets area: (1) Notice 89-21, dealing with notional principal contracts; (2) repurchase agreements and securities loans; (3) contingent payment obligations; and (4) the new REMIC reporting rules.

II. NOTICE 89-21

Notice 89-21 (the "Notice") is the first administrative pronouncement on the proper method of accounting for lump sum payments received in connection with interest rate and currency swap contracts, interest rate cap contracts and similar financial products.

The Notice provides that any lump sum payment received or paid at inception must be recognized over the life of the contract. It rejects as impermissible any method which either includes currently or defers the entire amount until the contract is terminated. The theory underlying the Notice was that the upfront payment should be treated like bond premium.

Prior to the Notice, taxpayers with expiring net operating losses or excess foreign tax credits had entered into transactions designed to rejuvenate those tax attributes.

Example 1: L, a loss company, has a net operating loss carry forward of US$ 10,000,000, which expires at the end of the year. L enters into a swap transaction pursuant to which L agrees to make annual payments equal to the then-current LIBOR plus a spread, applied to the swap notional amount. In a traditional swap, the counterparty would make fixed-rate annual payments. To accelerate income, the investment bank would make an upfront payment to L equal to the present value of the fixed rate stream. As a result, the net operating loss is preserved, and converted into a series of forward operating loss deductions. L hedges its floating rate liability through an offsetting interest rate swap, an interest rate cap or the acquisition of a floating rate asset. Most often, the investment bank would also require some security, usually in the form of a letter of credit. Frequently the interest rate used to discount the payment may exceed the rate at which the fixed rate payments are being made and, in one sense, create an economic loss. Also, purchase of the second swap often created a loss equal to the bid-asked spread.

Example 2: L and the investment bank enter into an interest rate swap whereby L makes annual payments equal to the then-current LIBOR plus a spread, applied to the swap notional amount. L also reserves the right to sell the series of fixed payments from the investment bank to a third party in exchange for upfront payments. L remains obligated to make semi-annual LIBOR-based payments.

These transactions were also common where a company desired to "acquire" a target's net operating loss.

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Example 3: Assume that ("AC"), an acquisition company, wishes to acquire L, the loss company described in Example 1. The swap described in Example 1 is entered into, with AC agreeing to guarantee the obligation of L to make the floating rate payments. Again, the net operating loss is preserved, and converted into a series of forward operating deductions.

Prior to the announcement, there was some concern that the Commissioner would exercise its regulatory authority under Sec. 382(m) to disallow the loss. Alternatively, there was an argument that the deduction generated by the swap constituted a built-in deduction, under Sec. 382(h)(6).

The same principles could be used to make use of expiring foreign tax credits.

Example 4: Assume the company described in Example 1 entering into the swap is a profitable German manufacturing company owned by a U.S. company. The swap described in Example 1 is entered into. The swap payment would not be taxable to the German company when received; instead, it would be amortized over the life of the swap. Upon receipt of the payment, the German company pays a dividend to the U.S. company. The dividend is characterized as general limitation income under the Subpart F Regulations and look through rules of Sec. 904. The dividend is absorbed by otherwise expiring foreign tax credits.

A. Analysis of the Notice

There are a number of holdings in the Notice:

1. *Upfront payments received*
The Notice held that in the case of payments received during one taxable year with respect to notional principal contracts where such payment relates to the obligation to make a payment or payments in other taxable years under the contract, a method of accounting that recognizes such payment over the life of the contract clearly reflects income.

2. *Upfront payments paid*
The Notice also indicates that the taxpayer making payments must amortize payments made.

3. *Assignment payments*
The Notice indicates that it will also apply to payments made or received in connection with the assignment of the right to receive future payments in the absence of a corresponding assumption of the obligation to make payments under the contract.

4. *Mark to market system*
The Notice also indicates that a mark to market system for dealers in notional principal contracts is under consideration. No guidance is provided on this subject, however.

5. *Regulations to be prospective on amortization method*
The Notice further indicates that specific rules for the manner of amortization of payments made or received with respect to various types of notional principal contracts will generally be prospective.

6. *Litigating position*
The Internal Revenue Service (IRS), in effect, states its litigating position with respect to pre-Notice swaps. The IRS will treat the use of an accounting period as clearly reflecting income only if it takes such payments into account over the life of the contract using a reasonable method of amortization. Accordingly, the IRS will not accept as reasonable an accounting method that accelerates the income, even if it was entered into prior to the effective date of the Regulations.

7. *Requirement to change accounting method*
Taxpayers who have adopted an accounting method that is inconsistent with the foregoing must obtain the consent of the Commissioner to change to an acceptable method. Notwithstanding any provision in Rev. Proc. 84-74, 1984-2 C.B. 736, the IRS, in examining a taxpayer's return, may require that a method of accounting consistent with the required amortization method be adopted for the earliest year under examination.

8. *Excluded transactions*
The Notice excludes from its application transactions that are not properly characterized as notional principal contracts. Specifically, the Notice excludes from application contracts that are more properly designated as loans or as insurance or annuity contracts.

B. Open issues

Commentators have raised a number of questions concerning the application of the Notice.

1. Rejection of *Schlude*[1]

The most frequently asked question concerns the application of *Schlude*. *Schlude* is most often cited for the proposition that an accrual basis taxpayer must include cash received in income notwithstanding that the cash relates to services to be performed over an extended period of time. It has been said that the rejection of *Schlude* will cost the Treasury upwards of $ 750 million.

Schlude is one of a trilogy of cases in which the Supreme Court held that where the taxpayer received advanced payment for services with no fixed performance date and, without restriction as to disposition, the entire amount should be reported as income in the year of receipt. In the earlier cases, the IRS relied on the claim of right doctrine; in the later cases, the IRS instead used its authority to reject methods of accounting that do not clearly reflect income. Interestingly, there is substantial post-*Schlude* authority to support the position that deferral is possible if future services are to be performed with certainty or on fixed date.[2] In rejecting *Schlude,* the IRS, in the Notice, said that the taxpayer's accounting method did not properly reflect income. (Some have said that, in one sense, the IRS is actually adopting *Schlude,* i.e. it will exercise its authority to disallow accounting methods which do not reflect income.)

This also leads one to the discomforting conclusion that whenever the IRS feels that the taxpayer's treatment of a transaction is inaccurate, that it will assert application of Sec. 446 (b) as a catchall.

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1. *Schlude v. Commissioner,* 372 U.S. 128 (1963).
2. *See Artnell v. Commissioner,* 400 F.2d 981 (7th Cir. 1968), *acq.* 1968-1 C.B. 2 (prepaid ticket revenue for baseball games to be performed at fixed dates); *TFH Publications v. Commissioner,* 72 T.C. 623 (1979) (deferral possible where performance of services is certain by virtue of predetermined schedule); *Handy Andy T.V. and Appliances, Inc. v. Commissioner,* 47 T.C.M. 478 (1983) (deferral possible where future performance can be assured through contract terms); *Collegiate Cap & Gown Co. v. Commissioner,* 37 T.C.M. 960 (1968) (deferral allowed where certainty of future performance of services).

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2. Changes to accounting method change rules

Taxpayers who make an accounting method change to conform with the Notice will be required to file Form 3115, Application for Change in Accounting Method. Those who have previously reported income will be required to make a negative Sec. 481 adjustment with respect to income previously reported. Normally, a change in accounting methods is effective on a prospective basis, and is spread over a number of tax years that the taxpayer used the prior accounting method. Where the taxpayer is under examination, the change is made with respect to the most recent tax year under examination. In either case, prior years are left untouched. The Notice indicates that where a return is under examination, the change will be effective for the earliest year under examination. Where the return is not under examination but the taxpayer files Form 3115 to make the accounting period change, the IRS may also require that the change be retroactive to the earliest open year.

a. *Amortization period for negative adjustment*
It is unclear whether the IRS will permit the amortization of the negative adjustment, or instead, require that it be taken all in one year.

b. *Swap begins before the earliest open tax year*
What happens if the earliest open tax year precedes the beginning of the contract? What is the period over which the payments should be amortized? Is it the number of years left under the agreement?

3. Contracts to be covered by the Notice

The IRS has yet to propose a definition of a notional principal contract. The specific reference in the Notice to "interest rate cap contracts" as well as the use of the term "lump sum payment" indicates that "notional principal contracts" covered by the Notice include contracts in which one party makes only a single payment. Questions have been raised, however, about forward swaps, i.e. swap contracts pursuant to which payments are made after a specified date in the future, as well as swaps with "uneven" cash flows.

a. *Interest rate swaps*
Notice 87-4, 1987-1 C.B. 423, which provides sourcing rules for income and expense from "United States dollar denominated interest rate swaps," provides that in general such a swap consists of an exchange pursuant to a single contractual arrangement between 2 parties of a fixed rate amount for floating rate amounts, or floating rate amounts measured by different indices, denominated in U.S. dollars. These amounts are calculated by reference to a mutually agreed principal amount. The term "interest rate swap" is also used in Treasury Regulation 1.954-2T(h)(1), promulgated under Sec. 954(c), but no definition is provided.

b. *Similar financial products*
There is also concern regarding the use of the phrase "similar financial products". Although analogous to Sec. 988(c)(1)(B)(iii), which has been held to include currency swaps[3], that section refers to "any forward contract, futures contract, option or similar financial instrument".

c. *Derivative products*
It is unclear whether the principles established by the Notice will apply to derivative products, such as swap options, cancellable swaps, forward swaps, forward rate agreements, options on caps and options on floors. On the other hand, futures, forwards and options are most definitely not covered by the Notice.

d. *Currency swaps*
Precedent defining the term "foreign currency swap" has lagged demonstrably behind that defining the term "interest rate swap". Part of this relates to the confusion that exists between that term and the use of foreign currency forward rate agreement. Moreover, some foreign currency swaps, involving the exchange of foreign currency principal amounts, actually resemble foreign currency loans and, accordingly, a snag in the tax analysis in this area has resulted.

In the letter ruling cited above, the IRS distinguished the term "foreign currency swap" from the term "foreign currency contract", as it is used in Sec. 1256(g)(2) because of differences in the way in which interest rate differentials on the currencies that are the subject of the contracts are taken into account (i.e. in a currency swap, interest rate differentials are taken into account through a present and continuing exchange of payments, while forward rate agreements account for differences at maturity). Absent hedge treatment under Sec. 1256(e), forward rate contracts must be marked to market at year-end. How should a foreign currency swap calling for upfront payments, either on the dollar side or the foreign currency side, or both be treated?

4. Payments to which the allocation rule applies

The Notice's application is limited to payments received or made with respect to notional principal contracts. The Notice also states that future Regulations will provide rules governing the treatment of payments made or received in connection with the assignment of the right to receive future payments under a notional principal contract in the absence of a corresponding assumption of the obligation to make payment under the contract.

a. *Swap termination and assignment payments*
The Notice does not apply by its terms to payments pursuant to which one assumes the obligation under the swap contract. Frequently, underwater swap contracts are terminated as a year-end planning technique, designed to accelerate tax deductions. Termination or assignment is accompanied by an upfront payment.

(1) *Treatment of the payor*
With respect to the payor, it would seem that a deduction should be allowed since there is no longer any period over which to amortize the payments. We understand, however, that Treasury is considering amortizing this over the obligation that relates to the notional principal contract.

(2) *Treatment of the recipient*
Read literally, the Notice suggests that the recipient need not include the payment into income when received; rather, it should be amortized over the life of the obligation. Would it make a difference if the contract were terminated, rather than being assigned?

(3) *Other issues*
What is the appropriate treatment where the obligor under the swap changes? Does the creditworthiness of the new obligor make a difference? Finally, what is the character of such a payment?

b. *What is a lump sum payment?*
Is there a difference between a zero coupon swap, for which all of the payments are prepaid, and a yield adjustment fee? Should it make a difference whether the fee is paid at the

3. Private Letter Ruling 88-18010 (4 February 1988).

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inception of the swap or is made to induce one to assume an underwater swap? Will there be a de minimis rule? If so, will it be elective or mandatory?

5. Appropriate method of allocation

This seems to be the most perplexing area. It is not surprising that the IRS chose to defer to reasonable accounting methods, in absence of its own decision on this topic. In the material that follows, we review some of the methods available.

a. *The zero coupon swap*
Assume the following:
Same facts as in Example 1. The agreement calls for the investment bank to prepay the 3 annual fixed rate installments. Each of these installments would amount to $ 100,000. The investment bank agrees to pay $ 248,694, which is the present value of each $ 100,000 payment, assuming a discount rate of 10%.

Current thinking is that L should be deemed to receive each of the $ 100,000 payments annually and incur interest expense, on an annual basis, for each payment which is deferred.

This would result in the following:

To L:

	Swap receipts	Interest expense	Net income	Straight line
Year 1	100,000	24,863	75,137	82,898
	100,000	17,353	82,647	82,898
	100,000	9,090	90,910	82,898
Totals	300,000	51,306	248,694	248,694

To investment bank:

	Swap expense	Interest income	Net expense	Straight line
Year 1	100,000	24,863	75,137	82,898
	100,000	17,353	82,647	82,898
	100,000	9,090	90,910	82,898
Totals	300,000	51,306	248,694	248,694

b. *The back-end swap*
Assume the following:
Same facts as in Example 1. The Agreement calls for the investment bank to defer making its 3 fixed rate installments. Each of these installments would amount to $ 100,00. L agrees to pay $ 364,000, which is the future value of the three $ 100,000 payment streams at a discount rate of 10%.

Following on the prior analysis, the taxpayer should be deemed to receive each of the $ 100,000 payments annually and incur interest expense, on an annual basis, for each payment which is deferred.

This would result in the following:

To L:

	Swap receipts	Interest income	Net income	Straight line
Year 1	100,000	10,000	110,000	121,333
	100,000	21,000	121,000	121,333
	100,000	33,000	133,000	121,334
Totals	300,000	64,000	364,000	364,000

To investment bank:

	Swap expense	Interest expense	Net expense	Straight line
Year 1	100,000	10,000	110,000	121,333
	100,000	21,000	121,000	121,333
	100,000	33,000	133,000	121,334
Totals	300,000	64,000	364,000	364,000

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Other variations of this method would call for the obligation to be discounted using the zero Treasury yield curve, which reflects differences in interest rates at different maturity levels. A further question that arises is whether it is appropriate to discount the obligation at a standard rate, such as the applicable Federal rate.

It is important to note, however, that it is by no means clear that interest income or expense may be imposed; rather, it could very well be that the payment be amortized on a "net" basis.

c. *Use of straight-line method*
Pending the issuance of Regulations, Treasury will be hard-pressed to prevent taxpayers from using the straight-line method of amortization. Use of inconsistent methods between the parties will most assuredly produce distortions. A straight-line approach would produce taxable income or expense equal to the sum of payments to be made, $ 248,694 or $ 364,000 in each of the examples, divided by the number of payment periods, thus equalling $ 82,898 and $ 121,333, respectively. Even if conformity is achieved, it remains to be seen whether the mathematical calculations used in determining the discounting process are mandated. For instance, if deemed interest expense is imposed, will the economic accrual method of calculation be mandated?

d. *Treatment of caps*
The treatment of caps requires a slightly different analysis. This results from the economic equivalency that each cap payment has to cash settlement options. Unlike a swap contract, where one party can be a payor or recipient, in a cap, the obligation is typically one-sided. That is, while there will be a right to receive, there is generally no obligation to pay on the part of the cap purchaser.

The financial community generally views interest rate cap agreements as being the equivalent of a series of cash settlement, European-style put options on a debt instrument (one option for each determination date in the contract), i.e. the cap purchaser is viewed as having the right to sell a debt instrument (e.g. a Eurodollar time deposit) having a face value equal to the notional principal and bearing an interest rate equal to the cap rate. Conversely, a floor is generally viewed as a series of cash settlement, European-style call options on a similar debt instrument. A collar is viewed as a combination of caps and floors. If the strike price of the cap and floor are equal, the transaction is economically equivalent to a swap.

(1) *The Black-Scholes model*
Since an option's price is a function of the combination of current market prices, the striking price, volatility and time to expiration, a formula has been developed from these variables. It is this model which is generally used to calculate the amount of cap premium that will be charged by the investment bank selling the interest rate cap contract. A by-product of this pricing methodology is that option premiums are lowest for the period closest to the purchase date and highest for the period furthest from the purchase date. This feature can be most readily understood by comparing the prices of exchange traded options for a range of option periods. Options will always be more expensive where the period is farthest out.

Prior to the adoption of the Notice, many investment and commercial banks requested their cap purchasers to agree in advance to an allocation procedure that conformed to the Black-Scholes pricing model. Since this appears to be the model which most mirrors economic reality, it is likely that IRS Regulations will adopt this methodology for cap pur-

chasers. Again, in the interim, purchasers, who may not have access to the pricing methodologies, should be permitted to amortize the payments on a straight-line basis.

(2) *Collars*
As noted above, often, a cap is combined with a floor to create a collar. Consistency will most certainly be required with respect to the amortization of both the cap and the floor.

e. *Integration with another position*
There are a number of other methods which must be considered. First, in many cases, the swap or the cap will be purchased to change the character of a specific debt instrument. Assume that a taxpayer issues a 10-year bond, with a face amount of $ 100,000, calling for floating rate payments. The issuer then purchases a cap pursuant to which it will receive payments in the event interest rates exceed 8%. Economically, the issuer has issued a variable rate obligation, at a discount, calling for capped payments. Pending the issuance of Regulations, consideration might be given to amortizing the discount in the fashion called for by the Original Issue Discount (OID) Regulations.

f. *Stepped rents*
Sec. 467 requires that rental and interest income attributable to a deferred rental payment agreement be reported as income by the lessor and deducted by the lessee as if both were on the accrual method, irrespective of the actual method of accounting. If the transaction is subject to these provisions, the amount of rent to be accrued by the parties for the taxable year will be based upon a rental rate that is constant or level for each period of the lease. In addition, the lessor will annually accrue interest income, and the lessee will deduct interest expense, at a rate equal to 110% of a self-adjusting statutory rate, on any unpaid accrued rent and interest. Deferred payments under service contracts are treated in a manner similar to deferred rents.

Sec. 467(f) also provides for similar treatment for advance payments. It does not appear, however, to be applicable to service payments.[4]

In any case, a further alternative would be to treat the advance payment or deferred payment under Sec. 467. In such case, it would appear possible to use an interest rate equal to 110% of the applicable Federal rate, rather than the interest rate implicit in the contract.

g. *Applicable period*
What is the life of the agreement in the case of a master swap agreement? Is it the agreement itself, or the subagreement?

F. Planning

The *anti-Schlude* rule will be the center of many planning opportunities, as it again provides taxpayers the ability to receive cash while not recognizing the income. Perhaps this will be a valuable way to repatriate earnings from foreign subsidiaries. Further, it is unclear whether the IRS will impose a consistency rule with respect to both parties in a swap transaction; to the extent no consistency rule is imposed, taxpayers will most assuredly take advantage of any mismatch.

Taxpayers who nonetheless wish to avoid application of the ruling, arguably, may do so through the contingent interest Regulations, which, in effect, require a modified cash method of accounting.

III. SECURITIES LOANS AND REPURCHASE AGREEMENTS

We continue to receive inquiries regarding securities loans and repurchase agreements. More importantly, we understand that a Regulation project has opened in this area. In this section of the outline, we review some of the relevant issues.

A. Securities loans

Many taxpayers obtain additional income by lending their securities to others, such as brokers, who use securities to cover short sale and so-called "fail sale" situations (in which the seller does not deliver securities sold on the settlement date). Securities lending takes place because the borrowers need possession of the securities.

In a securities loan, the broker agrees, typically, to fully collateralize the loan with cash or other securities and to return identical securities to the lender on demand or within a short time thereafter.

The lender receives a fee as compensation for the use of the securities and an amount equal to any dividends or interest payments made by the issuer of the securities when the securities were loans. These payments are referred to as substitute payments. Tax-exempt organizations and regulated investment companies frequently lend their portfolios to earn current income.

B. Repos

Repos and reverse repos generally are financing transactions. One party is viewed as the seller-debtor and the other party is viewed as the buyer-creditor.

In a repo transaction, a taxpayer who owns securities borrows funds using his securities as collateral. The borrower obtains cash by selling the securities to the other party and agrees to repurchase equivalent securities from the other party at a future date.

1. Reverse repo

A reverse repo transaction is the reverse side of a repo. The taxpayer purchases securities from the other party and agrees to sell equivalent securities to the other party at a future date.

2. Types of repos

Repos transactions can be overnight, for a longer specified period or open dated.

3. Termination of repos

Repo transactions are generally terminated by returning to the seller-debtor at the same price as they were transferred to the buyer-creditor plus charges representing an agreed-upon interest rate added to the principal at the maturity of the contract.

C. Sec. 1058

Sec. 1058, which applies to securities loans after 1976, provides that if a qualified loan agreement is in place, neither

4. We understand that there is presently a draft set of Regulations, not yet released, dealing with deferred rental payments. We understand that the Regulations do not deal at all with services, although they appear to cover advance rental payments.

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gain nor loss is recognized on the loan or return of securities, if the borrower agrees to return, and does return, identical securities of the taxpayer. Sec. 1058 was necessary because the IRS had stopped issuing rulings on whether a securities lending transaction constituted a sale or exchange or whether the transaction interrupted the lender's holding period.

1. Sec. 1058 requirements

To qualify for Sec. 1058 treatment, a number of requirements must be met:
(a) The agreement must provide that identical securities will be returned to the lender.
(b) The agreement must require that payment be made to the lender in an amount equivalent to all interest, dividends and other distributions that the owner of the securities is entitled to receive, during the period from transfer of the securities until identical securities are returned to the lender.
(c) The agreement cannot reduce the lender's risk of loss or opportunity for gain on the securities transferred back.
(d) The agreement must meet any other requirement provided in Treasury Regulations consistent with normal commercial practices as permitted by the SEC.
(e) Treasury Regulations proposed in 1983 provide that the agreements must be in writing and must allow the lender to terminate the loan upon notice of not more than 5 business days.

2. Payments to lender under proposed Regulations

(a) All substitute payments paid to the lender are treated as a fee for the temporary use of property (except for Code Sec. 512(a)(5)).
(b) An amount received by the lender that is equivalent to a dividend paid during the term of the loan does not constitute a dividend to the lender but is taken into account as ordinary income.
(c) Accordingly, payments lose their original character. As a result, a corporate lender generally loses the benefit of the dividends-received deduction, and the lender of tax-exempt securities receives ordinary income during the period the securities are lent under the qualified loan agreement.

3. Treatment of non-Sec. 1058 transactions

The tax consequences of a non-qualified loan transaction vary depending upon whether the loan transaction ever qualified for Sec. 1058 protection.

(a) *Transaction initially meets Sec. 1058 requirements*
Under the proposed Regulations, if the security loan initially meets the requirements of Sec. 1058(b), but the borrower fails to return to the lender identical securities or otherwise defaults under the terms of the agreement, gain or loss is recognized by the lender on the day the borrower fails to return identical securities. This means that even if the terms of the agreement are proper, but the borrower defaults, the lender recognizes gain or loss on the day of the default.

(b) *Transactions not a Sec. 1058 agreement*
The proposed Regulations provide that if the agreement was intended to comply with Sec. 1058, but securities were not transferred pursuant to a qualified loan agreement, the transfer does not meet the requirements for non-recognition. As a result, gain or loss is recognized at the initial transfer in accordance with Sec. 1001.

4. Revenue Ruling 60-177

In Revenue Ruling 60-177, 1960-2 C.B. 9, the IRS held that a dividend substitute paid to a lender of stock by a short-seller on stock borrowed to cover a short sale was not a dividend and the stock lender was not entitled to partial exclusion of the substitute payment as a dividend. The same result was reached in connection with tax-exempt interest in Revenue Ruling 80-135, 1980-1 C.B. 18. The theory was that the lender was not the stock owner since in a short sale, title passes.

5. Technical advice memorandum (TAM) 85-38001

In TAM 85-38001 (6 June 1985), the IRS advised that where a corporation, as part of its securities lending agreements made loans of common stock to securities brokers for fail sale transactions, the dividends paid over to the corporation by the brokers were entitled to the dividends-received deduction. The IRS reasoned that in the case of the fail sale (but not the short sale) transaction, the lender has a contractual right to receive the dividend payments and there is no possibility for 2 parties to claim dividends on the loan stock because, unlike short sales, dividends on 2 shares of stock are involved: (1) the shares loaned to the broker and transferred to the purchaser (purchaser's dividend); and (2) the seller's shares that have yet to be delivered to the broker and returned to the lender (lender's dividend).

TAM 88-28003
In TAM 88-28003 (6 April 1988), the IRS revoked TAM 85-38001, stating that although there were 2 sets of stock outstanding on the ex-dividend date, as contrasted with the short sale in which there is only one set outstanding, the lender is not the owner of either; hence, the dividends-received deduction should not be available even where the stock is loaned to cover a fail.

6. Sec. 6045(d)

Brokers are required by this section to report substitute payments to lenders. Not all substitute payments must be reported to customers, however.

7. Private Letter Ruling 88-22061

In Private Letter Ruling 88-22061, the IRS held that fees received for lending securities were industrial and commercial profits under a treaty with the United States (presumably the Japanese treaty). Accordingly, the fees were exempt from U.S. tax. There was no discussion of the tax treatment of the substitute payments.

8. Impact on repo rules

The legislative history is very clear that Congress did not intend to change the tax treatment of repurchase agreements. The distinction between repos and securities is often unclear.

9. Treatment of repos

A repo can be characterized as either a sale or loan, assuming the transaction does not run afoul of the Sec. 1058 proposed Regulations. In general, repos are treated as secured loans. In certain circumstances, however, repo transactions are viewed as sales.

(a) *Loan treatment*
When repos are treated as loans, neither gain nor loss is recognized by the seller-debtor on the initial transfer as will a Sec. 1058 security loan. The securities are "sold" as collat-

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eral to secure the loan. As with other financing transactions, repos may be subject to the Original Issue Discount (OID) rules.

(b) *Transfer of security*
It is unclear whether the seller-debtor in a repo transaction (that is a loan) remains the owner for tax purposes by the buyer-creditor to a third party under the theory of Rev. Ruls. 60-177 and 80-135 and the 1058 proposed Regulations Sec. 1058. What if a new bond is received?

(c) *Sale treatment*
In those cases in which a repo is a sale, the buyer-creditor becomes the owner of and entitled to the income from the securities acquired subject to repo agreements. The seller-debtor, for example, cannot treat the interest received as tax- exempt.[5]

(d) *Fixed rate repo*
A fixed rate repo with a term to maturity may be viewed as a sale for tax purposes at the time it is entered if the repo interest is pegged to the interest on the underlying security. The seller-debtor may not be viewed as having any remaining risk of loss or opportunity for gain on the securities.

10. IRS concerns

The IRS is concerned that foreign taxpayers should not be able to resource substitute payments outside the United States (by lending securities to foreign persons). Similarly, the IRS is concerned about multiple parties claiming the exemption for portfolio interest.

11. Street accounts

Most brokerage margin accounts permit the lending of securities when those accounts are held "in street name", without advance notice to customers. Under Sec. 1058, the payments received by the brokers and passed through to customers become substitute payments, ineligible for the dividends-received deduction or tax-exempt status. Many investors may not be aware of the risk that securities lending imposes on them.

12. Planning

Can a securities loan or a repurchase agreement be used in cross-border tax planning? Assume a controlled foreign corporation (CFC) loans depreciated securities to an investment bank. If the foreign jurisdiction does not have a section comparable to Sec. 1058, the loss might be recognized locally, thereby reducing the local tax rate.

13. Alternative minimum tax (AMT) planning

Can tax-exempt securities be shifted, without gain or loss, during periods in which the taxpayer falls into the AMT and otherwise receives a reduced return on the tax-exempt income?

IV. CONTINGENT PAYMENT OBLIGATIONS

A. In general

The proposed Regulations provide that OID be calculated without regard to contingent payments. Contingent payments are only considered after they have become fixed. Thus, recognition of interest income with respect to contingent payments is effectively deferred until the contingent payment becomes fixed. This follows the treatment of such instruments prior to the Regulations.[6]

B. Contingent payment rules

The contingent payment rules are largely divided into the rules governing transactions issued for property (and thus governed by Sec. 1274), and those governed by Sec. 1272.

1. Contingent payment obligations issued for property

Non-contingent payments are subject to the OID rules contained in Secs. 1271-1275.[7] The issue price of the non-contingent payment is the issue price of the overall debt instrument. In general, contingent principal payments which are not accompanied by a payment of adequate stated interest are considered to be payments of principal up to the present value of the payment, and to be payments of interest in the amount of any excess over the present value. Where the obligation states a fixed or maximum amount, the principal amount determined to be principal, under this rule, when added to the issue price and any amount previously treated as principal, may not in any event exceed such stated fixed or maximum amount. Any amount received in excess of such stated or fixed amount will be treated as interest.[8]

A different set of rules applies to contingent debt instruments to which Sec. 1274 applies and which (1) provide for fixed or minimum payments at an uncertain time within a specified period of time; and (2) either does not provide for adequate stated interest or contain a provision providing for recharacterization of a portion of such payment as interest to the extent necessary to constitute adequate stated interest.

In general, the payments are treated as non-contingent payments up to the amount of the minimum payment due at the latest possible time under the terms of the obligation. The remainder of the payments are treated as contingent payments under the rules above.

2. Contingent payment obligations issued for cash or publicly traded property

There are 2 sets of discrete rules.

(a) *Contingent interest*
Where the obligation provides for contingent payments at least equal to the issue price of the overall debt instrument:
(1) the non-contingent component of the obligation is subject to the rules of Code Secs. 1271-1275;
(2) the contingent payments are treated as interest and are included in the income of the holder and deductible by the issuer in the year in which the payment becomes fixed;
(3) a delayed contingent payment (one which is not due until 6 months or more after the liability is fixed) is treated as a separate OID obligation.

(b) *Contingent principal*
Debt instruments issued for cash or publicly traded property and which provide for contingent payments of principal (i.e.

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5. Compare Rev. Rul. 74-27, 1974-1 C.B. 24 (transfer of securities under a repo held to be a loan); with *Citizens National Bank of Waco v. U.S.* (CT. C1. 1977) (transfer was a sale, not a loan where seller agreed to repurchase securities at par on demand; bank not required to resell; and no payment of interest specified) and *Union Planters National Bank of Memphis v. U.S.* 426 F. 2d 115 (6th Cir. 1970) (bank's purchases of bonds from dealers were loans).
6. See *Utility Trailer Manufacturing Co. v. United States,* 212 F. Supp. 773 (S.D. 1962) (dealing with notes where principal would increase based on consumer price index changes).
7. Prop. Reg. Sec. 1.1275-4(c)(1).
8. Prop. Reg. Sec. 1.1275-4(e)(3)(i).

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where the contingent payments do not equal the issue price) are subject to yet another set of rules:[9]

(1) the non-contingent payments under such an obligation are treated as principal payments, whether they are designated principal or interest;
(2) contingent payments are not included in the income of the holder or deductible by the issuer until they become fixed;
(3) the amount of OID attributable to contingent payments is determined by first separating the contingent payments into those payments received prior to maturity and those received at maturity.

Payments received prior to maturity are treated first as interest, to the extent of interest deemed accrued on the obligation and not allocated to prior payments. Once the total amount of payments received and characterized as principal equals the issue price of the instrument less the sum of all past and future contingent payments, any remaining contingent payments are treated entirely as interest.

Deemed accrued interest is the adjusted issue price of the instrument at the beginning of the accrual period multiplied by the Applicable Federal Rate (AFR).

Contingent payments received at maturity are treated first as principal, to the extent of any outstanding principal balance. The remainder, if any, is treated as interest.

Delayed contingent payments are treated as separate OID obligations.

The Regulations give the IRS the authority to reallocate contingent principal and interest amounts in order to prevent abuse.[10]

The contingent payment rules differ dramatically from the comparable rules under Sec. 453. Where an installment obligation provides for contingent payments, the Regulations provide the manner for determining the amount of the taxpayer's basis which is to be used to calculate gain recognized in each taxable year.

In general, the Regulations generally require the taxpayer to recognize income on a contingent sale as early as possible.

C. Convertible securities

Often likened to contingent payment obligations are convertible securities. Convertible securities offer taxpayers the ability to reduce interest expense. Under the proposed Regulations, no part of the consideration can be attributed to the conversion feature and subtracted from the issue price to lower the issue price of the debt feature and thus to create OID.[11] The "true" interest is determined at conversion, although neither deductible to the issuer nor taxable to the borrower (until a subsequent disposition). Conversion is not a taxable event.

9. Prop. Reg. Sec. 1275-4(f).
10. Prop. Reg. Sec. 1.1275-4(g).
11. Prop. Reg. Sec. 1.273-2(e).
12. Treas. Reg. Sec. 1.6049-7T(b)(2) and (f)(5).

V. REAL ESTATE MORTGAGE INVESTMENT CONDUITS (REMICS)

A. Notice 89-72

On 14 June, the IRS issued Notice 89-72, announced simplified reporting procedures for REMICs and other collateralized financings.

1. Present Regulations

The current Regulations ensure that information regarding the income of a REMIC is provided to the ultimate recipient, through a chain of reporting. For example, a REMIC must report tax information to the IRS and to each interest holder of record. If the interest holder of record is a nominee of another, then the nominee must report the information to the IRS, and to the person for whom it holds the REMIC regular interest. Each middleman is allowed 30 days from the time it receives the tax information until the time it must report that information.[12]

2. New Regulations

The new Regulations will require a REMIC or other issuer of collateralized debt to file new Form 8814, Information Return for Real Estate Mortgage Investment Conduits and Issuers of Collateralized Debt Obligations. On that form the REMIC must list the name, employer identification number and the Committee on Uniform Security Identification Procedure (CUSIP) number assigned to each class of regular interest or collateralized debt obligation. The REMIC must also provide the name, address, and telephone number of a person who can be contacted by a broker or other middleman to obtain the tax information needed to fulfill its reporting obligation to the actual owner and the IRS. The IRS will compile information from Form 8811, and publish it in Publication 938, Real Estate Mortgage Investment Conduits Reporting Information (Including Other Issuers of Collateralized Debt Obligations). This is designed to follow the reporting of original issue discount in Publication 1212.

3. Trade-off

Brokers need no longer provide Form 1099s to nominees, thus reducing an expensive administrative task. Now, they must stand ready to provide the necessary information to those persons that must supply information to the beneficial holder.

4. Time to file

The REMIC must file Form 8811 within 30 days of its start-up date, REMICs and other issuers of collateralized debt obligations that have issued collateralized debt obligations before 1 July 1989, must file Form 8811 with the IRS by 31 July 1989.

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CANADA:

New Tax on Large Corporations

Ingrid Sapona*

INTRODUCTION

The so-called Tax on Large Corporations was proposed in the 27 April 1989 Federal Budget and expanded upon in Bill C-28[1] tabled in Parliament on 20 June 1989.

This article was prepared based on the information set forth in Bill C-28. Normally, no changes are made to tax bills such as Bill C-28, as they go through the necessary 3 readings in Parliament before being enacted.

The Tax on Large Corporations is found in new Part I.3 of the Income Tax Act (the Act). The proposed tax is a capital tax applicable to all taxable Canadian corporations and all other corporations with a permanent establishment in Canada with taxable capital employed in Canada in excess of C$ 10 million.

The tax rate will be 0.175%[2] and will be applied on a corporation's taxable capital employed in Canada in excess of a capital deduction of $ 10 million.[3] The Tax on Large Corporations will not be deductible in computing income for income tax purposes but will be creditable against that portion of the existing 3% federal surtax that relates to the corporation's Canadian income.[4]

Financial institutions, including insurance corporations, credit unions, registered or licenced securities traders, and deposit insurance corporations will also be subject to the Tax on Large Corporations. There are special rules for the calculation of the capital and investment allowance for financial institutions. The special rules pertaining to financial institutions are beyond the scope of this article.

The following example outlines how the Tax on Large Corporations is derived. First, the corporation's taxable capital is determined by deducting the corporation's investment allowance from its capital. (Determining what is included in a corporation's capital and what investments qualify for the investment allowance is explained below.) Then the corporation's taxable capital is prorated based on the percentage of capital employed in Canada, and all or a portion of the $ 10 million capital deduction is subtracted, yielding the base on which the tax of 0.175% is levied.

Capital of Largeco	$ 95,000,000
less investment allowance	($ 44,000,000)
Taxable capital	$ 51,000,000
Percentage of capital employed in Canada (based on ratio in Part IV of Regulations):	× 70%
Taxable capital employed in Canada	$ 35,700,000
less capital deduction	($ 10,000,000)
Amount subject to tax	$ 25,700,000
Tax rate:	× 0.175%
Tax payable	$ 44,975

A. Capital

A corporation's capital will include the following items, determined at the end of the taxation year in accordance with generally-accepted accounting principles[5] but on an unconsolidated basis: the amount of capital stock (or for corporations without share capital, the amount of its members' contributions),[6] retained earnings and earned surplus (a deficit reduces capital),[7] contributed surplus, as well as capital, appraisal and other surpluses,[8] reserve funds,[9] the value of the corporation's interests in the capital of partnerships,[10] and loans and advances.[11] Also included in a corporation's capital are: indebtedness represented by bonds, debentures, mortgages and other securities of the corporation,[12] and other forms of indebtedness of the corporation, such as accounts payable, but not including indebtedness with respect to a lease, if such debts are long-term, i.e. outstanding for more than 365 days prior to the end of the corporation's taxation year,[13] deferred income tax reserves and contingent, investment, inventory and similar reserves, other than those deducted under Part I of the Act[14] (a deferred tax debit reduces capital), and dividends declared by the corporation but not paid before the end of the year.[15]

B. Investment allowance

A corporation will be allowed to deduct the cost of the following investments in computing its taxable capital: shares of other corporations,[16] loans and advances to other corporations,[17] bonds, debentures, mortgages and other securities issued by other corporations,[18] amounts representing the corporation's proportion of partnerships' investment allowance,[19] and long-term debt of financial institutions.[20]

These deductions constitute an investment allowance, which is permitted to avoid double taxation where the capital of one corporation is not employed directly by the corporation but, instead, is invested in another corporation.

The investment allowance permitted under the Tax on Large Corporations differs from similar allowances permitted under various provincial capital taxes in that the full amount of tax payable for the year is deductible in computing taxable capital. The investment allowance is not prorated.

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1. Bill C-28, an Act to amend the Income Tax Act, the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, the Old Age Security Act, the Public Utilities Income Tax Transfer Act, the War Veterans Allowance Act and a related Act, received first reading in the House of Commons on 20 June 1989 [hereinafter cited as Bill C-28].
2. Bill C-28, at clause 48, subsec. 181.1(1).
3. Id. at clause 48, subsec. 181.5.
4. Id. at clause 48, subsec. 125.3(1).
5. Id. at clause 48, subsec. 181(3).
6. Id. at clause 48, para. 181.2(3)(a).
7. Id. at clause 48, para. 181.2(3)(a).
8. Id. at clause 48, para. 181.2(3)(a).
9. Id. at clause 48, para. 181.2(3)(b).
10. Id. at clause 48, para. 181.1(3)(g).
11. Id. at clause 48, para. 181.2(3)(c).
12. Id. at clause 48, para. 181.2(3)(d).
13. Id. at clause 48, para. 181.2(3)(f).
14. Id. at clause 48, para. 181.2(3)(b).
15. Id. at clause 48, para. 181.2(3)(e).
16. Id. at clause 48, para. 181.2(4)(a).
17. Id. at clause 48, para. 181.2(4)(b).
18. Id. at clause 48, para. 181.2(4)(c).
19. Id. at clause 48, para. 181.2(4)(e).
20. Id. at clause 48, para. 181.2(4)(d).

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Corporations will not be permitted an investment deduction with respect to loans to, deposits with, or any other investments in financial institutions, other than shares or long-term debt.[21] The rationale for such a restriction is that such investments are not included in the capital of the institution.

C. Percentage of capital employed in Canada

Only that portion of a corporation's taxable capital (i.e. capital less deduction of the investment allowance) that may be regarded as being employed in Canada will be subject to the Tax on Large Corporations.

The portion of capital employed in Canada by companies resident in Canada (other than financial institutions) will be the prescribed proportion of the corporation's taxable capital for the year.[22] The income allocation formula in Part IV of the Income Tax Regulations[23] will be used as the basis for determining the prescribed proportion of a corporation's taxable capital employed in Canada.[24]

Non-resident corporations (other than financial institutions) with a permanent establishment in Canada will be subject to the Tax on Large Corporations on their capital employed in Canada, which will be computed as the cost of their Canadian assets,[25] other than investments that would qualify for an investment allowance to a corporation resident in Canada,[26] less indebtedness that would not be part of the capital of a resident corporation.[27]

D. $ 10 million capital deduction

Corporations will be entitled to a $ 10 million capital deduction from taxable capital employed in Canada,[28] thereby limiting the application of the tax to "large corporations". However, the $ 10 million deduction must be allocated among the members of a related group of corporations.[29] A corporation that is related to another corporation will be permitted to file with the Minister, on a prescribed form, an agreement on behalf of the related group whereby an amount that does not exceed $ 10 million is allocated among all corporations that are members of the related group for each taxation year of each such corporation ending in the calendar year and at a time when it was a member of the related group.[30] The least amount allocated for a taxation year to a member of a related group under such an agreement will be the capital deduction of that member for that taxation year.[31]

It should be noted that there is a distinction between the concept of "related group" under the Tax on Large Corporations and the concept of associated corporations that is used for purposes of the small business deduction.[32]

E. Payment of tax

The Tax on Large Corporations will apply for taxation years ending after 30 June 1989[33] and will be prorated for a taxation year commencing before 1 July 1989 on the basis of the number of days in the year after 30 June 1989.[34] No payment of taxes will be required before 1990, however.

For example, suppose that each of the following corporations has taxable capital employed in Canada of $ 22 million for taxation years 1989 and 1990 and the taxation year ends as indicated. The Tax on Large Corporations is computed at 0.175% on capital in excess of $ 10 million. Therefore, the tax for 1989 and 1990 will be due as follows:

		Tax payable	
Corporation	Year end	1989*	1990
Corporation A	– 31 August 1989	$ 3,500	$ 21,000
Corporation B	– 30 November 1989	$ 8,750	$ 21,000
Corporation C	– 28 February 1990	$ —	$ 14,000
Corporation D	– 31 May 1990	$ —	$ 19,250

* Prorated based on number of days after 30 June 1989.

F. Monthly instalments

The monthly instalment payments will be the lesser of: (i) 1/12 of the amount estimated by the corporation to be its tax payable under this part (Part I.3) for the current year; (ii) 1/12 of the corporation's first instalment base for the year; or (iii) for the first 2 months in the year, 1/12 of the corporation's second instalment base for the year, and for each of the following months in the year, 1/10 of the amount by which its first instalment base for the year exceeds 1/6 of its second instalment base for the year.[35] The definition of first and second instalment bases for the Tax on Large Corporations is similar to that applicable to instalment bases[36] of Part I tax.[37] For the 1990 taxation year, the instalment base of a corporation for purposes of the Tax on Large Corporations will be determined by reference to its taxable base at the end of its 1989 and 1990 taxation years.[38]

For corporations with a taxation year ending after 30 June 1989 and before 1990, the tax payable for the 1989 year will

21. Id. at clause 48, para. 181.2(4)(b).
22. Id. at clause 48, subsec. 181.2(1).
23. Part IV of the Income Tax Regulations sets forth rules for allocating a corporation's income to the various provinces wherein the income was earned.
24. See 27 April 1989 Budget Papers (official release) at 41.
25. Bill C-28 supra note 1 at clause 48, subsec. 181.4(a).
26. Id. at clause 48, subsec. 181.4(c).
27. Id. at clause 48, subsec. 181.4(b).
28. Id. at clause 48, subsec. 181.5(1).
29. Id. at clause 48, subsec. 181.5(1).
30. Id. at clause 48, subsec. 181.5(2).
31. Id. at clause 48, subsec. 181.5(4).
32. A related group, defined in subsec. 251(4) of the Income Tax Act, is a group of persons each member of which is related to every other member of the group. Subsec. 251(2) of the Income Tax Act sets forth, in detail, the definition of relationships between individuals and corporations. Basically, the following corporations are among those related under the Act: any 2 corporations if they are controlled by the same person or group of persons; any 2 corporations if one is controlled by a person and that person is related to a member of a related group that controls the other corporation or is related to each member of an unrelated group; any 2 corporations each of whom are controlled by one person and the persons who control each of the corporations are related; any 2 corporations if one is controlled by a related group and a member of the related group is related to each member of an unrelated group that controls the other corporation; and any 2 corporations if one is controlled by an unrelated group and each member of the unrelated group is related to at least one member of an unrelated group that controls the other corporation.
The concept of associated corporations, which only applies for the purpose of determining who shares the small business deduction available to Canadian Controlled Private Corporations, is defined in subsec. 256(1) of the Income Tax Act.
33. Bill C-28 supra note 1 at clause 48, subsec. 181.9(3).
34. Id. at clause 48, para. 181.9(3)(a).
35. Id. at clause 48, para. 181.7(1)(a).
36. An instalment base is a basis upon which a corporation's monthly instalment payments for income tax (Part I tax) can be calculated. A company's first instalment base is calculated by multiplying its income tax payable (prior to certain deductions and credits, such as the share-purchase tax credit and the scientific research and experimental development credit) for the preceding taxation year times the ratio of 365 to the number of days in that preceding taxation year. A corporation's second instalment base is calculated in the same way the first instalment base is calculated, only the second instalment base is for the taxation year prior to the taxation year used to calculate the first instalment base.
37. So-called Part I tax is income tax.
38. Bill C-28 supra note 1 at clause 48, transitional subsec. 181.7(b) found under para. 181.9(3)(b).

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be due on the later of 15 January 1990 and the date on which any balance owing with respect to Part I tax for the year is due.[39] For such corporations their first instalment for taxation year 1990 will be due 31 January 1990 and will be an amount equal to their liability for 1990 prorated over the number of months in their 1990 taxation year occurring after 31 December 1989.[40]

For example, the first payment for Corporation A will be due on 15 January 1990 and will be the entire tax payable for taxation year 1989, i.e. $ 3,500. Corporation A's first instalment for its 1990 Tax on Large Corporations would be due on 31 January 1990 and, assuming Corporation A used the method whereby it paid instalments based on the estimate of its annual liability (the first method set out above), its first instalment for 1990 would equal 1/8 of its total 1990 liability, i.e. $ 2,625.

The first payment for Corporation B, in the amount of $ 8,750, will be due on the date any balance owing with respect to Part I tax for 1989 is due, i.e. 31 January or 28 February, depending on the corporation's entitlement to the small business deduction.

Corporation B's first instalment for its 1990 Tax on Large Corporations will be due on 31 January 1990. If Corporation B's taxable capital employed in Canada increases in 1990, Corporation B will most likely choose to calculate its 1990 instalments using its first instalment base option because doing so will permit it to pay smaller instalments during the course of 1990 and pay the balance owing at the same time it pays the balance of Part I tax. Using this option, Corporation B must annualize the amount of its 1989 tax due and then spread the amount over the number of months in its 1990 taxation year occurring after 1989.

For example, if Corporation B's taxable capital employed in Canada increases to $ 28 million in 1990, its liability for 1990 will total $ 31,500. If B chooses to use its first instalment base to determine its 1990 instalments, B must annualize the amount of tax it paid for 1989, and divide that amount by the number of months in B's 1990 taxation year after 1989. Therefore B's 11 monthly 1990 instalments will be $ 1909, i.e. 1/11 of $ 21,000, with a balance of $ 10,500 due with its Part I tax final payment. If, instead, Corporation B bases its instalments on the estimate of its 1990 liability, its instalments will be $ 2,864, i.e. 1/11 of $ 31,500.

Corporation C's first instalment will be due by 31 January 1990 and will be $ 7,000, i.e. its liability for the 1990 taxation year ($ 14,000) divided by the number of months in the taxation year after 31 December 1989 (2 months). Corporation D's first instalment will also be due on 31 January 1990 and will be $ 3,850, i.e. D's 1990 liability ($ 19,250) divided by the number of months remaining in D's 1990 taxation year after 31 December 1989 (5 months).

Payment of any balance of tax owing at the end of a year will be due either 2 or 3 months after the end of the corporation's taxation year, the same date on which the liability for the balance of the regular corporate income tax under Part I is due.[41]

G. Crediting Tax on Large Corporations against federal surtax

The Tax on Large Corporations, though not deductible by a corporation in computing its income for a taxation year, may be credited against that portion of its surtax payable under Part I that relates to the corporation's Canadian income.[42] For this purpose, the Canadian element of a corporation's surtax liability will be determined on the same basis used in calculating its capital employed in Canada.[43]

The amount by which a corporation's Tax on Large Corporations for a year exceeds the Canadian portion of its surtax for the year may be carried over and applied against any uncredited amounts of the Canadian portion of its surtax for any of its 3 previous years or 7 subsequent years.[44] However, the tax may only be credited against surtax with respect to income earned after 30 June 1989, determined on a prorated basis for taxation years commencing before 1 July 1989.[45]

In the previous example, Corporation A will be able to credit its 1989 Tax on Large Corporations against 2/12 of the Canadian portion of its 1989 surtax. Corporation B will be able to credit its 1989 Tax on Large Corporations against 5/12 of the Canadian portion of its 1989 surtax. Corporation C will be able to credit its 1990 Tax on Large Corporations against 8/12 of the Canadian portion of its 1990 surtax. And, Corporation D will be able to credit its 1990 Tax on Large Corporations against 11/12 of the Canadian portion of its 1990 surtax.

Special rules will apply regarding carryover of unused tax credits when there has been an intervening acquisition of control.[46]

H. U.S. foreign tax credit problems

Because the Tax on Large Corporations is a capital tax, and not a Part I income tax, it is doubtful that the tax will qualify for a U.S. foreign tax credit. U.S. foreign tax credits generally pertain to income taxes only. It is interesting to note that if the Canadian corporate surtax were creditable against the Tax on Large Corporations, instead of vice versa, the U.S. foreign tax credit position would be improved. Through informal discussions with the Ministry of Finance it has become apparent that Finance considered this issue when it was deciding how to structure the new tax. Finance's position, however, reflects its desire to protect the corporate income tax base. Finance's rationale is that by offsetting the surtax and thereby reducing the Canadian creditable taxes, pressure that might induce corporations to take action to lower foreign taxes by moving part of their Canadian tax base to the U.S. might be alleviated.

CONCLUSION

The Tax on Large Corporations is the first across-the-board capital tax levied in Canada at the federal level.[47] Though its impact will be limited to corporations with taxable capital employed in Canada in excess of $ 10 million, it will hit capital intensive industries, such as those in the resource and real estate sectors, quite hard.

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39. Id. at clause 48, transitional para. 181.7(1)(a) found under para. 181.9(3)(b).
40. Id. at clause 48, transitional para. 181.7(1)(b) found under para. 181.9(3)(b).
41. Id. at clause 48, para. 181.7(1)(b).
42. Id. at clause 48, sec. 125.3.
43. See 27 April 1989 Budget Papers (official release) at 44.
44. Bill C-28 supra note 1 at clause 48, para. 125.3(1)(a).
45. Id. at clause 48, subsec. 125.3(2).
46. See Bill C-28 supra note 1 at clause 29, subsec. 125.3(3). Basically, unless the business carried on by the corporation prior to the acquisition of control is carried on after the acquisition of control with at least a reasonable expectation of profit, there can be no carryover of the unused Tax on Large Corporations credit after acquisition of control. And, the credit that can be carried forward in such circumstances is limited.
47. A capital tax on financial institutions has been levied at the federal level for some time in Canada. The Tax on Large Corporations, albeit limited to corporations with taxable capital employed in Canada in excess of $ 10 million, is not limited to specific corporate sectors and therefore it can be considered an across-the-board capital tax. Various provinces have capital taxes.

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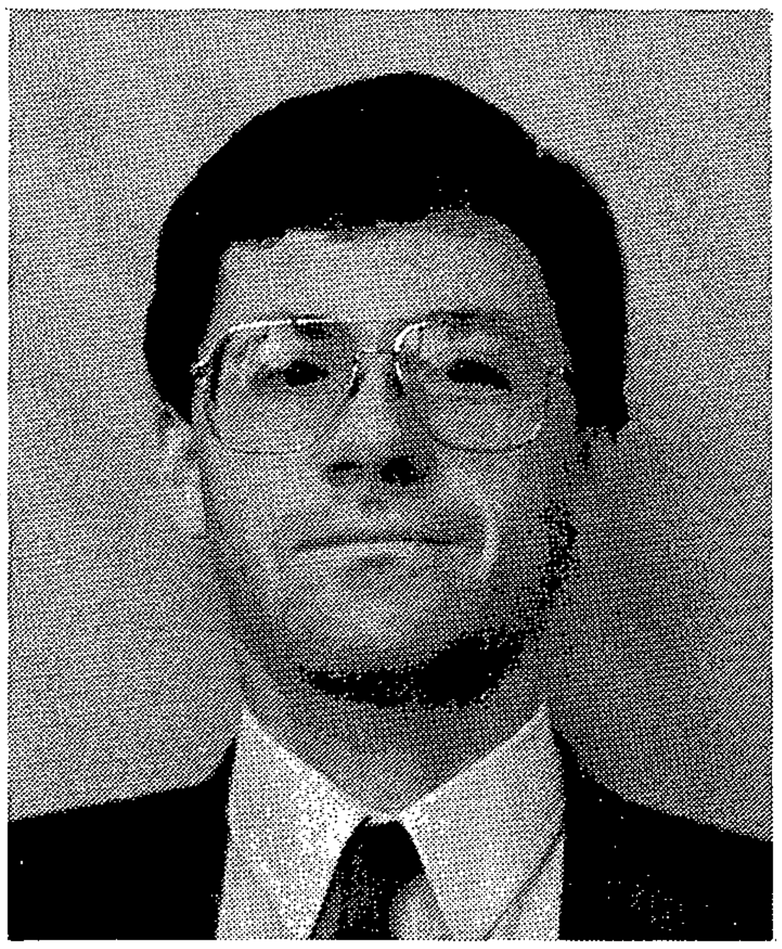

AUSTRALIA:

Proposed System for the Taxation of Foreign-source Income

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BACKGROUND

The Australian system of taxing foreign-source income is in the process of dramatic change. The reform began in 1987.

Until 1987 Australia taxed foreign income by means of a partial exemption system. The Government had, over a decade earlier, considered the adoption of a foreign tax credit system along with anti-deferral rules. The proposal was rejected as it was considered too administratively complex. Foreign-source income was thus generally fully exempt from Australian taxation provided the income was taxed in the foreign jurisdiction. Dividends to corporate shareholders were effectively freed from Australian tax by a rebate mechanism. Foreign tax credit was only appropriate in a limited range of circumstances.

However, in 1987 this partial exemption system was replaced by a comprehensive foreign tax credit system. That system exists in Australia today. Income of foreign subsidiaries is taxed on a remittance basis with credits available for withholding tax and underlying taxes.

The reforms considered in this article were initially proposed by the Treasurer in his "Consultative Document" issued 25 May 1988. The Consultative Document contained measures to end the deferral advantages of offshore investment through companies and trusts and contained proposals to change the taxation of dividend income. The reforms proceeded from inadequacies in the foreign tax credit system. Australian companies and individual taxpayers avoided current Australian taxation by operating offshore through companies and not repatriating profits by way of dividends. The objective of the foreign tax credit system was thereby frustrated.

On 12 April 1989 the Treasurer announced the detailed designed features of the proposed system in the form of an "Information Paper". The Information Paper is a lengthy white paper style document extending to some 155 pages. The Information Paper proposals are far more complex than those in the Consultative Document. The complexity has resulted from the presence of a control test and an active income exemption. These features were introduced as a result of sustained lobbying from the business and professional sectors. It is currently anticipated that draft legislation will be released in December of this year or in January 1990. The proposed investment fund rules are an exception to this timetable. No details on the design features of these rules have yet been released.

In order that the new rules may be properly enforced increased disclosure requirements and administrative powers have been proposed. Of particular interest is the suggestion that a provision along the lines of U.S. Internal Revenue Code Sec. 982 be introduced. This rule would ensure that where a request for foreign documents is not complied with, those documents may not be produced in evidence by a taxpayer to dispute an assessment.

It was originally envisaged that the system would first operate for the 1989-90 income year. However, due to delays in finalising the rules, the Treasurer delayed the commencement date until the 1990-91 year.

THE ACCRUALS RULES FOR COMPANIES

The so-called "accruals" system as it applies to companies is designed to subject the income of certain foreign companies to Australian taxation currently, irrespective of whether the income is repatriated.

The Australian revenue authorities are in an advantageous position in Australia since they can learn from the legislative developments and, in a sense, the mistakes of others. Our proposed system, at least as regards its design features, borrows heavily from foreign systems which are already in place. By way of example, our control test is based on the U.S. foreign personal holding company rules, the concept of tainted income borrows heavily from the U.S. Subpart F definitions, tracing in order to determine control comes from the U.K./New Zealand rules, and so on.

In order to determine whether the rules will apply, the following issues must be addressed:

- Is the company a controlled foreign company (CFC)?
- Is the company resident in a listed or unlisted jurisdiction?
- What is the nature of the income earned by the entity?
- Does the company benefit from the active income exemption?
- How is attributable income calculated?

Each of these issues is discussed in greater detail below.

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CONTROL

The presence of a control test in the Information Paper announcement represents a change from the Government's approach outlined in the Consultative Document. Under the system as previously proposed it was envisaged that there would be attribution notwithstanding the degree of control of the haven entity, with the exception that a substantial interest test would be introduced in the case of listed companies.

The problem with not having a control test is that minority shareholders may have difficulty in gaining access to sufficient information to enable them to calculate their attributable income on a current basis. In addition, small shareholders are likely to face liquidity problems in meeting a current tax burden since they may have little influence on the dividend policy of the foreign company.

A CFC will be defined by reference to both strict and de facto tests.

Strict control test

Under the strict control test a non-resident company will be a CFC if 5 or fewer resident shareholders, together with their associates, own or are entitled or able to acquire or to control directly or indirectly an interest of 50% or more in the company. Whether an associate relationship exists will be determined using similar criteria as are presently found in other cases of the Australian tax legislation.

This resembles the control test in the U.S. foreign personal holding company provisions with the exception that a 50% holding as distinct from a greater than 50% holding will be sufficient. The 50% interest in the company will be measured as the greatest of the percentage interest or, ability to acquire such an interest, in the issued capital, voting rights or dividend rights of the company. In applying the formula only shareholders with at least a 1% interest are considered.

This test does not require that the resident taxpayer has himself effective control of the offshore entity. In this respect the "control" test is something of a misnomer. The test is simply directed to ensuring that the taxpayer controls the non-resident entity in conjunction with other Australian residents. Those other Australian residents may be totally unrelated. This is, however, a feature shared with similar foreign regimes.

De facto control test

De facto control will exist, notwithstanding that the 50% test referred to above is not satisfied, if the shareholders have ability to exert de facto control through e.g. ability to control the company's Board of Directors, hold options or convertible securities, have power of veto, or the majority shareholders are widely spread.

There is a supplementary objective test to the de facto control test which is satisfied where one resident shareholder together with associates owns or is entitled to acquire directly or indirectly an interest of 40% or more in the company, unless the shareholder can show that control is exercised by non-resident shareholders (e.g. where a single non-resident owns the other 60% of the shares).

Control is measured at the end of the CFC's accounting period. General anti-avoidance measures will be legislated to avoid year end manipulations. Also specific rules to counteract dilution of control by stock stapling arrangements are proposed.

Tracing rules will be used to determine whether an Australian resident indirectly controls the foreign company. It should be noted that these tracing rules are not relevant in respect to the actual attribution of income. It is proposed that tracing should take place through CFCs, partnerships (where 50% or more of the interests in the partnership are held by resident partners or their associates, by CFCs or by non-resident trusts) and non-resident trusts. Note that while tracing will generally apply using a simple multiplicative technique, where a greater than 50% interest is held by the CFC or partnership it will be deemed for tracing purposes to be a 100% interest.

As far as attribution is concerned, a "chain rule" or "hopscotch" approach is taken, i.e. where there is a corporate chain, one generally attributes from the last CFC in the chain back to the first Australian resident. Attribution will only occur where the Australian resident has an attributable interest. This will be defined as an interest of 10% or more held either directly or indirectly or in conjunction with associated entities. It will be deemed to exist where the de facto control test is satisfied.

As a quid pro quo for the introduction of the control test the Government has also announced that it will introduce passive investment fund rules. These rules will presumably operate so as to counter deferral advantages irrespective of the level of control and are discussed in greater detail below.

JURISDICTIONAL COVERAGE

Reference to the jurisdiction in which the foreign company is resident is one of the methods used to define the scope of the new CFC rules. The approach taken in the Consultative Document proposals of listing designated tax haven jurisdictions has been reversed so that there is now proposed a list of comparable tax jurisdictions.

The move from a "black" list approach to a "white" list approach was seen as desirable as it reduced the scope for tax avoidance by way of artificial manipulation of the source of income and through creative planning in "friendly" but unlisted countries. Although recognised that a white list approach may add to the taxpayer's compliance burden, this is seen as mitigated by the active business and control concessions.

As before, there is to be a 2-part list. The primary list, attached as Appendix 1, consists of approximately 60 comparable tax countries. These are countries which levy an income tax on a comprehensive tax base, under a system with appropriate anti-avoidance measures, where the rate is at least 25%. This 25% base rate leads to a tax on remitted income of 36.25% (if a 15% withholding tax is assumed). All Australian treaty partners are listed.

Certain of these countries, however, grant special tax incentives. Income sourced from these countries and earned in respect of the specified designated concessions is potentially subjected to accrual. These concessions are listed in Appendix 2.

The Information Paper introduced the further concept of "general" designated concessions. Where a listed country does not tax capital gains, unremitted foreign-sourced income or concessionally taxes certain types of passive income, that income will likewise be treated as concessional. The introduction of this new category frustrates certain planning which was envisaged whereby comparable tax countries such as Singapore could be used because of their favourable tax regime (e.g. the non-taxation of capital gains).

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Thus, one cannot simply conclude that if an Australian resident holds an interest in a company in a listed (i.e. high taxing) country that there will be no attribution. There may be attribution from a listed country in 2 circumstances:

(1) As noted above, a company resident in a listed country will be accruals taxed to the extent it derives concessionally taxed income of either the general or specific type. To the extent that the company derives concessional income it is treated as if it were a resident of an unlisted country. Accordingly, the active income exemption (see below) is relevant and the tainted income ratio is applied in respect of the concessional income.

(2) There will also be attribution where a CFC or listed country derives income from unlisted countries that is not taxed in the listed country (e.g. branch income). Importantly, there will be no active income exemption in these circumstances.

Conversely, it is also not possible to conclude that holding an interest in a CFC in an unlisted (i.e. haven) country will inevitably lead to attribution. For example, there will be no attribution in respect of income which has been derived from sources in a listed jurisdiction and therefore subject to a comparable tax rate.

A CFC's country of residence will be important for the application of the jurisdiction rules (and also for the active income exemption and the corporate dividend exclusion). Essentially, if a company is not resident in Australia or in a listed jurisdiction, it will be resident where an unlisted country treats it as being so for tax purposes or, failing that, in the unlisted country in which it is incorporated.

Anti-avoidance rules are proposed to prevent planning based on residence manipulations. Where a company is "fiscally homeless" there will be no active income exemption available. This may effect, by way of example, U.K. incorporated companies managed and controlled in the United States. Further, where an unlisted country CFC is migrated to either Australia or a comparable tax jurisdiction, previously unattributed income will be accrued in the year of change. It would otherwise be possible to obtain income tax-free in Australia after migration through either dividend rebate or dividend exemption. Transitional rules are also proposed which will penalise attempts to benefit from migration on-shore to Australia prior to 1 July 1990.

Source of income is likewise relevant, for example, because of the rules that income derived by a company resident in a listed jurisdiction which is sourced in unlisted countries may be accrued. (In contrast, income derived by companies in an unlisted jurisdiction will generally not be attributed where sourced in a listed jurisdiction.)

Australian law currently provides for when income be treated as being sourced in Australia. These rules will continue to apply in the new system. However, the Australian rules have nothing to say about the particular source of foreign income. Income will be deemed to be sourced in a listed jurisdiction where it is liable to be taxed there or is exempt otherwise than because of its foreign source. Income not taxed in Australia or in a listed jurisdiction will be deemed to have its source in an unlisted country and will be attributable.

The authorities have indicated that a detailed review is to be undertaken with respect to the source of income rules and also with respect to the as yet largely ignored yet vital issue of the allocation of expenses.

ACTIVE INCOME EXEMPTION

The introduction of an active income exemption is another change from the Consultative Document proposals. The lack of an active business exemption was heavily criticised by business interests. It was seen as placing Australian companies at a competitive disadvantage compared to foreign country interest in foreign markets. Accordingly, the scope of the accruals rules are to be limited by regard to the type of income which the foreign entity earns. Whilst preferable on equity grounds the introduction of an active income exemption has considerably complicated the new system.

By adopting an active income exemption, the Government has acknowledged policy rationale, for the new accruals rules have shifted from an economic emphasis (i.e. capital export neutrality as indicated in the Consultative Document) to one of anti-avoidance. The distinction between active and passive income essentially recognises that passive income may more easily be manipulated to further tax avoidance ends.

Of course, the earning of passive income is not necessarily tax avoidance motivated. However, it is difficult to draw an objective distinction. Accordingly, the rules acknowledge that a certain amount of passive income may be earned without necessarily leading to an attribution.

Following the Japanese and U.K. models, Australia has adopted an "entity" approach to the active income exemption. That is, rather than looking through the entity and attributing the entity's non-active income, the Australian rules will attribute *all* the income of an entity provided that it is not substantially engaged in earning active income.

For an entity to benefit from the exemption, 2 conditions must be satisfied:
(1) the company must have a substantial business presence in the country of residence;
(2) the company must satisfy the tainted income ratio in its accounting period. In this respect, a CFC only qualifies for exemption if the ratio of gross tainted income – not including gross tainted proceeds of asset disposals – plus net tainted capital gains, to gross turnover – not including the proceeds of asset disposals – plus net capital gains is 5% or more. In contrast to actual attribution of income, the calculation of this ratio uses the accounting information of the CFC.

The relatively tight tainted income ratio, together with the entity approach, may lead to anomalous results. For example, it is possible that a company which earns 90% of its income from active sources will be forced to attribute all of its income, including the active component. This has led to the suggestion that companies will arrange their affairs so tainted income is earned in separate entities. The authorities have indicated that such planning is acceptable. Nevertheless, it is submitted that legislative change which forces taxpayers to adopt a particular business form while the substance of their operations remains unchanged is, to say the least, peculiar.

Obviously, the concept of tainted income is central to the exemption. Tainted income basically consists of passive income and related party business income (also described as "other tainted income").

Passive income

The passive income inclusions in the Information Paper appear to be broadly based on the U.S. foreign personal holding company income concepts.

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Passive income includes certain dividends, interest and income "equivalent to interest", rental income, royalties, attributable non-resident trust income (see below) and certain gains from asset sales, commodities transactions and foreign currency transactions.

Obviously these definitions are central to the proposed rules. The definitions are not framed favourably from the point of view of the taxpayer. Very little recognition is given to "passive" income which is earned incidentally to the carrying on of a genuine business. There are some indications that the authorities are softening their approach in this regard. The tainted income definitions in the legislation may be more generous than as indicated in the Information Paper.

Related party business income

Certain types of related party business income will also be regarded as tainted. This is because it is considered that such related party income, like passive income, is easily shifted to low tax jurisdictions for tax avoidance purposes.

Taxpayers may attempt to route purchases or sales through a tax haven affiliate in order to "drop off" a profit in the haven. Accordingly, as a general rule where sales or purchases are routed through a CFC in a tax haven, the profit of that CFC will be regarded as tainted provided that the goods either originated from or are to be sold to a party which is related to the CFC. The sales income will, however, generally be regarded as active if one of the other parties is also resident in the CFC's country of residence. This exception does not apply to the case where the other parties are a related resident in the CFC country and an Australian related party.

There is a further exemption where the goods originated by the manufacture, extraction, production, etc. by the CFC in its country of residence. One would expect that limits will be placed on definitions of manufacturing to exclude minor assembly, packaging, and the like.

Related party services income will also be regarded as tainted. Basically, any services rendered by the CFC will lead to tainted income except if rendered to a unrelated non-Australian resident. This test is obviously more onerous that than for sales income.

In addition, special rules are provided for insurance and financial intermediation activities.

There will be no attribution from comparable jurisdictions where a de minimis test is satisfied. A taxpayer may benefit from the exemption where attributable income is less than 5% of the CFC's total gross turnover and also less than $ 50,000.

CALCULATION OF ATTRIBUTABLE INCOME

One will need to proceed to the calculation of attributable income where a resident holds an interest in a CFC in an unlisted country which does not benefit from the active income exemption or in a listed country which does not benefit from the active income exemption or does not benefit from the de minimis exemption.

Broadly, the calculation is to be done under the principles of Australian tax law. It appears that in order to calculate the attributable income, essentially the CFC will be treated as an Australian resident. However, rules which are inappropriate in the context of CFCs, such as the interest and dividend withholding tax provisions, will not apply.

Unlike the Consultative Document proposals there is no alternative of using a reported profit figure. The reason for deleting the option is that it is thought that the introduction of a control test will mean there should be no bar to accessing information, whilst the active income exemption should decrease the need to undertake complex calculations on matters such as inventory, depreciation and the like.

The following specific issues are addressed:

(a) Attributable income will not include dividend or branch income when, broadly speaking, the income has borne a high rate of tax, either in the foreign country or Australia.

(b) The CFC may convert its income and expenses to Australian dollars using the average rate of exchange for the accounting period of the CFC or may make a once only election to use the rate of exchange prevailing at the last day of its accounting period.

(c) Special foreign exchange gain and loss rules will be provided for CFCs.

(d) International anti-avoidance provisions such as the transfer pricing and thin capitalisation rules will apply equally to CFCs as to Australian resident companies.

(e) Special rules are proposed for depreciation base and opening value of trading stock in the first year of accrual.

(f) Concessional treatment (i.e. tax incentives) applied to Australian residents under domestic law will generally not extend to CFCs.

(g) Capital gains will be calculated by reference to the actual cost of the capital asset at the time of acquisition by the CFC. Perhaps a more equitable approach would be to calculate the gain by reference to the market value of the asset at the time of introduction of the rules (unless cost exceeds market value at that time).

The rules acknowledge that income of tax haven companies may be subject to foreign tax, albeit not at comparable rates. Accordingly, relief is provided by way of a mechanism incorporated into the accruals rules which will be designed along similar lines to the existing foreign tax credit system.

TREATMENT OF DIVIDENDS AND BRANCH PROFITS

In addition to the anti-avoidance rules for companies, the Government has proposed changes to the operation of the foreign tax credit system as it affects dividend remittances (Australia currently grants an underlying credit on dividends from non-portfolio holdings) and branch profits.

Essentially, the aim of the changes is to simplify the taxation of foreign dividends and branch profits, but not to forsake revenues. The policy objective is to exempt dividends and branch profits if an Australian tax liability has already arisen on the income of which the dividend is paid due to attribution under the CFC rules, or if foreign tax credits would have substantially eliminated the Australian liability. The proposed rules for dividends have been designed with a view to reducing the compliance burden faced by taxpayers, e.g. by doing away with the requirement to undertake complex underlying credit calculations.

A major pillar of the proposed system is that dividends from companies in listed jurisdictions and branch profits earned in such jurisdictions will, without exception, be exempt from tax in Australia. This is based on the assumption that credits for underlying and withholding taxes would have covered the Australian liability under the foreign tax credit system. It will obviously be a principal planning point to

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take advantage of the blanket exemption by reducing foreign listed country effective tax rates.

The foreign tax credit system will continue for other categories of income such as interest, royalties and so on.

NON-RESIDENT TRUSTS

Trusts have suffered from rather a "poor press". Whether deservedly or not, they have gained a reputation as the "tax planner's tool". This reputation has, undoubtedly, influenced the architects of the accruals rules in so far as those rules apply to non-resident trusts. There appears to be an implicit suspicion in regard to the way that trusts have been used in the context of international tax planning. Such a reputation is to a large extent well-deserved. Nevertheless, as a result, the non-resident trust rules are considerably tighter than those which apply to non-resident corporate entities.

Under existing laws, it is only after a resident beneficiary becomes presently entitled to income of a non-resident trust that the income will be included in the resident beneficiary's assessable income. Hence, by vesting in the trustee, via the settlement deed, a discretion as to the distribution of trust income, foreign-source income can be accumulated offshore with the beneficiaries enjoying a deferral advantage.

Under the proposed rules, the primary liability for tax will fall upon a resident transferror of value to the trust. In the event the transferor cannot be assessed, a secondary liability will fall upon the beneficiaries of the trust. Such beneficiaries will also be subject to additional tax to compensate for any deferral of the payment of tax. The detail of the new rules is expanded upon below.

It would appear that the proposed trust regime goes beyond that which is necessary to ensure deferral advantages are eliminated. The fundamental problem is that while the rules have the objective of ending deferral for transferors with interests in a trust, they potentially affect transferors with no interest at all.

Taxation of resident transferors

Due to the difficulties of imposing tax on non-resident trustees it was decided that the rules would be designed such that a resident transferor of value to the trust would be subject to tax on a current basis in respect of the income derived by the trust. The rules will apply to trusts resident in an unlisted country or to a trust that derives income from a listed country with that income being subject to a designated concession in that country.

The Information Paper identifies the non-resident discretionary trust as a major vehicle for the offshore deferral of tax. A discretionary trust is essentially any trust which the trustee has discretion as to who will benefit from the trust or as to the allocation of the income or corpus of the trust to its beneficiaries. The provisions apply to any transfer of property to a non- resident discretionary trust, whether that transfer is for arm's length consideration or not.

The rules will further apply in the situation where a transfer is made to a fixed trust for inadequate or no consideration or under a non-arm's length arrangement. Transfers to non-resident fixed trusts on an arm's length basis will not be affected by the new rules. The application of the rules to fixed trusts would appear somewhat anomalous. The tax authorities apparently hold the view that persons who make a transfer which is not at arm's length must inevitably retain some sort of de facto control over the property transferred. This is so even if it can be shown that it is impossible under the terms of the trust deed for the transferor to benefit (i.e. because the trust has fixed beneficiaries). The only exception to this would appear to be the case of genuine family arrangements, which are discussed below.

Losses generated by non-resident trusts will not be attributed to the resident transferors. This treatment is in line with the treatment of losses of a domestic trust. The losses generated by a trust are only available for carry-forward in the trust to be offset against future income.

It is proposed that the resident transferor will not be given a credit for foreign taxes paid, rather he will receive a deduction for the foreign tax paid. It should be noted that it is foreign tax paid and not foreign tax payable which will give rise to the deduction.

Existing trusts

The proposed rules will apply to trusts existing at 25 May 1988 where a resident has transferred value to that trust. However, should the transferor be able to demonstrate that neither he nor an associate is able to control the trust the proposed rules will not apply. In this regard, the Australian authorities are likely to hold that a trust is controlled by a transferor if the trustee of the non-resident trust acts in accordance with a letter of wishes or similar instruments effected by the transferor.

The Information Paper indicates that a window be left for trusts in existence at 25 May 1988 to be wound up before the commencement of the transferor's 1990/91 income year. If this occurs, distribution made upon winding-up of the trust will be taxed at a maximum of 10% of the taxable amount of the distribution with no credit for foreign taxes. This concession will only be available in respect of trusts which have not had value transferred to them after the date of the Information Paper (i.e. 12 April 1989).

The precise details of the concessions have not been disclosed. It is understood that the assessment under this proposed concession will be raised under Sec. 99B of the Australian Income Tax Assessment Act. Thus, the rate of 10% will be applied to distributions representing accumulated income. To the extent distributions consist of corpus, these amounts will not be assessable.

Genuine family arrangements

The proposed rules are not intended to apply to non-resident trusts established as part of a genuine family arrangement. Where the trustee has powers regarding allocation of income to resident beneficiaries or appointment of resident beneficiaries, such an arrangement would not be accepted since although it may have a bona fide purpose initially, a potential for tax deferral through the use of the structure remains.

This "genuine family arrangement" exemption appears too narrow. At present, all beneficiaries must be non-residents. In the case of migrants, it is usual for particular members of a family to arrive in Australia at different times. A non-resident trust established for the benefit of family members would lose its exemption should any family member remain a beneficiary of the trust after becoming resident.

The exemption needs to be rather more flexible to be of practical value. Provided any resident beneficiaries are fully assessed in respect of their share of the income, the exist-

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ence of the resident beneficiaries should not result in the trust as a whole losing its exemption from the rules.

Non-resident transferors

The rules will apply where a non-resident transfers value to a non-resident trust and subsequently becomes a resident. The transferor will be subjected to tax on the amount of income derived by the trust during the time that person is a resident.

Non-resident trusts settled by non-residents who subsequently immigrate to Australia have been used in immigration planning for individuals from certain jurisdictions. Such planning will need to be re-evaluated in light of the new proposals. The exemption for genuine family arrangements and for trusts established prior to 25 May 1988 which are not controlled by the transferor should be borne in mind in this context.

Taxation of a resident beneficiary

Where for any reason the income of a non-resident trust is not subject to Australian tax in the hands of a resident transferor on a current basis, the beneficiaries of a trust will be subject to tax on the income when it is distributed to them. Additionally, such beneficiaries will be liable for additional tax which is effectively an interest charge to compensate the Australian revenue for the time during which the tax payable on the income has been deferred. It should be noted that this treatment will not apply to income of a trust which has been subject to tax on a current basis in a listed country.

Deemed rate of return

The Information Paper indicates that where a resident transferor does not have sufficient information to calculate his Australian tax liability on income derived by the non-resident trust an implied rate of return will be applied to the property transferred to the trust in order to determine the transferor's tax liability. The implied rate will be approximately 5 points above the long-term Government bond rate which is currently in the order of 13%.

Testamentary trusts

Where a non-resident trust is created as a result of the death of a resident or where an existing trust is subject to accruals tax and the transferor dies, then the accruals measures will not apply. In lieu of this imposition of a current tax liability on the appropriate taxpayer, distributions of income derived after the death of the transferor will be assessed where a resident beneficiary becomes presently entitled to such amounts and will be subject to an additional tax akin to an interest charge.

Tracing of interest

In a situation where a non-resident trust is used as a vehicle to hold other non-resident entities then tracing provisions apply to identify the extent of a resident interest in a lower tier entity. For these purposes a distinction is made between discretionary and non-discretionary trusts.

In the case of a non-discretionary trust a resident's interest will be measured as the greater of the resident's entitlement to the income of the trust and the corpus of the trust. Interest of the resident taxpayer in lower tier non-resident entities will be traced where 5 fewer residents have a 50% or greater interest in that trust.

Where a discretionary trust is concerned the interest held by the trust in a lower tier entity will be deemed to be held by the transferor.

Active income exemption

The Information Paper states that an active income exemption will not be available to non-resident trusts since such structures are normally used for tax avoidance purposes. This statement reinforces the Taxation Office's underlying suspicion of non-resident trusts. However, it is submitted that a trust may be used for bona fide business purposes in an unlisted country and thus an active income exemption should be available.

PASSIVE INVESTMENT FUNDS

The Information Paper also heralds the proposed adoption of a "passive investment fund regime" concurrently with an accruals tax regime. The motivation suggested for this was the prevention of the abuse of accruals tax exemptions, in particular the control test.

The details of the system to be implemented have not yet been finalised. Investment fund regimes have been adopted in other countries which have accruals rules. Passive investment fund rules are an essential backup to the main body of CFC rules.

Three distinct approaches were identified in the Information Paper, although no preference was expressed:

(1) Taxable income is defined by applying a predetermined rate of return to the defined capital value of the investment by the resident investor.

(2) Income of the fund is not taxed currently but is taxed upon resident derivation at a penalty rate of tax reflecting an imputed interest component.

(3) The increase of the market value of the investment is subject to tax.

It is not expected that a firm indication of the form the rules will take will be available until draft legislation is issued in respect of the main body of the rules.

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APPENDIX I

INTENDED LIST OF DESIGNATED COMPARABLE TAX JURISDICTIONS

Austria
Bangladesh
Belgium*
Brazil*
Brunei
Bulgaria
Burma
Canada
China (People's Rep.)
Czechoslovakia
Denmark
Fiji
Finland
France*
Germany (Dem. Rep.)
Germany (Fed. Rep.)*
Greece*
Hungary*
Iceland
India
Indonesia
Ireland (Rep.)*
Israel*
Italy
Japan
Kenya
Kiribati
Korea (Rep.)
Luxembourg*
Malaysia*
Malta*
Netherlands, The*
New Caledonia
New Zealand
Norway
Pakistan*
Papua New Guinea
Philippines*
Poland
Portugal
Romania
Saudi Arabia
Singapore*
Solomon Islands*
Spain*
Sri Lanka*
Sweden
Switzerland*
Tahiti (French Polynesia)
Taiwan
Thailand
Tokelau
Tonga
Turkey*
Tuvalu
United Kingdom
United States of America
Union of Soviet Socialist Republics
Western Samoa
Yugoslavia
Zimbabwe

* Listing is qualified by one or more specific designated concessions (see Appendix 2).

APPENDIX II

SPECIFIC DESIGNATED CONCESSIONS

Subject to further evaluation prior to enactment of the list of comparable tax jurisdictions, income sourced from these countries and earned in connection with the concessionary tax provisions applicable to the activities or entities designated below will be attributable income if all other conditions for attribution are satisfied.

Belgium	– Co-ordination centres – Foreign sales corporations
Brazil	– Authorized investment funds
France	– Headquarters of foreign companies
Germany (Fed. Rep.)	– Management centres (Kontrollstellenerlass)
Greece	– Offshore companies
Hungary	– Banking activities of foreign financial institutions
Ireland (Rep.)	– Headquarters operations – Income (including income from financial services and shipping) subject to tax at 10%
Israel	– Foreign international trade companies – Rental income from property of which at least 50% is designated for apartment rentals
Luxembourg	– Holding companies – Reinsurance business
Malaysia	– Inward reinsurance business – Offshore insurance
Malta	– Insurance income of non-residents – Offshore Banking Units
Netherlands, The	– Headquarters of foreign companies – Foreign sales corporations
Pakistan	– Approved air transport enterprises
Philippines	– Regional headquarters of multinational companies – Offshore Banking Units – Foreign Currency Deposit Units
Singapore	– Asian Currency Units – Insurance and reinsurance of risks outside Singapore – Gold bullion, gold futures and financial futures – Syndicated offshore credit and – underwriting facilities – Operational headquarters – Offshore managed funds – Engineering and consultancy services
Solomon Islands	– Air transport operations – Life insurance business
Spain	– Headquarters of foreign companies – Venture capital companies and funds
Sri Lanka	– Foreign Currency Banking Units – Income from services rendered outside Sri Lanka
Switzerland	– Holding companies – Service or auxiliary companies
Turkey	– Export incentives (including international transport earnings)

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AUSTRALIA:

Thin Capitalisation Legislation

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I. THE PURPOSE OF THIN CAPITALISATION LEGISLATION

In 1987 Australia joined a select group of OECD countries with comprehensive legislation addressing the problem of 'thin capitalisation'. In terms of both length and complexity of its legislation, Australia has jumped directly to the top of that elite group.

The problem which thin capitalisation legislation seeks to address is the different treatment accorded investment by way of debt and investment by way of equity. The differences are most pronounced under a classical company/shareholder tax system, where interest payments are deductible to the borrower and taxable to the lender (and hence are taxed once only), while dividends are paid from after-company tax profits and taxed again in the hands of shareholders. Not surprisingly, the inconsistent treatment leads to a strong bias for debt investment in preference to equity investment. This is particularly true in the case of controlling shareholders, who may be relatively indifferent to the form in which their investment is structured and who therefore are likely to be guided primarily by tax considerations when characterising the legal form of their investment.

In a domestic tax system this bias towards debt investment can be mitigated, if not eliminated, by the adoption of an integration system or imputation system designed to partially or fully eliminate the company level of tax imposed on distributed income. However successful an integration or imputation system may be at achieving this objective in a domestic context, it is unlikely to remove the bias in favour of debt for non-residents, given the failure of almost all imputation systems to provide non-residents with credit for domestic income taxes previously imposed on distributed income.

Australia is one of the few countries whose company/shareholder tax system does not discriminate in favour of resident shareholders. Companies are taxed at a flat rate of 39% and resident shareholders are fully taxed on distributed income, subject to an imputation credit where dividends have been paid out of income previously taxed in the company's hands. Non-residents receiving dividends paid out of fully-taxed company income (known as franked dividends) are exempt from any further ordinary or withholding taxes on the distribution. Non-residents receiving dividends paid out of profits which have not been taxed in the hands of the company (called unfranked dividends) are subject to a withholding tax on the distribution, but the rate of taxation, 30% in the case of a shareholder resident in a country with which Australia has no double tax agreement and 15% in the case of a shareholder resident in a jurisdiction which has entered into a double tax treaty with Australia, is generous compared to that imposed on most residents, for whom the top marginal tax rate is 48%.

Generous as the Australian company/shareholder tax system may be for non-residents, it still imposes a higher tax on dividends distributed to non-residents than it does on interest paid to non-residents. That is because Australia imposes a remarkably low withholding tax on interest paid to non-residents – 10% whether the recipient is resident in a treaty or non-treaty country. This 10% tax compares with the 39% company tax borne by franked dividends (paid from taxed company profits) and the 30% (in the case of non-treaty countries) or 15% (in the case of treaty countries) withholding tax imposed on unfranked dividends paid to non-residents. In the absence of provisions discouraging excessive debt, it is clear that foreign investors, particularly controlling shareholders, will take advantage of the differential and rely as much as possible on debt funding to minimise their exposure to Australian taxes.

II. OVERVIEW OF THE AUSTRALIAN SYSTEM

Australia's thin capitalisation rules were originally established in the context of its foreign investment legislation. The governing law, the Foreign Takeovers Act, provided for the establishment of a Foreign Investment Review Board responsible for initial approval and ongoing scrutiny of foreign investments in Australia. A condition imposed by the Board on foreign investors was adherence to approved debt-equity ratios in Australian subsidiaries.

As part of a general policy initiative to dismantle restraints on foreign investment, the responsibilities of the Board have been severely circumscribed in recent years. As a result of the winding down of the Board's activities, it was no longer feasible for the Board to administer thin capitalisation rules and responsibility for administering the anti-avoidance policy was transferred to the tax office. This was accomplished by the insertion into the income tax law of thin capitalisation provisions similar to the administrative

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guidelines formerly enforced by the Foreign Investment Review Board. The adoption of formal income tax based thin capitalisation provisions was announced early in 1987 and the new law came into effect on 1 July of that year (the commencement of the Australian tax year), although legislation giving effect to the measures was not introduced to Parliament until October 1987.

In broad terms, the thin capitalisation rules prevent Australian taxpayers from deducting as a business expense 'excessive' interest payments to foreign controllers. Excessive interest payments are those payable on loans from a foreign controller which exceed a prescribed multiple of the controller's equity investment. While the excess interest is non-deductible, it is treated as ordinary interest in all other respects, including being subject to withholding taxes imposed on interest payable to a non-resident. The rules apply to all resident business entities – companies, trusts and partnerships and to branches established in Australia by non-residents. Their greatest impact, however, is on corporate subsidiaries.

The shift from administrative guidelines to legislation and income tax sanctions has resulted in 3 significant changes to the thin capitalisation rules. The first is an extraordinary increase in the detail and complexity of the rules. Not only is the legislation complicated in comparison to its predecessor guidelines, but almost all observers suggest it is significantly more intricate than that of almost all other jurisdictions which impose similar rules.

A second change is the elimination of executive discretion on the terms of the rules. For example, under the Foreign Takeovers Act the Treasurer could rely on de facto evidence to find that an offshore entity was not a foreign controller of an Australian firm. The Commissioner of Taxation, responsible for applying the new income tax rules, has no similar discretionary powers, however, and must treat a foreign company as a controller if it satisfies the statutory tests, whatever the de facto situation may be.

Finally, a most important change to the thin capitalisation rules is the adoption of inflexible and fixed measurements of acceptable and unacceptable debt/equity ratios. The ratios set out in the legislation – 3:1 for foreign controlled taxpayers other than financial institutions and 6:1 for financial institutions – are the same as those used as a general benchmark under the former regime. The guidelines were subject to a discretion under the original system, however, and exceptions were often permitted in a wide variety of cases after officials took into consideration such factors as the finance arrangements which were common in the particular industry of the foreign controlled taxpayer, the age of the company, future finance plans, etc. Interestingly, the move to adopt fixed statutory ratios came not long after the release of an OECD report on thin capitalisation[1] which generally supported the conclusions of an earlier OECD study that recommended against legislation prescribing rigid statutory formulae in favour of a more flexible arm's length approach.[2]

III. PRINCIPAL ELEMENTS OF THE THIN CAPITALISATION RULES

The thin capitalisation rules and denial of interest deductibility are triggered when a resident taxpayer incurs interest expenses on debt investment by a foreign controller which is in excess of a prescribed multiple of the foreign controller's equity investment in the resident.

A. Foreign controller

A foreign controller is a non-resident who, alone or with an associate or with associates, has 'substantial control' of the voting power in a resident company or is entitled to receive 15% or more of the dividends or share capital distributed by a resident company. 'Substantial control' of the voting power is defined as direct or indirect control (i.e. through one or more interposed companies, partnerships or trusts) of at least 15% of the votes in the company.

The formal definition is protected by a provision applicable to de facto control situations which might otherwise escape the strict legal measurement rule. The de facto control provision applies whenever a resident company or its directors is under an obligation, whether or not it is legally enforceable, to act in accordance with the directions, instructions or wishes of a non-resident.

The definition of foreign controller has a number of interesting features to it. To begin with, it incorporates the broadest definition of an 'associate' found in Australian tax legislation – the definition alone runs for 3 and a half pages. Taxpayers are associated where the link between them is as low as 15%. A 50% linking must exist before taxpayers are associated for almost all other income tax purposes in the Australian tax act.

Equally expansive are the tracing provisions used to measure indirect interests in resident companies. In ordinary circumstances, indirect interests in lower tier entities are usually determined by multiplying a taxpayer's interest in a higher tier entity by that entity's interest in the lower tier subsidiary. The applicable provision in the Australian legislation speaks of a taxpayer who controls or is capable of controlling, either directly or indirectly, at least 15% of the votes in a resident company. The language of the provision is not without some ambiguity and revenue authorities have interpreted it in a broad manner, which has, to date, not been challenged in the courts.

When the provision was first introduced, the Treasury explained it would be interpreted as treating controlling interests as 100% interests for the purpose of calculating interests through a chain of ownership. This sort of rule is common in tracing situations. Without a rule to this effect, it would be technically possible to dilute apparent ownership below the 15% level without losing effective control. This would happen, for example, if a non-resident had 50% of the shares of first tier resident, which in turn had 50% of the shares in second tier resident, which in turn had 50% of the shares in third tier resident. On a straight mathematical calculation, the non-resident enjoys only a 12.5% ownership in third tier resident (50% × 50% × 50%). However, by virtue of control over first tier resident, the non-resident can control second tier resident, which can control third tier resident. In these circumstances, a deemed 100% ownership in cases of control is appropriate for measuring levels of lower tier ownership.

Revenue authorities are extending that logic significantly, however, by tracing control through a chain so long as a higher tier entity has a 15% interest in the entity below it. Thus, in the above example, if 15% interests were substituted for 50% interests, the non-resident would have a 0.3% indirect interest in third tier resident company (15% × 15% × 15%). The taxation office has indicated it will

1. OECD, "Thin Capitalisation: Taxation of Entertainers, Artistes and Sportsmen", *Issues in International Taxation,* No. 2 (Paris 1987).
2. OECD, *Transfer Pricing and Multinational Enterprises* (Paris 1979).

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treat this case as one where third tier company is 'controlled' by a non-resident. The tax office's interpretation has, not surprisingly, been subject to considerable criticism by some tax advisers.[3]

B. Resident interests via foreign controllers

As it was originally formulated, Australia's thin capitalisation legislation did not apply to resident companies with a non-resident controller where Australian residents had an 85% or greater interest in the non-resident controller. In other words, the legislation was directed at tax minimisation by non-resident investors only.

The exclusion from the thin capitalisation rules for indirect investments by residents is not explicable on the basis of any tax policy rationale but rather was an anomaly arising from the fact that their focus was inherited from the foreign investment procedure, which was more concerned with actual foreign investment than indirect resident investment.

The original thin capitalisation proposals were strongly criticised by some observers because of their failure to recognise the possibility of tax minimisation by residents investing via offshore entities. To some extent, the problem was indirectly addressed by the announcement in May 1988 that Australia would adopt a broad foreign-source income attribution system under which resident shareholders would be assessed on a proportionate share of income derived by non-resident companies in which they had direct or indirect interests. The proposals would have had the effect of negating any tax advantages sought by routing investment capital as debt from an offshore lender.

The original foreign income attribution proposals were subject to considerable criticism and in April 1989 the government announced it was withdrawing its original scheme in favour of a more traditional Controlled Foreign Company (CFC) system under which income derived by non-resident companies would be attributed to resident shareholders only when the non-resident company was 'controlled' by 5 or fewer resident shareholders. The definition of control used in the CFC proposals was much stricter than that employed in the thin capitalisation legislation – control was defined as a 50% or greater interest for CFC purposes, while a 15% or greater interest constituted control for thin capitalisation purposes. There remained, therefore, a considerable gap between the 2 systems, one which was certain to be exploited after the CFC rules came into effect on 1 July 1990, their scheduled commencement date.

A response to the problem finally came in August 1989 when the Treasurer announced that the thin capitalisation legislation would be amended to remove the exemption for non-resident controllers ultimately controlled by residents. The change will come into effect on 1 July 1990, when the CFC system commences operation.

C. Foreign debt

Foreign debt which may be subject to the thin capitalisation rules is limited to interest-bearing debt of the foreign controller or its associates. Interest-free debt and arm's length debt from a third party are both outside the scope of the legislation. And finally, debt is excluded from the rules where the interest it generates is taxable in Australia under ordinary tax provisions, and is not only subject to withholding tax. This could happen, for example, where the interest forms part of the income attributable to a non-resident's permanent establishment in Australia. Certain amounts which are deemed to be interest under other provisions in the income tax act, such as discounts on certain bills of exchange or deemed interest payments under hire purchase and lease agreements, will be treated as giving rise to corresponding debt for the purpose of the thin capitalisation rules.

The integrity of the foreign debt measures is protected by an anti-avoidance provision dealing with back-to-back loans. These are debt arrangements made through non-associated third parties and which, prima facie, fall outside the calculation of foreign debt. This could be accomplished, for example, if the foreign controller lent funds to a foreign bank which in turn lent an equivalent amount to the Australian subsidiary. The anti-avoidance provision causes such back-to-back loans to be treated as foreign debt. Commentators have suggested the anti-avoidance measure is easily sidestepped by replacing the original loan to the third party intermediary with equity in the form of redeemable preference shares.[4]

D. Foreign equity

The definition of foreign equity interests used to determine a company's debt-equity ratio incorporates concepts quite unusual for Australian tax legislation. Rather than rely on somewhat inflexible tax law or company legislation terminology, the drafters of the thin capitalisation provisions attempted to incorporate broader accounting concepts into the definition of foreign equity.

In broad terms, the value of a company's foreign equity is calculated as the sum of the foreign controller's actual equity interest in the company (equity in a legal sense, i.e. paid-up capital and share premiums) and its proportionate interest in the company's retained profits, less any loans by the company to the foreign controller or a non-resident associate of the controller. Equity interest is measured at the end of the income year.

A foreign controller's interest in the company's retained profits includes an interest in unrealised capital gains revealed through a revaluation of the company's assets. This interest is measured at the beginning of the company's income year and provision is made for an adjustment should any stock dividends be issued during the year, in which case the value of the retained earnings will be counted as direct equity at the end of the income year.

As a general rule, only equity interests beneficially owned by foreign controllers or non-resident associates of foreign controllers are taken into account when determining a company's debt-equity ratio. The one exception to this rule is where a foreign controller has an indirect 100% interest in a resident company via a wholly owned resident holding company. Thus, if a non-resident controller has a 95% interest in a resident operating company through a wholly owned (100% interest) resident holding company which in turn holds 95% of the shares in the operating company, there will be no foreign equity in the operating company.

This result was quite deliberate. It was an underlying principle of the former foreign investment rules that foreign debt should follow the foreign equity chain and this principle has been retained in the thin capitalisation legislation. In other

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3. See further, K. Spence, "Thin Capitalisation", 23 *Taxation in Australia* (1988) at 8.
4. See, for example, R. Vann, "Trans-Tasman Taxation of Equity Investment" (Wellington, New Zealand: Institute of Policy Studies, 1989), at 96.

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words, the rule is designed to ensure that loans to lower tier companies are provided by higher tier resident companies in preference to foreign controllers.

Where there is a 100% ownership chain from the foreign controller to a resident operating company, the foreign controller's equity interest is measured at the first level of ownership in a resident company. The need for this rule can best be illustrated with a simple example: A foreign controller invests A$ 100,000 in an Australian resident Holdco. Holdco borrows $ 900,000 and invests $ 1 million in Australian resident Opco. For the purpose of debt/equity rules, the equity in Opco is said to be $ 100,000, not its actual share capital of $ 1 million.

In the absence of specific anti-avoidance provisions, it would be possible to avoid the thin capitalisation rules by temporarily boosting foreign equity, for example, by issuing redeemable preference shares, just prior to the end of the income year, when foreign equity levels are measured. To prevent short-term injections of capital of this sort, claw-back provisions reduce foreign debt where shares are redeemed or cancelled within 2 years from the year of income.

As mentioned above, foreign equity is reduced by the amount of any loans outstanding to the foreign controller at the end of the year (commonly called loan-backs). Loans is broadly construed and in the original legislation clearly included ordinary trade credit. The government received many representations claiming the treatment of trade credit as a loan-back was frustrating normal trading relations between resident companies and foreign controllers. In response to those representations, the Treasurer announced in March 1989 that genuine short-term (less than 30 days) trade credit would be exempted from the equity measurement provisions, the change being retrospective to the commencement of the 1988-89 tax year (which commenced 1 July 1988).

E. The deduction denial formula

As originally enacted, the deduction denial formula operated by reference to a taxpayer's excess debt (i.e. debt which exceeded the permissible amount), as determined at its highest point during the year. Interest for which no deduction was allowed was calculated by multiplying total interest outgoings on foreign debt by the fraction of excess foreign debt to total foreign debt. To illustrate the operation of the deduction denial formula, imagine a resident company with $ 1 million foreign equity and $ 4 million foreign debt, on which it incurs an annual interest obligation of $ 400,000. Permissible foreign debt is 3 times foreign equity or $ 3 million. Thus, $ 1 million foreign debt is excess foreign debt and a deduction would be denied on ¼ of the $ 400,000 interest expenditure or $ 100,000.

In the scenario just illustrated, the operation of the thin capitalisation provisions is not particularly harsh considering the purpose behind the measures. The formula was capable of considerable injustice in some cases, however. This is because it operated by reference to the taxpayer's highest foreign debt exposure for the year and based on that exposure denied a deduction for a percentage of the entire year's interest expenses incurred on foreign debt. Thus, if the taxpayer in the above example had a $ 3 million foreign debt for 364 days of the year and incurred an additional $ 1 million foreign debt for one day, it would be denied a deduction for one quarter of its foreign debt interest expenses for the entire year.

While the interest deduction disallowance provision had the advantage of simplicity, taxpayers argued it caused unnecessary hardship in many instances. The government responded to the complaints in March 1989 with the announcement of a new daily interest formula available on an elective basis to taxpayers who have kept a daily record of their level of excess foreign debt. Under the alternative formula, total interest outgoings related to excess foreign debt are determined on a daily basis and only this amount is non-deductible. The actual formula consolidates all excess foreign debt levels and excess foreign debt days to arrive at an average daily excess foreign debt. The change is retrospective to the commencement of the 1988-89 tax year (which commenced on 1 July 1988).

F. Interaction with treaties

Tax advisers commenting on the draft thin capitalisation legislation prior to its enactment suggested that the measure might conflict with provisions in some of Australia's double tax treaties. In particular, they pointed out that Art. 23 of the U.S.–Australia treaty provides that interest (and other disbursements) paid by a resident of a Contracting State to a resident of the other State shall be deductible for the purpose of determining taxable profits under the same condition as if they had been paid to a resident of the first-mentioned State. The Article further provides that a Contracting State cannot impose more burdensome taxation of a subsidiary company owned by residents of the other Contracting State than it imposes on similar companies which are locally owned.

Revenue authorities considered the comments but concluded the legislation would have no impact on Australia's treaty obligations. Art. 23 contains an exclusion for taxes that are reasonably designed to prevent avoidance or evasion of tax and the Tax Office indicated it believed the thin capitalisation legislation was of an anti-avoidance nature and thus protected by the Art. 23 exclusion.

G. Special rules for banks

The thin capitalisation rules utilise a more generous 6:1 debt-equity ratio for financial institutions in recognition of their special role as financial intermediaries, onlending borrowed funds. Other features of the financial business led to a number of additional special measures applicable to banks.

1. Equity investment via a holding company

The first special rule was necessitated by the structure used by many foreign banks to hold Australian subsidiaries. When the Australian government deregulated the banking sector in 1985 and encouraged foreign banks to enter the Australian market, it urged them to provide for some Australian participation in their new ventures. This was sometimes accomplished through joint ventures and sometimes through Australian shareholdings. In the latter case, it was common to establish an Australian holding company to hold the foreign parent's interest in the Australian bank. However, loan funds required by the new Australian bank to carry on operations were often provided directly by the foreign parent. Because the debt did not follow the equity path, the Australian banks had significant foreign debt and often no direct foreign equity.

To ensure that banks which encouraged Australian participation in the manner described are not disadvantaged by the thin capitalisation rules, a change to the rules was an-

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nounced in March 1989 which causes domestic bank holding companies of this sort to be treated as offshore companies for the purpose of calculating the direct foreign equity in the operating company. The change was retroactive to 1 July 1987, when the thin capitalisation rules first came into operation.

2. Nostro and vostro accounts

A second special rule for banks in the thin capitalisation legislation was the exclusion of nostro and vostro accounts from the calculation of debt-equity ratios. Nostro and vostro accounts are short-term clearance accounts denominated in foreign currencies used to settle international transactions. It was submitted to Treasury officials that the practice of including nostro and vostro accounts in the determination of foreign debt and foreign equity levels could lead to anomalies if small delays in settling transactions between residents and foreign associates (usually no more than a a day) caused a bank to technically run foul of the prescribed debt-equity ratio. This would happen, for example, if a foreign controller had large, but very short-term credit in an account with its resident subsidiary on the day its foreign equity holdings in the Australian resident were determined.

Following submissions on this problem, the government announced in March 1989 that nostro and vostro account balances would be excluded from debt-equity ratio calculations, once again with the change operating from 1 July 1987.

3. Widely-held securities

Australia's interest withholding tax contains an exemption for interest on widely-held securities issued overseas. Originally securities qualifying for the withholding tax exemption were taken into account when determining foreign equity if they were held by foreign controllers or associates of a resident company. In essence, they were treated in the same manner as all other loan-backs from a resident to a foreign controller and they reduced the measurement of foreign equity by an amount equal to their face value.

It was argued that, in the case of banks, this treatment was both arbitrary and unfair. Australian banks which floated widely held debt offshore often sought the services of overseas parent companies or associates to act as managers, dealers or underwriters for the placement of the securities. Critics pointed out that the widely held tests in the withholding tax exemption provisions ensured that offshore parent or associates could hold the debt for a limited time at best and they suggested that the inclusion of such debts in the thin capitalisation rules was quite unnecessary. The government eventually recognised the force of these arguments and in March 1989 the Treasurer announced that this type of debt would be excluded from the rules, with effect from 1 July 1988.

IV. DEBT CREATION RULES

By setting fixed legal criteria for the application of the thin capitalisation rules, the government unwittingly opened the door to a new type of avoidance. The establishment of clear borderlines encouraged taxpayers whose finance arrangements were within the permitted ratios of the thin capitalisation rules to leverage their investments to the extent permitted by the rules. These tax minimisation schemes were known as debt creation schemes and involved the introduction of new debt into a company group without the acquisition of any new assets into the group. Most commonly, one company in the group would borrow from an offshore parent or associate to acquire a productive asset from another taxpayer in the group. So long as the asset generated taxable income, the interest payments incurred in the acquisition would be deductible for tax purposes notwithstanding the economic reality that the inter-group transfer had not resulted in the acquisition of any new asset by the group. Inter-group capital gains rollover provisions ensured there was no associated tax penalty to be paid in carrying out the scheme.

Legislation to attack debt creation schemes was passed in 1988, with retrospective operation to 1 July 1987 (though it was subject to relatively generous transitional provisions until 20 June 1988, when the measures were introduced to Parliament). Although the debt creation provisions have priority over the thin capitalisation measures (that is, they operate even when new financing is within the thin capitalisation guidelines), in one sense they are triggered by much stricter criteria. The debt creation rules come into operation when a foreign controller has an interest in the buyer or seller of an asset (or both) or one of these parties is itself a foreign controller. However, while a 15% interest is sufficient to create a foreign controller for the purpose of the thin capitalisation rules, a 50% or greater interest is required for a non-resident to be a foreign controller for the purpose of the debt creation rules.

The measurement of a foreign controller's interest in a resident company is also narrower in the debt creation rules than in the thin capitalisation provisions. Once again, interests of 'associates' are combined to determine total interests. However, parties are associated for the purpose of the debt creation rules where one holds as little as a 15% interest in the other, while 50% interests are needed before taxpayers are associated for thin capitalisation purposes. Interest is determined not as voting rights, but rather as the percentage entitlement of the person to receive directly or indirectly a distribution of the company at the time of measurement.

Where the debt creation rules apply, a borrower's right to deduct interest payments will be reduced or even extinguished by reference to a complicated formula. The formula takes into account the level of ownership by the seller in the transferred asset and the interest of the foreign controller (as defined above) in the buyer or seller (or both, if it is a controller with regard to both parties).

The potential scope of the debt creation rules is quite broad – in theory, they apply even where the borrower has obtained finance from a third party outside the company group. However, the Commissioner of Taxation is given a discretionary power to exempt taxpayers from the rules where he is satisfied the transactions which would otherwise trigger the rules have not increased the overall indebtedness of the company group.

Further reading

D. Williams, "The Application of the Thin Capitalisation Rules in Australia", 23 *Taxation in Australia* (1988) at 577.

K. Spence, "Thin Capitalisation", 23 *Taxation in Australia* (1988) at 8.

K. Horton, "Thin Capitalisation: Application to Companies", 1 *CCH Journal of Australian Taxation* (February/March 1989) at 8.

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PEOPLE'S REPUBLIC OF CHINA:

Foreign Tax Update

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It is probably too early to make any informed forecast as to the likely effect that the recent tragic events in China will have upon foreign investment there. Certainly, potential investors will be cautious and will wish to wait until the situation becomes clearer before committing large sums of money to establish new projects or expand existing ones. It may take quite some time for foreign investors to build up enough confidence in China again, despite the Chinese Government's efforts to convince the world that the "open to the world" policy will not be changed. The overall level of new foreign investment in China is thus likely to be considerably lower in 1989 than in the previous year. 1988 was a record year for foreign investment in China. Late in 1987 the total number of approved foreign investment projects had reached 10,000; by the end of 1988 this number had grown to 15,900, with 5,890 new projects approved during the year. The great majority of these took the form of joint ventures, although 410 wholly foreign-owned projects were approved, nearly 9 times as many as in the previous year.[1]

The Chinese authorities attribute much of this growth to the existence of a stable investment climate and have developed an almost excessive reluctance to change their investment laws, lest this should unsettle foreign investors. As a consequence, the tax situation has seen little change during the past 2 years. There are, however, a few developments which seem to merit comment.

THE COOPERATIVE JOINT VENTURE LAW

The new Cooperative Joint Venture Law[2], though providing a welcome clarification of the legal status and framework for those joint ventures which are not established under the Joint Venture Law of 1979, did little to clarify their tax treatment. Basically, there now seem to be 3 distinct types of joint venture under Chinese law: equity joint ventures, cooperative joint ventures with full legal personality and cooperative joint ventures of the partnership type.

Equity joint ventures

An equity joint venture (EJV) is one formed under the 1979 law.[3] It constitutes a separate legal person, incorporated in China, is governed by a Board of Directors, has a share capital, and its profits (and residual assets upon liquidation) are divided among the members in accordance with their shareholdings.

Cooperative joint venture (CJV) with full legal personality

The CJV Law of 1988 permits 2 types of CJV to be formed. The one type, similar to the EJV but permitting greater flexibility, allows a separate legal entity to be established, which is governed by a Board of Directors, but in which participatory rights are not necessarily determined according to shareholding.

Cooperative joint venture of partnership type

In the other type of cooperative joint venture, the venture is in effect a partnership between the Chinese and foreign party. In such a case no separate legal person is created, and the affairs of the joint venture are managed by a "joint managerial institution". The important thing, from a tax point of view, is that the venture is not regarded as a taxable person and each party is taxable upon its own share of the profits of the venture.

The tax status of the EJV and of the CJV of the partnership type is fairly clear. In the former case, the joint venture is considered to be a Chinese company and is taxed on its profits under the Joint Venture Income Tax (JVIT) Law of 1980, with a further withholding tax if dividends are remitted abroad to shareholders. In the case of the partnership type of venture, it seems clear that the foreign participant is taxable upon its own share of the profits, which are perceived as deriving from a permanent establishment in China, under the Foreign Enterprise Income Tax (FEIT) Law of 1981. The Chinese participant pays tax on its share of profits under the relevant domestic legislation. But in between these 2 organizations there remains the CJV which has elected to have separate legal personality.[4] In such a case, some Chinese commentators take the view that each member should be taxed under the relevant tax law on its own share of the total profits; but others regard the venture as a Chinese legal person, taxable under the JVIT Law on its profits before distribution. Whatever the strict legal position, it seems in practice that those joint ventures which opt for legal personality are being treated as distinct taxable persons and are taxed under the JVIT Law, rather than the FEIT Law.

In the specially designated coastal regions this really makes very little difference, since virtually all enterprises with foreign investment pay tax at a reduced rate. But elsewhere the distinction may be quite important since, normally, the JVIT Law levies tax at a flat 30%, whereas the FEIT Law charges tax on a progressive scale rising from 20 to 40%. When local tax is also taken into account, the effective rate of tax under the JVIT Law is 33%, and that under the FEIT Law is from 30 to 50%. Under the JVIT Law, however,

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1. For full data, see *Beijing Review,* 6-12 March 1989 at 16; and *Renmin Ribao (Haiwai Ban)* (People's Daily – Overseas Edition), 24 March 1989 at 3.
2. Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures, adopted by the 1st session of the 7th National People's Congress on 13 April 1988.
3. Law of the People's Republic of China on Chinese-Foreign Joint Ventures, adopted by the Second Session of the Fifth National People's Congress on 1 July 1979 and promulgated on 8 July 1979.
4. It can make it clear that it adopts this status by registering under the Legal Persons Registration Regulation of 13 May 1988.

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there is an additional tax of 10% on profits remitted abroad. As a result, there will normally be a substantial advantage for all but the smallest ventures to opt for separate legal status and it seems that most CJVs are now doing so.

THE CHINESE PARTICIPANT IN JOINT VENTURES

Very little attention has been paid, in the past, to the tax liability of the domestic Chinese participant in a joint venture, yet the tax burden upon one's venture partner is surely a matter to be considered when the initial terms of the venture are being negotiated. In the case of a CJV – at least one without legal personality – the position seems reasonably clear; each participant pays tax separately upon its share of the profits. The foreign participant is taxed under the FEIT Law and the Chinese participant will pay State enterprise income tax (SEIT)[5], collective enterprise income tax (CEIT)[6] or private enterprise income tax (PEIT).[7] In most cases, this will involve the Chinese party paying tax at a higher rate than its foreign partner.

In the case of an EJV – or a CJV with legal personality – the joint venture itself is taxed, and dividends remitted abroad to the foreign participant are subject to a separate withholding tax. The JVIT Law itself makes no reference to the tax treatment of dividends paid to the Chinese party, but in practice it seems that any profit so distributed is included in the taxable income of the recipient and is subject to SEIT, CEIT or PEIT, with a credit for the tax already paid by the joint venture.[8] For instance, if a State enterprise invested in an EJV with capital provided by the State, a credit for JVIT is granted in the following manner:

An EJV makes a profit of 1,000,000 RMB.
JVIT at 30% = 300,000 RMB.
Profit available for distribution = 700,000 RMB.
The JV pays a dividend of 200,000 RMB to each participant.

(a) The *foreign* participant suffers tax of 10%, if the dividend is remitted outside China = 20,000 RMB.
(b) The *Chinese* participant pays SEIT at 55% on the dividend = 110,000 RMB *less* a credit of (30% × 200,000) 60,000 RMB for the tax previously paid by the venture in respect of the dividend.

If the State enterprise invested in the EJV out of its own capital, such as the production development fund, new product experimentation fund or reserve fund retained by the enterprise from after-tax profits, the dividends received from the EJV are exempted from the SEIT for the first 5 years. In the case where the EJV qualifies as a "technologically-advanced" or "export-oriented" enterprise and enjoys tax exemption or reduction, the Chinese State enterprise is still entitled to a tax credit for the tax exempted or reduced (i.e. a form of tax sparing is permitted).

ALLOCATION OF FOREIGN EXCHANGE EARNINGS

Another problem which sometimes arises between the foreign and domestic parties to a joint venture concerns the allocation of foreign exchange and renminbi earnings. Since renminbi earnings are not freely convertible, a venture which has large domestic sales may well be unable to repatriate much of its profit. Renminbi earnings can be used to pay tax in China, but it is not generally appreciated that if that tax qualifies for an immediate foreign tax credit in the home country, paying tax in China operates to convert RMB into "hard" currency at the official exchange rate. Thus it is not always advantageous to secure tax privileges in China. But once tax has been paid, the foreign partner would naturally like to allocate to itself the foreign exchange earnings, so as to be able to repatriate its share, leaving its Chinese partner with the RMB earnings. The Chinese partner, however, is unlikely to agree to this solution. It may have its own needs for foreign exchange and, in any event, on the official foreign exchange market "hard" currency is worth about 1.7 times the normal rate of exchange. The Chinese position – which seems fair in the circumstances – is that foreign exchange and RMB earnings should both be shared in proportion to each partner's contribution to the capital. If some other arrangement is contemplated, then it seems that express provision should be made in the joint venture contract and articles.

TAX TREATIES

China's tax treaty programme now seems largely complete. A total of 22 treaties have been signed, the most recent being that with Yugoslavia, and 18 of these have already entered into force. Although there will doubtless be further treaties, the network now covers nearly all of China's main trading partners and investors. The most conspicuous absence, of course, is Hong Kong.

Hong Kong itself has not entered into any tax treaties, though it has reciprocal arrangements with some Commonwealth countries for the avoidance of double taxation. The treaties of the United Kingdom are generally restricted to Great Britain and Northern Ireland, and do not apply to Hong Kong.

The question is sometimes raised, however, as to the applicability of China's tax treaties to Hong Kong after 1997. The answer normally given by the Chinese authorities is that their present treaties define the "People's Republic of China" to include those territories over which it has jurisdiction in accordance with international law and in which the laws relating to Chinese tax apply. Since, for a period of 50 years at least, Hong Kong will continue to apply its own tax laws, China's existing tax treaties will not become automatically applicable there.

One other recent development of interest has been the increasing use of the Exchange of Information provisions in China's treaties, notably those with France, Japan and the United States.

TRANSFER PRICING

Given that most foreign investment in China is conducted through a wholly-owned or, in the case of a joint venture, a partly-owned subsidiary of a multinational corporation, it is not surprising that transfer pricing problems have arisen and have attracted the attention of the Chinese tax authorities. Transfer pricing rules have been introduced in the Shenzhen SEZ[9], this being China's first attempt at regulat-

5. Regulations of the People's Republic of China on State Enterprise Income Tax, promulgated by the State Council on 18 September 1984.
6. Provisional Regulations of the People"s Republic of China on Collective Enterprise Income Tax, adopted by the State Council on 11 April 1985.
7. Provisional Regulations of the People's Republic of China on Private Enterprise Income Tax, adopted by the State Council on 25 June 1988.
8. Interim Measures on the Allocation and Management of Profits of Chinese Investors in Chinese-Foreign Joint Ventures, approved by the State Council on 20 May 1987.
9. Provisional Measures for the Administration of Taxation in Respect of Transactions and Business Operations between Enterprises with Foreign

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ing tax abuses occasioned by artificial pricing between affiliated entities. The Transfer Pricing Measures apply to transactions between enterprises with foreign investment located in the Shenzhen SEZ (including EJVs, CJVs and wholly foreign-owned enterprises) and their affiliates. The term "affiliate" is defined in a broad fashion: "two or more companies with direct or indirect relations in terms of administration, control, capital, etc.". Affiliated enterprises are required to deal with each other on an arm's length basis. In the case that the arm's length criterion is not met, the tax authorities have the power to levy tax on profit assessed in accordance with the standards set forth in the Transfer Pricing Measures. For instance, in the case of sale of goods, the tax authorities have the right to determine profit by one of the following methods:

(a) by reference to the arm's length price of the same kind of product on the open market;
(b) by reference to the cost of the product, in which case the profit margin shall generally be no less than 5%; or
(c) by "any other reasonable method".

Similarly, in the case of royalties for the transfer of proprietory technology, the Transfer Pricing Measures require that the royalty charged be the same as that charged to a non-affiliated third party. Otherwise, the tax authorities have the discretion for tax purposes to assess a royalty in accordance with general standards.

The proposed draft law to unify JVIT and FEIT (see below) also includes an "arm's length" rule authorizing the tax authorities to impose tax on the income of affiliated enterprises on an adjusted basis if these enterprises failed to deal with each other on an arm's length basis. Such transfer pricing rules may, however, be questioned as to whether they are consistent with the Chinese policy of encouraging foreign companies to make available advanced equipment and technology on preferential terms. In certain circumstances, Chinese parties have been known to demand that the foreign party reduce its royalty for technology licensed to a proposed joint venture as a precondition for approval of the project. Normally, of course, the rules are designed to prevent the payment of excessive royalties to foreign affiliates; but in theory, at least, they might also apply in situations where the royalty is unreasonably low. In such a case, a foreign party could be faced with the prospect of agreeing to a technology licensing royalty far below market value in order to have the project approved, while paying tax based on the market value.

LOCAL TAXES

Three newly introduced local taxes, though primarily affecting purely domestic transactions, may also have some impact on foreign investment.

Urban land use tax

This tax was introduced in July 1988 and became effective as of 1 November 1988. All units and individuals who use land located in cities and towns are payers of the tax. The tax rates vary from 0.5-10 yuan in large cities to 0.3-6 yuan in county towns and mining areas, the exact rate being determined by the local government.[10] Local authorities are required to adopt implementing measures, which will replace existing land use fees.

Stamp tax

The Stamp Tax Law[11] imposes a tax on all individuals and entities who execute or obtain a specified document. The specified documents include contracts for purchases and sales, undertaking of processing work, contracting of construction projects, lease of property, transportation of goods, storage and custody, lending of funds, insurance of property and technology; conveyances; business accounts books; registration certificates for rights and licenses; and other documents determined to be taxable by the Ministry of Finance. Tax rates vary in accordance with the nature of the document. For example, purchase and sales contracts are taxed at 0.003% of the sale price and construction and installation contracts are taxed at 0.003% of the fee charged; contracts for the undertaking of processing work and for transportation of goods are taxed at 0.005%. Taxpayers are required to pay the tax at the applicable rate by purchasing and affixing tax stamps which must be pasted on the taxable document. The tax is exempt on duplicates or manuscript copies of documents on which stamp tax has already been paid and instruments written by the owner of property by which such property is donated to the Government, a social welfare entity or a school. For the present, it seems that enterprises with foreign investment (if they are registered payers of Consolidated Industrial and Commercial Tax, as will normally be the case) are exempt from the tax.

Banquet tax

To promote reasonable consumption and discourage waste, a banquet tax[12] was introduced to charge a tax on entities and individuals who hold banquets in restaurants, hotels and other catering places. The tax is charged at 15 to 20% of the banquet price exceeding 200 to 500 yuan, the exact amount being subject to determination by the local government. The owner or manager of a restaurant or hotel which provides the banquet is required to withhold the tax from the price charged. This tax will mostly affect joint ventures in the hotel and catering business.

TAX SIMPLIFICATION AND UNIFICATION

As already observed, China's tax laws for foreign investors are somewhat complex and distinctions are made according to the form which the investment takes. During 1988 the State Tax Administration announced plans to simplify and unify the foreign tax system and a number of drafts have circulated informally.

JVIT and FEIT

At present, EJVs (and those CJVs with legal personality) pay tax under the JVIT Law; other CJVs, wholly foreign-owned enterprises and representative offices of foreign companies pay tax under the FEIT Law. In the Special Economic Zones and Open Coastal Areas a variety of tax concessions are granted[13], so that in practice the different forms of investment receive broadly similar treatment, but elsewhere there are the following main differences:

Investment in the Shenzhen Special Economic Zones and Their Affiliates, effective as of 1 January 1988.

10. Urban Land Use Tax Law, Arts. 4 and 5.
11. Provisional Regulations of the People's Republic of China on Stamp Tax, adopted by the State Council on 24 June 1988 and effective as of 1 October 1988.
12. Interim Regulations of the People's Republic of China on Banquet Tax, adopted by the State Council on 9 September 1988 and promulgated on 22 September 1988.
13. See 42 *Bulletin for International Fiscal Documentation,* 11 (1988) at 467.

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(a) *Tax rates*. Under the JVIT, profits are taxed at a flat rate of 30%.
(b) *Local tax surcharge*. Under the JVIT, this is 10% of the Central Government's tax, i.e. an effective rate of 3%. Under the FEIT, the local tax rate is 10%.
(c) *Withholding tax* at 10% is imposed under the JVIT on profits remitted abroad. There is no such charge under the FEIT.
(d) *Tax holidays* are generally rather more generous under the JVIT.

A proposal to unify the 2 laws was prepared and was to have been submitted to the Second Session of the Seventh National People's Congress early in 1989. However, due to the pressure of more urgent business it had to be postponed and it now seems unlikely that it can be adopted before 1990. The proposal sought to eliminate all 4 of the differences between the 2 laws, but the unification of the local tax surcharges presented problems which apparently have not been resolved. As to the basic tax rate, there was a difference of opinion, with some preferring a rate of 30% and others 25%.

Other taxes

A longer term aim is to unify the tax treatment of foreign and domestic enterprises. At the present, enterprises with foreign investment pay product and turnover tax under the 1958 Consolidated Industrial and Commercial Tax, whereas domestic enterprises pay product tax, value added tax or business tax under the reformed laws introduced in 1984. The vehicle and vessel tax, urban real estate tax and land use tax which apply to foreign investors are also different from their domestic equivalents, though there is little real difference in the rates. The explanation for these differences lies in the cautious attitude of the Chinese authorities towards tax changes affecting foreign investors. Consequently, domestic laws have been reformed whilst the original laws have been retained for foreigners. The ultimate aim is to apply a single system, but the intention seems to be to leave the "foreign" laws untouched until such time as the domestic reforms have been fully worked out.

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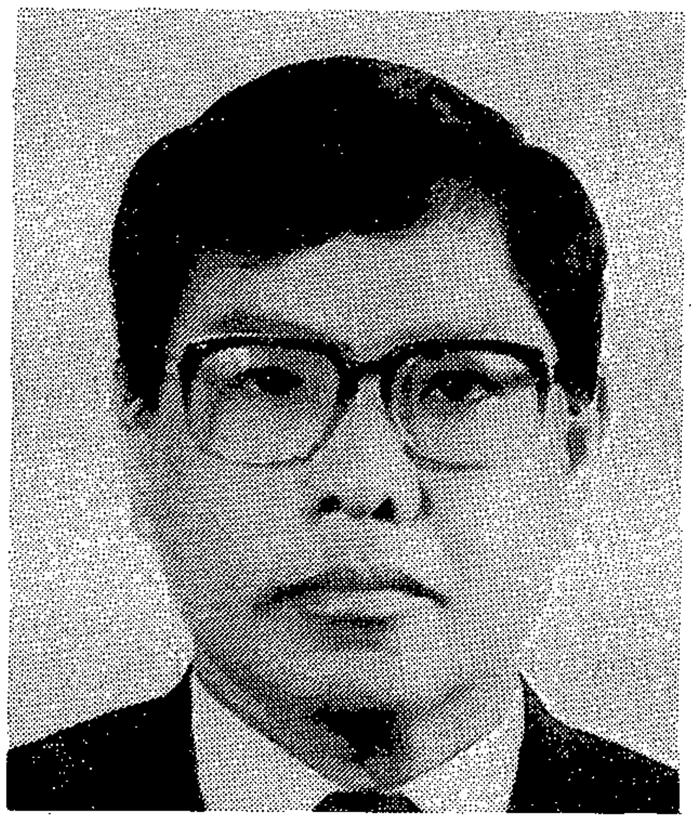

THAILAND:

Highlights on Tax Changes in 1989

Montri Hongskrailers

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On 14 January 1989, the Thai Government enacted Emergency Decree 15/1989, to change various provisions of the Revenue Code, in particular provisions concerning individual income tax. On 28 December 1988 and 14 January 1989, 4 other laws (Royal Decrees 199, 200, 201 and 202) were enacted to exempt the sale of securities from the business tax, effect changes to the provisions on automobile depreciation and to exclude dividends and/or distributions of profit from the computation of taxable income for income tax purposes provided the payer of the income (with the consent of the taxpayer) withholds 15% tax at source. On 20 March 1989, another law came into effect, i.e. Royal Decree 203, which exempts interest on loans from foreign companies or juristic partnerships.

TAX CHANGES UNDER THE EMERGENCY DECREE

Emergency Decree 15/1989 aims to reduce the individual tax burden by increasing standard expenses and allowances, raising the minimum amount of assessable income that the individual taxpayer must declare and extending the time for the individual taxpayer to exercise his opinion of paying tax on certain categories of income without aggregating them with other categories of income for tax computation. The individual income tax rates have been amended as follows:

(1) The standard expense deduction from income assessable under Sec. 40(1) and (2) of the Revenue Code has been increased from 30% of said income with a maximum of 40,000 baht to 30% with a maximum of 50,000 baht.[1]

(2) The allowance for the taxpayer and his spouse has been increased from 13,000 baht to 15,000 baht.

(3) The child allowance has been increased from 6,000 baht to 7,000 baht. However, the allowance for the child's education of 2,000 baht per child remains unchanged.

(4) Previously, where a taxpayer's child earned 6,000 baht in the preceding tax year, the taxpayer was not granted any allowance. The taxpayer's child can now earn 7,000 baht before this allowance is forfeited.

(5) The allowance for the taxpayer and his spouse, in the case where both husband and wife are income-earners and their marital status exists throughout the year, has been increased from a jointly deductible amount of 26,000 baht to 30,000 baht.

(6) The allowance for an estate has been increased from 13,000 baht to 15,000 baht. The allowance for an ordinary partnership or a non-juristic group of persons has been increased from 13,000 baht for each partner or each person of the group with a maximum of 26,000 baht to 15,000 baht for each partner/person with a maximum of 30,000 baht.

(7) An individual taxpayer may elect to exclude certain interest[2] from the computation of taxable income and instead pay tax at the rate of 15%. Previously the interest had to be received by the end of 1988. However, this provision has been extended until 1991.[3] After 1992, the interest will be taxed at the progressive individual income tax rates.

(8) The minimum amount of assessable income which is required for a taxpayer to file a tax return has been increased as follows:

(a) Previously, if a single or married taxpayer had assessable income from salary or wages only of more than 18,600 baht (for a single person) or 37,200 baht (for a married couple), he was required to file a tax return. These amounts have been increased to more than 21,500 baht (for a single person) or more than 43,000 baht (for a married couple).

(b) Previously, if a single or married taxpayer had assessable income from all other sources of more than 13,000 baht (for a single person) or more than 26,000 baht (for a married couple), he was required to file a tax return. These amounts have been increased to more than 15,000 baht (for a single person) or more than 30,000 baht (for a married couple).

(9) The Income Tax Schedule has been altered by expanding the taxable income intervals as follows:

1. Sec. 40(1) and (2) refers to income derived from salaries, wages, commissions, etc.
2. The following interest qualifies for this exclusion: interest earned from Government bonds or debentures; interest on other types of deposits but only the portion which exceeds 8.5% per annum; interest from bank deposits if the interest is more than 8.5% per annum; interest from deposits with cooperatives; interest from loans of financial companies and other financial institutions established by the law of Thailand to lend money for the promotion of agriculture, commerce or industry; and interest on promissory notes issued by finance companies.
3. See Sec. 48(3) of the Revenue Code.

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Old rates

Net income		*Rate (%)*
0 –	40,000	7
40,001 –	90,000	10
90,001 –	150,000	15
150,001 –	220,000	20
220,001 –	300,000	25
300,001 –	400,000	30
400,001 –	550,000	35
550,001 –	750,000	40
750,001 –	1,000,000	45
1,000,001 –	2,000,000	50
2,000,001 –	and over	55

New rates

0 –	50,000	5
50,001 –	200,000	10
200,001 –	500,000	20
500,001 –	1,000,000	30
1,000,001 –	2,000,000	40
2,000,001 –	and over	55

TAX CHANGES UNDER THE ROYAL DECREES

A. Change in business tax on the sale of securities under the Securities Exchange Law of Thailand

Royal Decree 199 exempts the sale of securities under the Securities Exchange Law of Thailand from the business tax in order to alleviate the tax burden of securities trading from 1 January 1989 to 31 December 1990. The sale of securities is normally subject to business tax at the rate of 0.1% per the Business Tax Schedule.

B. Change in automobile depreciation[4]

Royal Decree 200 amends the ceiling on automobile depreciation by increasing the maximum cost value of an automobile for depreciation purposes from 500,000 baht to 1,000,000 baht.

C. Exclusion of dividends or distributions of profit from aggregation with other income for tax computation

Royal Decree 201 introduces the exclusion of dividends and shares of profit from tax computation.[5]

D. Repeal of Royal Decree 193

It was felt by the Government that there was some degree of overlapping between Royal Decree 193 and Sec. 48(3) of the Revenue Code. Both Royal Decree 193 and Sec. 48(3) deal with interest, differences between the redemption values and selling prices of bills and gains arising from the transfer of government bonds, and allow the taxpayer the option of paying tax at the rate of 15% and excluding the income from aggregation for the purposes of the tax computation. Royal Decree 202 removes this anomaly by repealing Royal Decree 193.

E. Tax changes under Royal Decree 203

Royal Decree 203 was enacted to exempt from corporate income tax interest on loans which is paid from or in Thailand to companies or juristic partnerships established under the laws of foreign countries. Several conditions must be fulfilled, however, to qualify for the exemption:

(1) the loan must be made in foreign currency;
(2) the loan agreement must have been made between 1 March 1989 and 31 August 1989 and the repayment period must not be less than 36 months;
(3) the loan amount must be remitted to Thailand during that period; and
(4) the loan agreement must be registered with the Bank of Thailand.

This exemption only applies to the following borrowers:

(a) companies or juristic partnerships not carrying on commercial banking business under the Commercial Banking Laws or not carrying on finance business, securities business, or crédit foncier business under the laws on such businesses; and
(b) companies or juristic partnerships carrying on banking business, finance business, securities business, or crédit foncier under the laws mentioned above, if there is evidence of loans indicating that these companies or juristic partnerships act on behalf of the companies or juristic partnerships mentioned above.

EFFECTIVE DATE OF THE NEW LAWS

The changes made by Emergency Decree 15/1989 take effect as from 1 January 1989. The changes made by Royal Decrees 199, 200, 201 and 202 take effect as from 1 January 1989 and the change made by Royal Decree 203 of 1989 takes effect 1 April 1989.

CONCLUSION

With respect to the income tax changes, income earners in Thailand whose income ranges from 25,000 baht to 100,000 baht (the majority group of income earners in Thailand) will enjoy an increase of about 30 to 35% of their previous take home pay. The new cost value for automobile depreciation is raised from 500,000 baht to 1,000,000 baht to keep pace with the real market value of automobiles in Thailand.

For interest on loans from foreign companies, the new law follows the concept of similar laws the Thai Government enacted in the past. This type of law has been enacted from time to time when the Thai Government was in need of foreign currency.

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4. The word "automobile" refers to one with no more than a passenger capacity of 10 or a passenger car.
5. Royal Decree 201 reads as follows:
Income earners who are living in Thailand and who have received dividends or shares of profits from companies or juristic partnerships that are incorporated under Thai laws and that are not registered under the laws governing the Securities Exchange of Thailand from 1989 onwards and who agree to let the payers of those incomes withhold tax at source of payment at the rate of 15% of the income, when the deadline for submission or returns is due, shall be exempted from having to include the said dividends or shares of profits in the computation of income tax payment. This applies only to the said income-earners who do not ask for a refund of the tax money so withheld or who do not ask for a tax credit for the amount withheld, regardless of whether in full or a part thereof.

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BOLIVIA:

Tax Reform 1986-1989*

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Since the mid-1980s a number of major tax reforms have taken place in both developed and developing countries.[1] The principal thrust of these reforms has been toward tax structure simplification in the form of lowering the top marginal rates on income taxes, the elimination of myriad tax breaks, and, with certain exceptions, the use of a value added tax. The overall objective of this tax streamlining has been to enhance public revenues via the use of more efficient taxes and the reduction of tax evasion and avoidance.

Nowhere has this tax reform movement been better exemplified than in Bolivia. Initially begun in 1986 and ongoing as of mid-1989, Bolivia's existing internal tax structure was completely swept away and replaced by an integrated system of a mere 6 taxes, with a value added tax (VAT) placed at the heart of the system. In order to better comprehend why the government was willing and able to carry out such dramatic measures, a brief macroeconomic background is presented in Section I. The new tax system is then described in Section II, and Section III is reserved for an evaluation of the progress made on the tax reform front through early 1989.

I. THE MACROECONOMIC BACKGROUND TO THE TAX REFORM

The political instability of the years between 1978 and 1982 was accompanied by a cutoff of external loans, and this was combined with rising interest rates on outstanding external loans and falling commodity prices on tin and natural gas, Bolivia's 2 leading exports. The democratically-elected civilian administration which assumed the government in late 1982 proved totally inept, adopting 6 ineffectual stabilization packages between November 1982 and February 1985. As net resource transfers from the rest of the world turned negative after 1981, the printing press was increasingly employed to finance public spending. The non-financial public sector's deficit as a percentage of GDP rose from 14.5% in 1982 to 29.2% in 1984, and the tax ratio (tax collections as a proportion of GDP) dropped from 4.8% to 3.3% over the same period (see Table 1). Inflation skyrocketed, jumping from an annual average of 124% in 1982 to 1281% in 1984 and 11,750% by 1985. True hyperinflation (price increases of 50% or more per month) was reached by May 1984, and lasted through September 1985.

Via the Olivera-Tanzi effect[2], the inflationary process seriously eroded fiscal revenues, as collection lags literally wiped out the real value of tax revenues. Moreover, there occurred an increasingly serious overvaluation of the peso. For example, for all of 1984 the parallel market rate was almost 3 times that of the official rate. Since about three-fifths of central government tax revenues were linked to the official exchange rate, this exchange rate gap further depressed revenues.

The tax system in place during this pre-reform period was essentially what might have been expected given Bolivia's level of development and economic structure. During the 1970s the tax ratio had averaged around 9% of GDP, with customs duties generating approximately one-quarter of the total, internal revenues another one-third, taxes on mining and petroleum almost one-third, and a whole slew of some 400 minor taxes comprising the remainder. The principal elements of internal revenues were progressively structured income taxes on persons and firms, specific excises on goods and services, and a gross turnover impost on transactions. From 1975-1981 collections from the internal revenue taxes averaged between 3% and 4% of GDP.

By mid-1985 inflation was running at a rate of over 20,000%, less than 10% of GDP was being collected in the form of taxes, international reserves were severely depleted, and real per capita GDP had fallen by more than 20% since 1980. Elections were held in mid-1985, one year ahead of schedule, and a democratically-elected center right coalition acceded to power. The new government almost immediately promulgated a series of economic reforms known as the New Economic Policy (NEP). These reforms freed interest rates and prices, unified the foreign exchange market, began the long process of public enterprise reorganization, lifted import prohibitions, established a uniform import tariff rate (which by August 1986 was set at 20% for all goods), and raised the domestic prices of hydrocarbons to international levels (a measure which by the end of 1985 elevated these hydrocarbon revenues to over 6% of GDP). Tax reform would wait until the next year.

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* The information contained in this article was compiled during the author's tenure as a Harvard Institute for International Development (HIID) Project Director in Bolivia's Ministry of Finance.

1. These countries include (with the initial tax reform date in parentheses) Bolivia (1986), Canada (1987), Colombia (1986), India (1985), Indonesia (1984), Jamaica (1986), Malawi (1988), New Zealand (1986), Philippines (1986), Puerto Rico (1987) and the United States (1986).
2. Julio Olivera, "Money, Prices, and Fiscal Lags: A Note on the Dynamics of Inflation", *Banca Nazionale de Lavoro Quarterly Review,* Vol. 20 (1967); Vito Tanzi, "Inflation, Lags in Collection, and the Real Value of Tax Revenue", *IMF Staff Papers,* Vol. 24, No. 1 (March 1977) at 154-167.

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Through early 1989 this stabilization cum liberalization economic reform package proved moderately successful. Hyperinflation was stopped cold; the inflation rates for 1987 and 1988 were 14% and 20%, respectively. There is no significant parallel foreign exchange market, and real money balances have increased. Nevertheless, the public sector's fiscal deficit, which had dropped to 4% of GDP in 1986, rose to 10% and 9% of GDP in 1987 and 1988 respectively. Although the banking system's deposits have increased, they are mostly short term and held in dollars, and the banking system faces serious liquidity and solvency problems. Real interest rates remain high, and the currency is overvalued by some 20-30%. Real GDP, which fell by 2.9% in 1986, rose by a weak 2.1% in 1987 and 2.8% in 1988.

II. BOLIVIA'S NEW INTERNAL TAX SYSTEM

From the viewpoint of 1986, Bolivia's existing tax system was functioning very poorly. It was replete with earmarking clauses which often drew no economic-financial link between the tax source and the earmarked beneficiary, and administrative corruption was rife. The decision was taken to completely scrap the existing tax structure and replace it with a greatly simplified system designed to reduce corruption and improve taxpayer confidence and compliance. Revenue raising and simplification objectives became primary; equity and economic effects were relegated to secondary status.

The new tax system was approved by the Legislature on 20 May 1986. All former national and municipal taxes were annulled (with the exception of those municipal taxes whose base did not overlap that of the newly created imposts and those taxes created by laws governing the taxation of mining and hydrocarbons). The internal tax code now consists of a mere 7 taxes.[3] Most revenue earmarking provisions were eliminated with the exception that regional development corporations, municipalities and universities now receive 10%, 10% and 5%, respectively of internal revenues and tariff duties. Customs duties (not part of internal revenues) were modified to a flat 20% rate for all imports, which implied a rise in tariff rates for capital goods and a lowering of rates for most consumer goods.[4] Tax debts were designated in U.S. dollars at the official (and varying) exchange rate in order to reduce late payment incentives if inflation becomes a significant factor in the future, and interest rates on tax obligations were set at market levels. Sanctions for tax evasion were strengthened in the form of fines and threatened jail sentences.

A. The taxes

The 7 taxes comprising the new internal tax system are 4 consumption taxes, 2 presumptive income levies and an inheritance and gift tax later added in March 1987. The consumption taxes are a flat 10% VAT which allows for no exemptions at all, a so-called complementary tax regime to the VAT which actually consists of a 10% withholding tax on most sources of income against which VAT payments can be deducted, a 1% transactions tax on gross value, and a number of excise taxes against sumptuary items. The 2 presumptive income taxes are represented by a 2% tax on the net worth of enterprises and a property tax at varying and progressive rates on land, structures and automobiles (with average rates at 2%).

The centerpiece of the new tax system is the VAT, which is applicable to the sales of all goods (except real estate, services, rents, and imports). Exports are exempt, and the VAT paid by exporters via purchases and imported intermediate goods is reimbursed under a negotiable note mechanism. To reiterate, not even the most basic goods and services in the household budget are legally exempt from payment of the VAT, although, in fact, the regressivity of a no-exemption VAT is greatly reduced at the lower end of the income scale by the reality that it is administratively difficult to tax unprocessed food and goods and services sold directly to consumers by individuals and microenterprises; this is especially true in rural areas.

Thus, the Bolivian VAT is of the consumption type imposed on the destination principle and employing the tax credit collection method. The tax is paid against the total value of the transaction, with the tax included in the value shown on the invoice. Against this tax-generated fiscal debit, the taxpayer is able to take a fiscal credit equal to the 10% tax paid on all purchases of domestically produced and imported goods and services. Tax payments are liquidated on a monthly basis. Given that the above-described VAT system, which uses tax registry numbers and requires an invoice for each transaction, is not easily applicable at the level of small firms, microenterprises, and individuals, a so-called "simplified system" for tax collection has been designed. It applies to small retailers of goods and services and to small artisans whose businesses generate an annual amount of sales and who possess capital goods below specifically defined amounts. These amounts are to be annually adjusted according to movements of the official exchange rate. Those subject to this system pay a fixed annual tax (prorated and actually liquidated every 2 months) in substitution of the VAT, the transactions tax, the net worth tax, and the complementary tax to the VAT. A similar type of fixed quota tax system (the so-called "integrated" tax system) applies to those engaged in public transportation activities.

The link between the structure and the implementation of the VAT and the 2 guiding principles of Bolivian tax reform (i.e. revenue generation and administrative simplicity) are clear. By the end of 1988 the VAT was already the principal revenue generator in the internal tax system (i.e. excluding customs duties and hydrocarbons taxes), yielding over half of the total internal tax revenues (see Table 3). Administrative simplicity is derived from the use of a single tax rate and the absence of exemptions.

The complementary tax regime to the VAT is actually a 10% withholding tax on salaries, rents, dividends, royalties, and professional income, and, as such, perhaps should not be classified as a consumption tax. Rather, it is an income tax. In fact, the real raison d'être of this levy is to ensure compliance with the VAT itself, since those subject to the 10% withholding are expected to demand receipts for their expenditures.[5] This tax, too, is liquidated on a monthly basis, and carryovers to future months (with the real value of the carryover maintained) are allowed. The only exemptions from the tax base that are permitted under this impost are social security system quotas and benefits and an amount equal to 2 minimum wages for salaried workers (on a monthly basis).

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3. The 1986 law also included a one-shot temporary tax – "regularización impositiva" – intended to update due tax bills, or a sort of tax amnesty. It took the form of a 3% net worth levy on individuals and businesses, and offered complete forgiveness on all tax obligations through 31 December 1985.
4. Legislation approved in 1988 lowered rates on capital goods imports to 10% and on other imports to 17%.
5. This is because full deductibility of all VAT payments is guaranteed upon presentation of valid receipts, thereby reducing or completely eliminating the income tax obligation.

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The 1% transactions tax falls on all natural and legal persons engaged in trade, industry, professions, and other types of business ventures, on rental and service activities, and any other act which involves the transfer of any type of property. The tax base is the gross monthly income generated by the above activities. Exemptions apply to those transactions carried out by governmental agencies, exporters, publishing houses and book importers, private educational institutions and diplomatic personnel. Salaries in the private and public sectors and interest payments are also exempt.

The specific excise taxes are levied against such traditionally taxed goods as alcoholic beverages, tobacco products, perfumes, cosmetics and jewelry, with rates varying between 30% and 50%. The taxes are paid by both importers and national producers of the products, and in the case of imported goods the tax base is the customs house CIF price, which excludes the VAT and the excise tax. In 1988 consumer durables were added to the list of goods subject to excises, and in 1989 it is planned to increase taxes on beer, automobiles and consumer durables.

The 2% net worth tax replaces the old system's net profits tax. This was done under the assumption that the probability of evasion is substantially reduced by targeting the concept of net worth (as opposed to net income), since for every liability a corresponding asset must appear in the firm's books. While the taxation of net worth could well create cash flow problems for the taxed firms, once again the reduction of tax fraud and the injection of greater simplicity are the overriding objectives. In a change from the past, this levy falls not only on private sector enterprises but also on public enterprises, the aim being to force greater operating efficiency on these quasi-governmental firms outside the scope of direct central government control. Exempt from this tax are non-profitmaking associations and institutions, housing cooperatives, and mining, hydrocarbon, and electricity enterprises, the latter are only exempted because they are taxed under other codes. The law dictates a series of norms to be used in the evaluation of assets acquired prior to and after 31 December 1985, and asset revaluation is to be carried out annually to take into account the rate of inflation and/or the rate of devaluation. Payment of the tax is annual.

The property tax falls on the properties of natural and legal persons, and is applicable on an annual basis to real property, automobiles, boats and airplanes. Certain types of real property are exempt (e.g. state lands and other real property, school areas). The tax is actually applied on 3 different scales to 3 different types of property: rural real property, urban real property, and automobiles, boats and airplanes. Rural property is differentiated into arable lands, structures and grazing lands; the tax on these forms of rural property was implemented in August 1989. Effectively, most small landholdings acquired under the agrarian reform are exempt from taxation, so that the 1% tax will fall on medium and large rural properties. In fact, those rural proprietors subject to this tax will also be subject to all 6 of the new internal revenue taxes. Three-quarters of these tax receipts are earmarked for rural development funds within the jurisdiction possessing the tax base. Tax rates on urban real property and on automobiles are mildly progressive.

B. Tax administration

Although legislative approval of the tax reform was achieved in May 1986, the central parts of the reform were not actually implemented until April 1987. This was due to the necessity of establishing the required administrative structures, regulations and codes. A new Ministry of Tax Collections (Ministerio de Recaudaciones) was created in January 1987, and disbanded in late 1988, when it was folded back into the Ministry of Finance. This office, which had been in charge of tax collections under the now defunct tax structure, had a long and sordid history of bribe taking. The new but ephemeral Ministry absorbed the functions and took control of the Internal Revenue Office, restructuring it and placing new personnel in key positions.

A tax system is only as good as its ease of implementation and its administration. In Bolivia, not only was a new and simplified tax structure put in place, but a number of critical measures aimed at improving and strengthening tax administration were taken.

Perhaps the most significant measure implemented is that payment of most taxes is now made through the banking system. Prior to the reform, each taxpayer had to go to the office of Internal Revenue to pay taxes, and for all of La Paz (population one million) there was but a single office. In addition to the congestion caused, the "give and take" between the taxpayer and the tax inspector led to a great deal of corruption. While it is true that the system of paying taxes via the banking system is not entirely new (some taxes had been so paid since the 1970s), the probabilities for "negotiations" between tax inspectors and taxpayers have been reduced, for the bank merely acts as collection agent. On the negative side, since the bank only acts as an intermediary and collects the stated debt without questioning its amount, verification still remains a job for tax inspectors. The banks, of course, receive a fee for each processed tax declaration, and are supposed to send the Internal Revenue Office the information tapes within a span of 10 days; currently there are prolonged delays at both ends with respect to the processing of this information.

Verification procedures have been modified and strengthened, especially with respect to the VAT. After blocking out a sample of businesses, university students hired on a part-time basis are used to carry out fiscal inspections. Internal Revenue personnel are not used, given the possibility that they are corruptible (their salaries are around 100 dollars per month). Each fiscal inspection may be combined with police support and perhaps with a customer who has just left the premises. If fraud is suspected a priori, 2 inspectors and the police can be present. Proven fraud is (and has been) penalized by closing the business.

Another key element of tax administration has been the creation of a new single tax registry (registro unico de contribuyentes). Under the old registry, although tax files existed for each taxpayer, there was no matching of registry numbers between taxes. The present registry corrects this problem. Tax forms have been shortened and distribution of the forms is more widespread. Within the Internal Revenue Office, a structural reorganization has made it easier to reach collection goals, and an employee bonus incentive system for surpassing collection goals has been implemented.

III. AN EVALUATION OF BOLIVIA'S TAX REFORM THROUGH EARLY 1989

It may seem premature to evaluate a tax reform that was legislated only 3 years ago and was not actually implemented until 2 years ago. Nevertheless, the positive and the negative features of the reform merit comment.

On the positive side of the ledger, the new internal revenue tax system is functioning more than reasonably well. The

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TABLE 1

Bolivia: Central government taxes as proportion of GDP
1976 - 1988

Year	(1) Overall tax ratio	(2) Internal revenue taxes	(3) External revenue taxes	(4) Total (2)+(3)	Taxes on hydro-carbons
1976	10.8	3.6	3.7	7.3	2.2
1978	11.4	3.8	2.6	6.4	1.4
1980	9.6	3.1	2.1	5.2	1.5
1981	9.2	3.0	2.1	5.1	2.8
1982	4.8	1.9	1.0	2.9	1.2
1983	2.8	1.5	0.4	1.9	0.4
1984	3.3	0.8	0.6	1.4	0.4
1985	10.1	1.3	1.6	2.9	6.5
1986	13.2	3.2	1.9	5.1	7.5
1987	17.4	5.1	2.6	7.7	8.6
1988	17.5	6.3	2.1	8.4	8.8

Source: Ministry of Finance of Bolivia, Undersecretariate of Tax Collections, work sheets: SAFCO. March, 1989.

TABLE 2

Bolivia: The structure of central government current revenues
1976 - 1988
(Percentages)

Year	Internal revenue taxes	External revenue taxes	Mining taxes	Hydro-carbon taxes	Other tax and non-tax revenue	Total
1976	30.3	23.0	11.5	15.9	19.3	100.0
1978	33.2	23.0	18.1	12.7	13.0	100.0
1980	32.6	21.7	16.1	15.7	13.9	100.0
1981	32.0	22.9	6.2	30.2	8.7	100.0
1982	39.9	20.0	9.1	24.3	6.7	100.0
1983	52.5	15.2	4.0	12.7	15.6	100.0
1984	24.4	18.0	27.6	12.2	17.8	100.0
1985	12.8	15.4	2.7	64.8	4.3	100.0
1986	24.0	14.1	0.2	56.7	5.0	100.0
1987	29.5	15.1	0.4	49.7	5.3	100.0
1988	35.8	11.9	0.4	50.1	1.8	100.0

Source: See Table 1.

VAT has already taken its place as the linchpin of the system, as during 1988 it generated 55% of internal revenue income and reached 3.5% of GDP. Moreover, the complete system of the 6 internal revenue taxes comprised over 6% of GDP for all of 1988 (see Table 1), placing the tax ratio of internal revenue levies well above that of the early 1980s and light years ahead of the 0.8% registered in 1984. Behind these tax ratio increases are ongoing efforts to improve tax administration processes, with external aid being provided by some international organizations. In 1988 a new unit to fiscalize large taxpayers (who generate more than one-third of internal revenues) was created, and, as previously stated, a rural property tax was recently implemented. Taxpayer consciousness and compliance have markedly improved, as certain sanctions (e.g. the closing of firms for non-payment of VAT) have actually been applied. Clearly, the public sector's willingness to tax and enforce compliance has been strengthened and maintained, and future progress on the administrative front will depend upon maintenance of this commitment.[6]

On the negative side, the internal tax system remains a

TABLE 3

Bolivia: Central government gross current revenues
1988

Revenue source		Amount, millions of bolivianos	Percentage distribution
I.	Internal revenue taxes, total	630.2	35.8
A.	Value added tax (VAT), total	348.3	19.8
1.	State petroleum company (YPFB)	75.8	4.3
2.	Imports	144.0	8.2
3.	Internal consumption	128.5	7.3
B.	Complementary tax regime	48.4	2.7
C.	Business net worth	28.4	1.6
D.	Specific excises	45.9	2.6
E.	Transactions	58.4	3.3
1.	General	50.9	2.9
2.	State petroleum company (YPFB)	7.5	0.4
F.	Simplified tax regime	4.6	0.3
G.	Integrated tax regime	2.9	0.2
H.	Property taxes	51.6	2.9
I.	Others	41.7	2.4
II.	External revenue taxes	208.9	11.9
III.	Hydrocarbon taxes	883.9	50.1
A.	Internal market	399.5	22.7
B.	External market	484.4	27.5
1.	Cash	205.8	11.7
2.	Countertrade (Argentina)	278.6	15.8
IV.	Mining taxes	7.6	0.4
V.	Transfers from public enterprises (excluding YPFB)	19.2	1.1
VI.	Others	12.9	0.7
TOTAL		1,762.7	100.0

Source: SAFCO, March 1989.

minority partner as a generator of total taxes in Bolivia. As is apparent from Tables 1, 2, and 3, Bolivia's central government current revenue structure continues to strongly depend upon hydrocarbon taxes, a position gained by these imposts in 1985 when domestic hydrocarbon prices were adjusted to international levels. In 1987 and 1988, half of total central government tax revenues were derived from these levies[7], and given the government's policy of maintain-

6. Another indicator that the strengthening of tax administration procedures is having a positive effect is that the internal revenue projections for the 1989 budget included a 12% upward adjustment factor based precisely upon administrative improvements.

7. There are 2 basic taxes on hydrocarbons which generate revenues for the central government coffers. For hydrocarbon output that is marketed domestically, 19% of the output value at wellhead (volume times the international price) goes to the central government, another 12% is allocated to the regional development corporations, 10% (less the state petroleum company's fiscal credit) is paid as the VAT, and 1% represents the transactions tax. Of that portion of output marketed externally, 50% of the gross proceeds flow to the central government, 11% to the regional development corporations, and the remainder to the state petroleum company. Given the revenue distribution of proceeds from the domestic marketing of hydrocarbons, it becomes readily apparent that hydrocarbon taxes actually generate a higher percentage of central government current income than the 50.1% for 1988 that appears in Table 3. After adding to this 50.1% the VAT and the transactions tax paid by the state petroleum company, the proportion of total central government current revenue directly generated by hydrocarbons output in 1988 amounted to 54.9%.

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ing the average of petroleum product prices constant in terms of U.S. dollars, there will be little future slackening off of their importance.[8] However, the hydrocarbon taxes represent transfers from the state petroleum company, thereby hampering the financial position of this truly key state enterprise in its future operations and exploration efforts. On the tax administration front, although efforts to this juncture are certainly praiseworthy, Ministry of Finance officials agree that far more money should be poured into the continued strengthening of activities, especially those relating to coercion. Moreover, very little, if any, money is presently available to the ministry for informative activities such as the placement of advertisements in newspapers. The administrative cost of tax collection is currently running at 3.5% of collections, a figure which can certainly be lowered. The salaries of tax inspectors remain abysmally low, reopening possibilities of increased future corruption.

There are 2 other issues which will have to be resolved. Tax co-participation under the reform allocates 20% of internal revenues and customs duties to the municipalities and the regional development corporations. However, the present distributive formula is based on taxpayer residence or location, meaning that the rich get richer. The second issue deals with the perceived "fairness" of the internal tax system, as there exists a gnawing sentiment that the tax structure is not progressive enough, due in particular to the 10% VAT with no exemptions. Exactly what form tax modifications might take is mere speculation, but if they involve the introduction of multiple VAT rates or exemptions on specific goods and services the very cornerstones of the reform, i.e. simplicity and income generation, will be compromised.

In the final analysis, the success of tax reform may well depend upon the success of the New Economic Policy. Both are linked to the very nebulous concept of "willingness to tax", for without sufficient tax revenues the fiscal deficit will once again become bloated, and unjustified monetary emission will result. Both the NEP and tax reform benefited from strong domestic political leadership, a large influx of resources from international organizations, and a hyperinflationary/instability weary populace. With the change of government in August 1989, these underlying factors also may change.

8. This policy measure has not been followed since late 1988 due to the politics of the May 1989 elections.

Conference Diary

FEBRUARY 1990

Wat is een Bedrijf Waard? Overname en waardebepaling van ondernemingen. Amsterdam, 2 February (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

Steueroptimale Gestaltung der Unternehmen (Arbeitsseminar). Cologne, 5-9 February (German):
Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

Het Financiële Instrumentarium van de Leveraged Buy-out. Bussum, 6 February (Dutch):
Studiecentrum voor Internationaal Management, World Trade Center, Strawinskylaan 331, 1077 XX Amsterdam, The Netherlands.

Corporate Tax Structuring in the 1990s; The European Community Challenge. London, 12-13 February (English):
Clare Lally, Legal Studies & Services Ltd., Bath House, 56 Holborn Viaduct, London EC1A 2EX, United Kingdom.

Negotiating and Implementing Joint Ventures and other Business Arrangements in the U.S.S.R. New York, 12-13 February (English):
National Foreign Trade Council Inc., Conference Secretariat, 2828 Wisconsin Ave., NW. Suite 301, Washington, DC 2007, U.S.A.

International Company Lawyers Conference / Conférence Internationale des Juristes d'Entreprise. Rome, 21-23 February (English, French):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

Werken over de grens. Rotterdam 22 February (Dutch):
Kluwer Seminars, Antwoordnummer 424, 7400 VB Deventer, The Netherlands.

International Tax Planning Conference – Current issues for practitioners in the Field of International Tax. London, 22 February (English):
Tolley Publishing Co. Ltd., Conference Department, FREEPOST, Tolley House, 2 Addiscombe Road, Croydon, Surrey, CR9 9EA, United Kingdom.

Latin America: How new Administrations will meet the Challenges. Third biennial Conference. London, 22-23 February (English):
International Herald Tribune, Conference Office, 63 Long Acre, London WC2E 9JH, United Kingdom.

MARCH 1990

The Tax Treatment of International Capital Markets Transactions. London, 12-13 March (English):
International Tax Academy, c/o International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

APRIL 1990

The Third East-West Tax Conference. Warsaw, 19-20 April (English, German):
International Tax Academy, c/o International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

MAY 1990

9th National Convention of The Taxation Institute of Australia. Adelaide, 4 May (English):
Ann Ewer, Convention Co-ordinator, 9th National Convention of the Taxation Institute of Australia, P.O. Box 232, Kensington Park, S.A. 5068, Australia.

Leasing – Flexible Off-balance Sheet Financing, Achieving Fiscal Advantages, Effective Sales Aid. Brussels, 8-11 May (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

AUGUST 1990

44th Congress of the International Fiscal Association. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125. 3001 DE Rotterdam, The Netherlands.

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JAMAICA:

Tax Reform: Evaluation and Lessons

Roy Bahl

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The Government of Jamaica implemented a major reform of its income tax structure in 1986. A complicated, narrow-based individual income tax, levied under a progressive statutory rate structure, was replaced by a broad-based, flat rate tax. The top marginal rate was reduced from 57.5% to 33⅓%. In 1987, the company income tax was also simplified and its rate reduced from 45% to match the new individual income tax rate. A new property tax roll was introduced in 1986 and the tax rates were rolled back to cushion the shock. To keep step with the structural reform, the organization of the Revenue Services was revamped, a comprehensive programme of revenue agent training was established, and a full computerization of the tax administration is well underway.[1]

The programme appears to have been a success. The structural reform gained general acceptance from the public, Government revenues increased (in spite of the nominal tax rate reductions), – the performance of the business sector of the economy improved, and there was a noticeable improvement in tax administration. Jamaica's comprehensive reform programme is not yet complete. A general consumption tax of the value added type has been designed to replace much of the present, complicated system of 5 separate indirect taxes, and a total overhaul of the payroll system tax has been proposed. In both cases the emphasis is on simplification, removing the tax influence of economic decisions, fairness and revenue neutrality.[2]

The purpose of this article is to describe the tax reform programme, provide a first, ex post evaluation of its success, and to suggest the lessons from the experience that could be useful to fiscal planners in other developing countries.

THE ECONOMIC AND POLICY SETTING

The Jamaica case may dispel a longstanding myth about comprehensive tax reform: the proposition that it cannot take place in a weak economic setting. Severe economic problems had to be confronted during the period of the Jamaican tax reform, and the Government could not keep its attention focused solely on restructuring its tax system and improving its administrative set-up. The following will give some idea of the calls on economic policy during this period:

- There was a serious exchange rate disequilibrium which eventually led to a major devaluation of the Jamaican dollar in November 1983.
- The bauxite industry collapsed, depriving the Government of a major foreign exchange earner. The performance of tourism, the other major foreign exchange earning sector, was spotty.
- There was a substantial Government deficit (around 8% of GDP in 1985). This is an especially important policy issue because the Government is a major employer of unskilled workers, hence expenditure retrenchment (vs. revenue increases) would be a very difficult path.
- There was a heavy debt service burden, averaging over 45% of export earnings in the mid-1980s.
- Both the inflation rate and the unemployment rate remained high during most of this period.
- The International Monetary Fund (IMF) and the World Bank brought pressure on the Government to take drastic measures to control the size of the fiscal deficit and to reform its tariff structure.
- It was reasonable during this period to suppose that a U.S. tax reform was in the offing, and that a lowered U.S. corporate tax rate would force a reduction in the Jamaican corporate tax rate.

In short, there was a great deal of pressure to find ways of raising more revenue to solve some of the Government's immediate problems and this seemed incompatible with the goal of developing a structural reform that would gain broad public support and stimulate new private investment.

But not all was negative. Prime Minister Seaga was elected in 1980 with a mandate to "free-up the economy", and there was much to free up. The foreign trade sector was charac-

1. The tax reform project was carried out jointly by the Revenue Board of the Government of Jamaica and the Metropolitan Studies Program of the Maxwell School of Syracuse University. The co-directors of the Project were Canute Miller, Chairman of the Revenue Board, and Roy Bahl, Maxwell Professor of Political Economy at Syracuse University. The research staff included Jamaica's top tax analysts and several of the most experienced public finance scholars and practitioners in the world. A set of the 37 staff papers from the project is available from the Metropolitan Studies Program, Maxwell School, Syracuse University, Syracuse, New York 13244-1090; and *The Jamaican Tax Reform* is forthcoming from Oegleschlager, Gunn and Hain of Boston.
2. Michael Manley became Prime Minister in early 1989 and one of the first steps of his administration was to label a Ministry Paper proposing adoption of a general consumption tax. Details of the proposal have not yet been worked out.

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terized by quotas and licensing to restrict imports and to compensate for an overvalued Jamaican dollar. An inherited import substitution growth strategy and a very complicated tariff structure were in place, and there were substantial price controls, Government ownership of some traditionally private sector activities, and very high marginal income tax rates. The Prime Minister's economic strategy of replacing Government controls with market forces fit very well with a structural tax reform programme designed to "get the prices right". Moreover, the Seaga administration won an overwhelming majority in Parliament in a 1984 election. This enhanced the possibilities of eventually passing a tax reform bill. Another stimulus to action came from the external donors – the U.S. Government, the World Bank and the IMF – all of whom were enthusiastic about Jamaica's plans for tax reform. Finally, the Jamaican tax system had become so onerous, so obviously unfair and so out of control that there was substantial public sentiment for a major overhaul. In many ways, then, the time was right for tax reform.

Tax policy strategy

At the outset of the Project, assessment of Jamaica's tax problems pointed to 3 issues. First, taxes were too high. Taxes were too high by comparison with other countries at similar levels of income and foreign trade. More important, however, is that the Jamaican system taxed such a narrow base that the nominal average and marginal rates had to be very high to generate an adequate revenue yield. For example, a value added tax, equal in yield to the present indirect tax system and using the same exemptions as existed in 1983, would have required a rate of about 20%; the top marginal personal income tax rate was 57.5% (not including payroll taxes) and was reached at the relatively low income level of J$ 14,000.[3]

The second basic problem was the tax structure. It was complicated and therefore difficult and costly to administer and there were important disincentives inherent in the rate and base structures. Interest was tax-free but dividends were taxed twice, there was a high income tax rate on formal sector (PAYE) labour income but the self-employed went virtually untaxed, the high marginal tax rates produced a substantial incentive for evasion and avoidance, many types of imports were exempt from the indirect tax system, and so on. The system was also characterized by a poor enforcement which compounded the inequities. The problem was simply that the Jamaican tax structure had evolved over a period of time – as much because of year-to-year pressures to solve budget deficits as for any other reason. By 1983 the issue was clear: the Government had gone as far as it could with piecemeal tax reform and the time was right for a comprehensive overhaul of the tax structure.

Third, the administration of the tax system was weak. There were too few trained tax administrators, salaries were not competitive with the private sector and there was limited opportunity for advancement. These administrative problems were heightened by the complicated system which was difficult to administer in any case, and by outmoded procedures. For example, there was no manual for income tax administration, nor were there procedures in place to assess the self-employed or to use third party information to detect non-reporting or under-reporting. Audit activities were limited and not productive, and the administration of the income and payroll taxes was not integrated. Finally, the administrative system was not fully computerized and there was general disarray in the record-keeping.

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In the face of this assessment of problems, the Project took the view that the highest priorities were (a) simplification of the system, and (b) making the tax structure more neutral with respect to consumer and investor choices. The policy direction of these objectives is clear: establish broader based, flatter rate taxes that are more easily administered. The basic hypothesis is that the price effects introduced by non-neutralities in the Jamaican tax system do matter, i.e. the tax system has contributed to a reduced work effort, increased capital and labour mobility from the formal to the self-employed sector, thin capitalization of companies, capital flight, low investment relative to consumption, high retained earnings relative to distributions and a larger underground economy.

The Project did not take the view that the correct tax reform strategy was to develop a system that would lead and "fine tune" economic policy. The general position taken was that the market and not tax treatment should dictate business and individual economic decisions, and that, in any case, the present administrative system could not carry the implementation of such a programme. Experience with the existing system, which is in more of an interventionist tradition, was that the goals of the present, complicated structure were not being achieved anyway: progressive rate structures were not generating a progressive distribution of tax burdens, complicated provisions for payroll taxes of the self-employed could not induce them to make payments, tax incentives for overtime were being abused and not leading to increased overtime work, a system of non-taxable perquisites had become a major loophole rather than a tax relief and was beyond the control of the income tax administration, etc.

This assessment of problems and definition of objectives of the Project led to a 3-part programme for the tax reform: policy analysis to restructure the system, improved administrative procedures and the establishment of a training programme. The basic tenet of the Project was that the reform should be comprehensive and that the administrative improvements should be designed to be compatible with the policy changes. To try to improve the administration of a system so deficient as that in Jamaica clearly would have been counterproductive.

Individual income tax

The individual income tax base, in theory, included all sources of income except bank deposit interest. In practice, there was no tax on capital gains and most self-employed income was outside the tax net. There were 2 rate structures – depending on whether income was above or below J$ 7,000. The top marginal rate was 57.5%. When payroll taxes are taken into account, the marginal tax rate on a Jamaican income (J$ 14,000) was well in excess of 60%. There was no standard deduction but taxpayers could qualify for 16 separate tax credits. These credits had been added to the tax system over a period of years for purposes that ranged from personal allowances to stimulation of savings and home ownership, and even employment of helpers in the home. Because the credits were not indexed to inflation, their value had substantially eroded during the early 1980s. The income tax administration did relatively little monitoring of the credit system.

The base of the tax was further eroded by the practice of permitting employers to grant non-taxable perquisites ("al-

3. The average exchange rate when the income tax reform was constructed in final form in 1985 was US$1 = J$ 5.56.

lowances") to employees. These perquisites were a matter of negotiation between employer and employee (including Government ministries) and it was not required that they be reported to the Income Tax Commissioner. There was a great deal of speculation about the magnitude of allowances – some prominent Jamaican analysts speculated that the allowance-taxable wage ratio averaged as much as 40%.

The analysis of reform options required first estimating the number of taxpayers, taxable incomes, non-taxable perquisites and tax credits – all by income class. This was done by drawing a large random sample of Jamaican taxpayers and manually recording data on taxable income, tax credits, tax liability, etc. from the files on each employer and each individual. The Prime Minister organized a special survey of employers to estimate the value of non-taxable allowances by income bracket. This was supplemented with a sample survey of a large number of self-employed individuals to determine the extent of evasion by non-reporting. The results of this analysis indicated that about half of potential individual income tax liability was not covered in the tax net. Moreover, higher income Jamaicans – many outside the PAYE system – tended to avoid or evade a substantially higher percentage of their tax liability than did lower income families. The progressivity of the statutory rate structure was all but negated by evasion and avoidance.

Simulation of alternative rate and base structures, with a revenue neutral target in mind and with simplification and neutrality as primary objectives, led to the following reform programme:

- Replace the present graduated rate structure with a flat rate of 33⅓%.
- Replace the 16 tax credits with a standard deduction of J$ 8,580 per year.
- With a few exceptions, bring all non-taxable allowances into the base.
- Include bank deposit interest (above a low ceiling) in the income tax base.

The Government enacted this programme after a Tax Reform Committee of private sector citizens spent several months scrutinizing and amending the proposals. The Committee, comprised of union, business and public interest group representatives, reached consensus that the flat tax seemed more fair than the present system and recommended its adoption to the Prime Minister. The income tax reform became effective at the beginning of 1986 and was almost totally operative by the end of the first quarter.

Company income tax

Prior to the reform, companies paid a basic rate of 35% plus an "additional tax" of 10%, but the additional rate could be offset against withholding tax on dividends. To complicate matters further, there was separate treatment for agricultural companies, incentive firms and financial institutions.

This system led to 3 basic problems. First, the tax was complicated, not easily administered, and unfair to certain types of firms. Second, it discriminated in favour of debt and against equity finance, in favour of retaining rather than distributing earnings, and against risk taking. The "optimal" dividend distribution rate for a firm was about 27% of profits – above this amount "additional" profit tax liability would be due. Moreover, in the eyes of investors, dividends were taxed twice whereas interest received from savings accounts was not taxed at all. Third, the reduction in the top individual income tax rate to 33⅓% and the reduction in the U.S. corporate rate brought new pressures to lower the company tax rate.

The Government enacted a comprehensive reform of the company tax in 1987. The tax rate was reduced to 33⅓% and the "additional tax" was eliminated. This removed the disincentive to larger dividend distributions, and though the Government did not eliminate the preferential treatment of retained earnings, it did bring interest income into the tax base thereby removing another disincentive to equity finance. Full loss carry-forward was introduced, removing some of the bias against risk-taking, and branch and subsidiary companies were given an equal tax treatment.

The Project's proposal to exempt dividends from personal tax liability was rejected. The Government instead decided on a separate entity approach whereby company profits and dividends each would be taxed at 33⅓%, thus passing on the opportunity to fully (and simply) integrate the income tax. Why would such an opportunity be passed? One reason given was that the Government was in a crucial stage of its negotiations with the IMF and under pressure to minimize the revenue cost of the reform package. Another explanation is political, i.e. the Government's sensitivity to the growing public perception that it had become the party of the "big man". The Government was still feeling the criticism over the taxation of interest income that had been introduced, along with steep cuts in the marginal personal income tax rates the year before. There also was the problem of explaining to the public the difficult concept of integration.

Property tax

Relative to the amount of revenue it raises, the property tax is the most politically sensitive tax in the Jamaican system. In fact, the problems with the property tax in Jamaica are not primarily structural. The structure of the tax itself is one that, properly implemented, could serve as a model for other countries. For a number of years, however, the Government was unwilling to operate the tax according to the law with the result that it became negligible in revenue yield and unfair in the distribution of burden it imposed.

The base of the property tax is the unimproved market value of land, i.e. the value of raw land, or the value of a parcel of developed (improved) land as it would be if there were no structures on the site. The valuation roll is to be updated every 3 to 5 years, though in practice it is much less frequent. There are 3 important classes of preferential rate treatment or exemption: agricultural properties, hotel properties and low value properties. In effect, Jamaica's is a classified property tax with lower rate schedules applying to agricultural and hotel properties.

About 60% of Jamaica's 550,000 parcels have land values less than J$ 2,000 (about U.S.$ 500 in 1984), and are subject to a nominal property tax charge of J$ 5 per year. The remaining properties are taxed according to a rate structure that is progressive in terms of land value, rising to 4.5% on a site value of J$ 50,000.

The revenue yield from the tax has fallen over the past decade from a little over 5% of total revenues to about 2%. This decline occurred principally because the schedule of assessed values was not changed between 1974 and 1986. The property tax is a central government levy in Jamaica, and local governments do not share explicitly in the revenue yield.

There are 2 problems with the property tax as it has been practiced in Jamaica. The first grows out of the failure of the Government to bring in a new valuation roll for 12 years, and the second has to do with inadequacies in the

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day-to-day administration of the tax. More debatable as "problems" are whether the progressive rate structure discourages compliance, and whether the improved value of property would be a more appropriate base.

Before the 1986 reform, the taxed base was the 1974 value of sites. Because this base was fixed for over a decade, the yield from the property tax fell to its negligible present position in the revenue structure. This lack of buoyancy created a number of problems:

- The low revenue yield puts that much more pressure on the individual income tax and indirect taxes to carry the revenue load.
- Landowners are undertaxed relative to labour and owners of capital. This discriminatory practice fits neither the economic nor the social policy of the Government.
- Landowners were not taxed according to the present values of their properties, but according to the 1974 values. Because the pattern of land values has changed dramatically during this period, the resulting distribution of tax burden is unfair.

Finally, there are problems with the administration of the property tax. Consider the following:

- The collection rate for the property tax is only about 60%.
- The collection cost is equivalent to about 12% of revenue collected.
- There are no reliable records on derated properties, i.e. no list of the total number that receive preferential treatment, the nature of the preference, etc.
- About one-third of the sites on the roll do not have any coding as to use.
- Total property tax arrears are equivalent to over 2 years revenue yield.

The Project and the Tax Reform Committee considered a number of options for reforming the property tax, and recommended the following:

1. The land value base should be maintained.
2. The revenue from the property tax should be 3 times the present level. This would restore the property tax to the revenue level it would have achieved if its base had been kept up to date.
3. The 1984 valuation roll should be adopted, and a flat rate should be applied to all land with value in excess of J$ 6,000. This would keep about 60% of properties off the roll. To avoid tax shock, it is advisable to phase this new system in gradually, by even increments over a 3-year period.
4. Agricultural and hotel derating should be eliminated or substantially cut back.
5. The administrative system should be completely overhauled, with particular emphasis on (a) improving collection procedures and record-keeping, (b) developing a sales data bank that would permit assessment-sales ratio studies, (c) indexing land values to update the valuation roll between general revaluations, and (d) monitoring relief and derating in a more systematic way.

The Tax Reform Committee generally accepted these recommendations in proposing a tripling of the revenues to be accompanied by an equal amount reduction in the income tax, the bringing in of the 1984 roll, the retention of the land value basis, and a 3-year period to phase in the reform. The Committee was silent on the issue of derating and held to the present progressive rate structure.

The Government followed the recommendations to bring in the new land value base and to roll back the tax rates so as to minimize the amount of tax shock. The derating programme for agricultural and hotel properties was continued. On the subject of the next revaluation, the Government committed to work on an indexing system, but little progress has yet been made. The reform programme, enacted in 1986, has been a mixed success.

Revenue growth nearly reached target amounts after 2 years, thanks in part to significant administrative efforts. However, the Government responded by freezing the nominal rates at the 1986 level which probably guarantees that the property tax will remain at approximately 2% of revenues.

As in all countries, property taxation draws criticism from the public that it is far out of proportion to the amount of tax burden involved. This was also the case in Jamaica. One possible reason for the opposition is that it is a national tax and therefore the financing link to specific local services cannot be easily seen. Another is that the Government was unsuccessful in convincing voters that one price of the popular income tax rate reductions was an increase in the property tax.

A successful income tax reform?

No effort has yet been mounted to systematically monitor the impact of the flat tax reform. The major problem, of course, would be to try to separate the effects of tax changes from the effects of everything else that is affecting the Jamaican economy. Still, from the macro evidence, there is some indication of success. Perhaps the best indicator is the lack of any continuing public discontent with the income tax reform. The press was not critical, the political opposition did not raise substantial objections – even during the recent national elections, labour seems to be pleased with the relatively high standard deduction and with the fairness of a flat rate, and the business community clearly has benefited from the lower company tax rate. To be sure, there was initial resentment to taxing interest income – this led to exemption from small deposits – and there was the expected grousing from special interests about the loss of tax preferences. The important point, however, is that the public adjusted to the initial shock of the change and though taxes are never as low or even as fair as citizens would like, the new system would appear to be much more palatable than the previous one.

Did the income tax reforms stimulate the economy after 1986? Something did. Corporate profits rose – through August 1987, the 16 largest listed companies reported post-tax profits 84% higher than the same period in the previous year. The Jamaican stock exchange had record growth during 1986 and 1987. The market index went from 941.5 at the end of 1985 to 1499.8 at the end of 1987 and stood at 1757.7 in 1987. Of course, the tax reform is only one of the number of positive factors that affected the Jamaican economy. The interest rate dropped from 93% at the beginning of 1986 to 16.7% in 1987. The real growth in exports was up by 10.3% in 1986 over the 1980-1985 period average and real GNP increased by 2.1% in 1986. The rate of inflation declined from 25.7% for all of 1985 to 15.1% for 1986, and was running at 7.1% for the first 5 months of 1987. On the basis of available evidence, no one could argue the extent to which these changes are due to the tax reform, but many would be prepared to argue that so favourable a perfor-

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mance of the Jamaican economy could not have taken place under the old regime.[4]

The revenue neutrality target of the reform was attained, perhaps even surpassed. Comparing the same quarter in the first year of the reform (1986) with 1985, PAYE collections were up 9.7%, and in 1987, the same comparison shows a 17.9% increase over 1986. Total company and personal income taxes in the second quarter of 1987 were about 18% above second quarter 1986 collections – a substantial increase in real terms. Some part of this increase no doubt is due to administration. The simpler income tax system has made it possible for the income tax department to concentrate more on enforcement of the system and there is evidence of a more effective audit and examination activity. More vigorous audit activities have led to a tripling of additional taxes and penalties in 1987 over 1986.

There is also a question of the fairness of the new reform. The Project has estimated that the combination of the lower, flat rate, the J$ 8,580 standard deduction and broadened base did not worsen the regressivity of the system and, indeed, that improved administration holds the promise of making the new system more progressive than the old.

The structural reform stimulated administrative improvements. The revenue services have been reorganized to better integrate assessment and collections; an extensive training programme for revenue agents has commenced; a number of courses for income tax assessments and collections have been successfully completed; and computerization of the revenue services is now well under way.

The reform is not without problems – no reform ever is. Perhaps the major problem is that the door was left open for abuse of certain perquisites to avoid income tax payment – the housing allowance, the travel allowance and uniform allowances. There already appear to be some misuses of these provisions for non-taxable income and if they continue to grow they could compromise the fairness of the new structure and bring pressure for a rate increase. Another important problem was that provision was not made in the original reform package to index the standard deduction. The result was "bracket creep" in the sense that real economic growth on the island pushed many taxpayers from the zero to the 33⅓% bracket. However, just prior to the 1989 elections, the non-taxable threshold was increased from J$ 8,580 to J$ 10,400. This approximately "indexed" the individual income tax for the 1986-1988 period and dropped 32,000 potential 1989 taxpayers from the roll, at a revenue cost of J$ 106 million or about 20% of projected revenues.

The Jamaican tax reform is in its early stages and is fragile. Indications are, however, that its early performance has more than lived up to expectations. The objectives of creating a simpler system that is more easily administered and has fewer price distortions appears to have been achieved. This has been done without compromising revenue yield and, using the Project's estimates, without having unfavourable effects on the distribution of tax burdens.

THE UNFINISHED AGENDA

A sweeping reform of the present system of indirect taxation has been designed but not yet implemented. Presently, there are 5 separate indirect taxes: (a) consumption duty, the most important revenue component of the system, is levied on the value of imported and domestically produced goods and is collected at the import and the manufacturing stage; (b) retail sales tax and excise duties which are insignificant in terms of revenues raised; (c) customs duty which is a relatively small revenue source by international standards; and (d) stamp duty on inward customs warrants which has become a major fiscal instrument. This system is overly complex, distorts economic choices, is income inelastic and badly administered.

The Project proposed that a general consumption tax replace the present system. The base of the tax will include importers, manufacturers and large distributors, with the value added feature of allowing a credit for taxes paid on inputs. Exporters would be zero-rated (no tax would be due on value added *and* all taxes paid on inputs would be refunded) and the major consumption items for low income families would be excluded from tax, but otherwise there will be few exemptions. This should lower the costs of administration and compliance, make the system less horizontally inequitable, and eliminate some unintended effects on methods of doing business. For reasons of administration, much of the service sector will be outside the base, as will small, handicraft-type manufacturers, smaller distributors and all but the largest retailers. It is proposed that the present system of taxing cigarettes, petroleum products and spirits remain unchanged for the time being in order to protect revenue and minimize the amount of disruption associated with the reform.

The other unfinished part of the reform is the payroll taxes. There are 2 major problems that the Government needs to address with structural reform. The first is the narrow base on which the payroll taxes are levied and consequently the high nominal rates of tax. The second problem is that administration of the 5 different payroll taxes is fragmented and there is little coordination among the programmes. The Project recommended that payroll tax reform should concentrate on simplification of the system, a broadening of the tax base and a lowering of rates, and a general overhaul of the administration of these 5 taxes.

At the time of the income tax reform in 1986, the rate of payroll tax contribution was frozen, and at the time of this writing, no permanent improvements have been made.

LESSONS FOR TAX REFORM

The Jamaican tax Project was a rare opportunity for comprehensive tax reform in a developing country. The mandate at the outset called for a restructuring of the tax system to fit a new economic programme of a newly-elected administration, and the Project was given substantial latitude in defining the coverage of the work. The experience in Jamaica provides a real-world setting in which to rethink some of the principles of tax reform and tax policy analysis in developing countries. In some cases, old lessons were relearned. But the Jamaica experience also suggested some areas where the conventional wisdom ought to be challenged.

1. A comprehensive reform of the tax structure can be carried out when the economy is performing poorly

There is a sense that something must be done and tax policy is one area where the Government can take aggressive action. In such times, it is easier to focus the attention of policymakers on the structural problems within the entire

4. Prime Minister Edward Seaga, relating the tax project to the improved performance of the economy, said: "This year we are experiencing the highest levels of growth that the country has enjoyed since the early 1970s", *Daily Gleaner,* 10 October 1987.

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tax system and to think through the ways in which the tax system may be retarding economic growth.

Jamaica's tax reform project began when the economy was in dire straits: real GNP was declining, a devaluation was quite clearly in the immediate offing, the external debt burden was heavy and the country was under pressure from the IMF and World Bank to reduce its budget deficit and limit domestic borrowing, and the unemployment and inflation rates were at high levels. Things were bad enough that the Administration and the general public were in agreement that nothing short of a complete overhaul of the tax system would do.

2. Comprehensive reform can take place only if the system is shocked

The conventional theory suggests an incremental approach to tax reform, i.e. it argues that if the existing system is shocked too much, it will compromise the success of the proposed reform. While there is wisdom in this argument, the Jamaica experience suggests not only that the tax system can be shocked under the right circumstances, but that comprehensive reform can only take place if the system is shocked. There are 2 principal supporting arguments. The first is that the reform must bring enough of a change for the taxpayer to see a package of gains and losses. The second is that the response of savings, investment, work effort and compliance to a tax rate change may be quite small, and therefore it will take big structural changes to have any significant impact.

Every tax reform cannot be comprehensive, and all students of public finance in developing countries know that tax shock can be a disaster. The Jamaica case, however, can highlight the conditions under which big changes can work. First, the Government and the public must have lost confidence in the present system. Certainly Jamaica had reached the point where patchwork reform was no longer good enough. Second, the Government and the public need time to absorb the shock. There was a full 6-month debate of the proposals in the Jamaican press and by the time of enactment, the shock effect had pretty much dissipated. Third, the possibility of revenue shock – large first year losses that might result from transition problems or from the appearance of unexpected loopholes – were guarded against in the Jamaica reform. Finally, the administrative system must be able to absorb the change.

3. Vertical equity cannot be the driving force behind a comprehensive tax reform programme in a developing country

In part, this is because developing countries cannot successfully implement "progressive" features of tax systems and, in part, it is because the costs of vertical equity are very high. The creation of a progressive distribution of tax burdens may not even be a primary consideration in formulating a tax structure revision because of the inherent tradeoff between vertical equity on the one hand and the goals of efficiency and simplification on the other.

What is the place of equity in comprehensive tax reform? The first goal ought to be to protect the lowest income families in the society. The Jamaican Project carried out a family budget survey to identify the market basket of low income families and used these results in the recommendations for indirect tax reform, to work toward a system that was roughly proportional in its distribution of effective rates. Fine tuning the distribution of tax burdens to achieve some particular pattern of progression was not considered.

More important is the issue of horizontal equity – what the Jamaicans seem to have equated with fairness in taxation. The system was riddled with inequities: private sector workers received more income in non-taxable perquisites than public sector workers, self-employed workers paid lower taxes than those in the PAYE sector, those in certain industries had access to the preferential "overtime" tax rate while others did not, only some types of businesses could engage in arbitrage to avoid income taxes, etc. Such unequal treatment had undermined confidence in the tax system. The primary goal of the Jamaican study was to find a way to eliminate these horizontal inequities and the distortions in economic choices which they promoted.

4. Empirical estimates of the impact of proposed tax reforms lift the debate to a much higher level than otherwise would be the case

The quality of the underlying data may not be without problems, but they give a basis for removing some of the guesswork in evaluating the options. A major problem in defeating special interest group opposition to reform in almost every country is the mythology surrounding the implications of changing each element of the system.

In Jamaica, the individual income tax reform was particularly influenced by the data analysis. In fact, it is very doubtful that so sweeping a reform as this could have occurred in the absence of a rigorous statistical study. About 200 combinations of rate and base were eventually run through the simulation model before a final structure was chosen.

The empirical work was useful in demonstrating features of the tax system that were either not known or not obvious. The following are good examples: (a) several of the 16 income tax credits were not being used extensively, hence their abolition would not imply the revenue loss or the sensitive political issue that was feared; (b) the present graduated rate structure was not progressive in its distribution of effective tax burdens, and (c) the income tax regime which taxes dividend income at both the company and personal levels probably has less effect on dividend payout rates than does the preferential treatment of retained earnings.

5. Get the policy right and *then* deal with the administrative problems

The consumers and sponsors of a reform often cannot see beneath a plethora of administrative problems to the real issue, which may well be a badly structured tax.

There are 3 good reasons for giving policy reform priority over administrative reform. First, administrative improvements can often generate a quick revenue impact. Because this may satisfy some of the urgency about "reforming" the tax system, the Government may lose its enthusiasm about rethinking its tax policy. Second, the true underlying problem may be with the tax structure. It may be so complicated as to be beyond the capacity of the Government to properly administer, or it may be so unfair that payment of taxes will be resisted no matter how much the administration improves. Third, if the reform goes no further than administration, the Government will not go through the exercise of questioning whether the tax system is affecting the economy in ways that reinforce Government policy objectives.

The Jamaica case offers some good illustrations of why tax policy considerations should lead such work. The individual income tax was hopelessly complicated, with 3 rate schedules, 16 tax credits, and a system under which employers could choose to grant non-taxable perquisites to

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their employees. It would have been virtually impossible to improve the administration of such a tax and resources spent in that direction would likely have been wasted.

None of this is to say that poor tax administration is not at the heart of the fiscal problems of most developing countries. Indeed, policy reform without administrative reform can bring little gain. The Jamaica Project included a substantial effort in the direction of establishing a training centre, improving assessment procedures and computerizing the record-keeping function.

6. The results of a tax reform should be carefully monitored in the first years after implementation

While it is essential that the reform study generate the best possible forecast of revenue yield, tax burden impacts and economic effects, it is also essential that the tax planner know the actual outcome and be ready to adjust the new system as necessary. It is especially important that the monitoring begin immediately after the reform is implemented and before new avenues of avoidance become entrenched. The more dramatic the structural reform and administrative "shock," the more likely are such loopholes to appear and the harder they are to detect.

This is an important problem with the Jamaica reform. The income tax reform was meant to result in a significant adjustment in the compensation package for PAYE employees – away from allowances and toward wages and salaries. However, some loopholes were left open and these would dampen the propensity to convert allowances to wages. It is clear that there have been some abuses, but in the absence of monitoring it is not clear how much. Consequently, the guidelines for further tightening legislation or providing tougher enforcement regulations are not clear.

Another reason for monitoring is to determine whether the reforms have met revenue targets and consequently whether some base or rate structure revision is necessary. It is not enough to simply rely on the ex ante projections of the revenue impact of the reform. After the Jamaica reform, the revenue yield turned out to be much greater than had been expected because the economy grew much faster than had been assumed in the forecast. This resulted in revenues well above the first year targets, and an increase in the average income tax burden. Armed with accurate revenue projections, the Government would have been in a position to at least discuss a second round of rate reductions.

7. It is better to do a comprehensive fiscal reform – which also includes consideration of the expenditure side of the budget – than a comprehensive tax reform

To be sure, this is a more difficult job, requires more resources and time, and probably raises many more controversial issues, but it allows the Government to get a better picture of the overall implications of the tax reform under consideration.

Fiscal reform is also more desirable because it allows a more comprehensive study of the options for getting the prices "right", balancing the budget, affecting the distribution of income through the budget process, evaluating least cost methods of achieving certain objectives, etc. The Jamaica reform was more far-reaching than most tax studies in that it considered the financing of public enterprises, the benefits of tax incentive legislation and the effectiveness of the Government's food stamp programme. Still, the work came up far short of considering even some of the most relevant expenditure side issues; for example, the actuarial position of the payroll tax contribution programmes, and the possibilities for user charge financing. The Project did a reasonable job of estimating who pays for the Jamaican public sector but it did not go very far in considering who benefits.

8. Tax policies should be designed to mesh with the economic policies already in place

Perhaps the most difficult part of designing a comprehensive tax reform is to match the tax policy design with the set of economic policies that is already in place. It is easy to recite the maxims of a "good tax" and to come to the proper conclusion that it should be neutral in its effects on economic choices. In the case of Jamaica, this matched the stated goal of the Government to rely more heavily on market forces to guide economic growth. However, there is almost always another set of policies in place that raise questions about whether neutrality is an appropriate objective of the tax reform.

Jamaica's trade and industrial policies are highly targeted on specific industries, export promotion and the conservation of scarce foreign exchange. Moreover, the Government's policy was pointed to holding a fixed exchange rate in terms of the U.S. dollar. If the tax reform moved in the direction of removing some of the existing distortions in the system, would the Government respond by strengthening its targeted programmes to restore the special treatments that the tax system had taken away?

9. Successful comprehensive reform requires that special attention be paid to implementation of the reform measures

The Jamaica reform suggests 5 rules about how to get to successful implementation of a tax reform. First, the Government must see the project as primarily its own and not that of a donor or even that of a technical assistance research team. The personal and close involvement of the Prime Minister set the tone for the Jamaica work, and the Chairman of the Revenue Board was an active participant in the research and a leading contributor to the thinking. A very important, and beneficial development in the Jamaica work, was the Prime Minister's appointment of an independent Tax Reform Committee. The Committee was comprised of 12 leading citizens and included representatives of most of the major public interest groups. The Project worked directly as staff to the Committee in their review of the tax reform proposals and in the formulation of the alternatives which they put forth to the Government.

Second, the technical assistance team should have the right mix of skills and experience, and above all, should have expert credentials. Nothing short of well-known tax policy experts with extensive policy experience would have satisfied the Jamaicans. The Government was understandably uneasy about the risks and uncertainties associated with the reform and, moreover, some aspects of the reform were very complicated and others raised important issues of administration that appeared to be stumbling blocks. It was essential to have senior staff who could draw easily and confidently on knowledge of tax systems and of successes and failures elsewhere.

Third, tax reform should not be hurried. It takes time to get the technical proposals properly in place, and the public debate needs time. The design work on the income tax took more than one year, and on the CGT, took longer. The Jamaican press and public interest groups were all involved in the debate, at a surprisingly technical level, for a full 6 months before the income tax reform was implemented. By the time the law was enacted, a very major change in the system was not seen by the public as a tax "shock".

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Fourth, there is an important issue of timing. The income tax reform has been enacted but the Government has not yet moved to introduce the GCT or restructure the payroll taxes. The lesson here is that a Government is not willing to be identified indefinitely with tax reform, even good tax reform.

Comprehensive reform tends to be associated with a particular administration and there is need to get on with it while the power is in place and while there is still enthusiasm for the reform programme. Even the best of tax programmes carries unfavourable connotations for most citizens and politicians, and the zeal for even so noble a goal as "getting the prices right" wanes as time goes by and election years draw near.

Fifth, implementation requires a great deal of in-country attention. The Project had 2 income tax administration experts and a customs expert resident in country to work out administrative procedures and to assist in training, and a sales tax administration expert to do the same for the GCT. There were also a general economic advisor for one year, junior American and Jamaican staff, and a functioning project office in the Revenue Board in Kingston. This made the Project less remote to the Jamaicans and enabled daily liaison.

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Am 18. Oktober 1988 veröffentlichten das Finanzministerium und der Internal Revenue Service eine Untersuchung mit dem Titel: „Verrechnungspreise im Konzern". Die Studie kam teilweise zu dem Ergebnis, dass den Finanzbehörden die Vollziehung von Sec. 482 dadurch erschwert wird, dass die Steuerzahler die von ihnen benutzte Verrechnungspreismethode nicht aufzeichnen. Sie empfahl daher die zu Sec. 482 erlassenen Verordnungen zu ändern und Geldstrafen für den Fall aufzuerlegen, dass die Steuerpflichtigen ihre Verrechnungspreismethode nicht vor Einreichung der Steuererklärung vollumfänglich aufzeichnen. Der Artikel untersucht die Auswirkungen dieser Schlussfolgerungen und Empfehlungen.

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UNITED KINGDOM:

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Eric Tomsett

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I. FOREIGN ACQUISITION OF U.K. COMPANY OR GROUP

A. Tax basis in assets acquired

One of the most important points in structuring an acquisition of a U.K. company or group by a foreign group, such as one based in the United States, is that, with a few limited exceptions, the United Kingdom does not impose any tax on capital gains arising to a foreign resident from the disposal of shares in a U.K. company. Accordingly, there are usually no issues concerning maximising the tax basis in a U.K. acquisition with regard to U.K. tax. A U.S. acquiring corporation can concentrate on maximising its tax basis in the target company or group from a U.S. point of view as usually there will be no U.K. tax on gains arising from any future disposal.

The United Kingdom never taxed foreign residents on gains arising from U.K. shareholding, except in the limited circumstances discussed below. Of course, it is always possible that the position may change in the future. The present U.K. Government has never given any indication that it wishes to change the law to tax foreign residents on U.K.-source capital gains. However, during discussions of the 1988 Budget and Finance Bill in the United Kingdom there were suggestions by opposition Members of Parliament (MPs) that the law should be changed to tax foreign residents on capital gains derived from assets situated in the United Kingdom. This does not yet appear to be a firm proposal in the opposition Labour Party's political programme, but there is a possibility that such legislation might be introduced following a future change of government in the United Kingdom. Many of the U.K.'s double taxation treaties reserve the right to tax capital gains arising from shareholding to the country of residence of the taxpayer. Accordingly, under such treaties a foreign parent company of a U.K. subsidiary would normally be protected from any U.K. tax on capital gains arising to non-residents, if such a tax were to be introduced in the future.

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A very important exception amongst U.K. treaties is, however, the treaty between the United Kingdom and the United States which allows the country of residence to tax capital gains in accordance with its own law. Thus, if the U.K. tax law were changed in the future to tax non-residents on U.K.-source capital gains, a U.S. corporation directly owning a U.K. subsidiary would not qualify for any treaty protection from such a tax.

B. Optimising tax position on future dividend flows

1. Withholding taxes and advance corporation tax (ACT)

The United Kingdom is one of the few major countries in the world which does not impose any dividend withholding tax on dividends paid to a foreign parent corporation. Accordingly, the U.K. corporation tax rate, currently 35%, will represent the maximum U.K. tax liability a foreign corporation will incur from operating within the United Kingdom.

The present government in the United Kingdom has never given any indication that it intends to impose a withholding tax on dividends to foreign shareholders in the future. However, proposals for harmonisation of the tax system within European Community countries have suggested the imposition of a common dividend withholding tax, probably at a rate of 25%. If introduced, the U.K.–U.S. double taxation treaty would limit any such tax to 5% on a dividend paid from a U.K. subsidiary to a U.S. parent corporation.

Although the United Kingdom does not have a dividend withholding tax, it does have a system known as advance corporation tax ("ACT") which often confuses foreign shareholders. This is not a dividend withholding tax, but an internal tax chargeable on the U.K. company itself, effectively representing an early payment of its corporation tax liability on the occasion of the payment of a dividend.

The basic rule is that whenever a U.K. company pays a dividend, regardless as to who the recipient is, ACT (currently equivalent to a rate of one-third of the dividend) must be paid over to the U.K. Inland Revenue within 14 days after the end of the quarter in which the dividend is paid. This ACT paid in respect of a dividend may be primarily offset against the company's corporation tax liability for the same accounting period in which the dividend is paid (normally payable 9 months after the end of the accounting period). The amount of ACT offset against a company's U.K. corporation tax liability in respect of any one period is limited to 25% (the current basic income tax rate) of the company's taxable profits for the period in question.

Where ACT paid exceeds the amount which may be offset against the company's corporation tax liability for the year in which the dividend is paid, the excess may, at the election of the company, be carried back and offset against corporation tax liabilities for the preceding 6 years (taking later years first). If no election is made to carry back the ACT, it is carried forward for offset against corporation tax on future taxable profits of the company, although there can be certain restrictions on change of ownership as discussed below.

It is important to note that the obligation to pay ACT on a dividend payment is never varied by a double taxation treaty between the United Kingdom and the country of the foreign shareholder. An important part of planning following an acquisition will be ensuring the maximisation of the offset of future ACT liabilities.

2. Tax credit refunds

Far from imposing a dividend withholding tax on dividends paid to foreign resident shareholders, the United Kingdom makes a refund of tax to certain foreign shareholders receiving dividends from U.K. companies, known as a tax credit refund. This is often erroneously referred to as an ACT refund as, although the tax credit on a dividend paid by a U.K. company is numerically equal to the advance corporation tax paid by the company on the occasion of a dividend payment, the 2 systems are entirely separate, and the entitlement to a tax credit under a double taxation treaty does not alter the obligation to pay ACT on the dividend.

The United States was the first foreign country to persuade the United Kingdom to grant tax credit refunds to its residents under the terms of a double taxation treaty.

Under the U.S.–U.K. double taxation treaty, a U.S. corporation with a less than 10% shareholding in a U.K. company, or an individual shareholder with any level of shareholding, is entitled to the full tax credit refund (i.e. one-third of the dividend at current rates) on a dividend paid by a U.K. company, less a deemed withholding tax, deducted from the tax credit refund equivalent to 15% of the dividend plus the tax credit. It should be particularly noted that this 15% tax is not a real dividend withholding tax as, although it applies to the dividend plus the tax credit, it only operates to reduce the tax credit refund and cannot reduce the dividend itself.

Of more interest to U.S. parent corporations acquiring U.K. companies or groups is the one-half of the normal tax credit less a deemed withholding tax of 5% of the dividend plus the half credit granted to a U.S. corporation with a 10% or more shareholding in a U.K. company. At current rates, this partial tax credit is equivalent to 10.83% of the U.K. dividend and effectively reduces the U.K. tax rate on profits distributed by a U.K. company to a U.S. parent corporation from 35% to around 28%.

When structuring the acquisition of a U.K. company or group, it will clearly be important to ensure that the acquisition structure enables the foreign acquiring corporation to benefit, if possible, from the tax credit refund described above. For a U.S. corporation, this will be relatively straightforward as if the shares in the U.K. company are directly owned by a U.S. corporation; the tax credit refunds will be available. The United Kingdom does not grant more favourable refunds under any other double taxation treaty.

Several years ago the United Kingdom did take powers under its tax law to deny the tax credit refund to U.S. corporations which were connected with U.S. states operating the unitary tax system. This legislation is still in place, but has never been implemented. It now seems less likely that it will be implemented than when it was first enacted in 1985.

In situations where a U.S. corporation is not the direct acquirer of shares in a U.K. company, structuring the acquisition to obtain tax credit refunds may be much more difficult than where there is a direct acquisition by a U.S. corporation.

There are only 9 other countries with which the United Kingdom has concluded double taxation treaties which grant the half tax credit refund to a foreign parent corporation with a 10% or more shareholding in a U.K. company. These countries are as follows: Belgium (proposed treaty not yet in force), Canada, Denmark, Finland, the Netherlands, Norway, Sweden and Switzerland.

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The treaties with Canada and Norway impose a 10% deemed withholding tax on the dividend plus the half tax credit such that the actual refund is substantially lower than under the other treaties.

If the foreign acquiring corporation is not located in one of the above favoured treaty countries, the question arises as to whether the tax credit refund can still be obtained by structuring the acquisition through a foreign holding company located in one of the favourable territories. It is not easy to achieve this. The double taxation treaties with Belgium, Luxembourg, the Netherlands, Norway and Switzerland include anti-abuse provisions which normally prevent a foreign corporation located in a country without such a favourable treaty from establishing a holding company structure utilising companies in those territories to obtain the tax credit refund.

Whilst there are no anti-abuse provisions in the other double taxation treaties granting the tax credit refunds to a substantial corporate shareholder, there will often be difficulties in effectively utilising such treaties in planning structures as the taxes on the U.K. dividend in the country concerned may outweigh any advantage. In practice, the countries with anti-abuse provisions in their double tax treaties with the United Kingdom in relation to tax credit refunds are rarely used for holding company structures in order to seek to obtain the tax credit refunds.

C. Debt financing and thin capitalisation

Debt financing will often form an important part of the structuring of a U.K. acquisition, and interest on debt represents a significant alternative to dividends for routing funds from a U.K. investment out of the United Kingdom.

At first sight, the opportunities for extracting profits in the United Kingdom in the form of interest payments rather as dividends appears to reasonably promising. Interest paid to a foreign resident can potentially be fully deductible for U.K. tax purposes against the profits of the U.K. company, and under the terms of the U.K.–U.S. double taxation treaty the normal 25% U.K. interest withholding tax is reduced to nil.

There are, however, complications. Where a dividend is paid by a U.K. company to its foreign parent company which owns 75% or more of the shares of the U.K. company or to a fellow foreign subsidiary under similar 75% or more common ownership, under U.K. domestic tax law, the entire amount of the interest on the loan is treated as a dividend distribution rather than an interest payment. A substantial number of the U.K.'s double taxation treaties include provisions within the interest article to override this deeming of interest to be a dividend, and the U.K.–U.S. agreement is one such treaty. However, this override is conditional on the "special relationship" clause in the interest article being satisfied. In the U.K.–U.S. double tax treaty, this is drafted much more widely than in most double taxation treaties following the OECD Model Convention, such that the U.K. Inland Revenue may deny the benefits of the interest article where, as a result of the special relationship (e.g. a parent/subsidiary relationship), the interest paid exceeds, for whatever reason, the amount which would be paid in the absence of the relationship.

The U.K. Inland Revenue regard the wider wording of the "special relationship" clause in the interest article of the U.K.–U.S. double taxation treaty as entitling them to apply a "thin capitalisation" test in relation to interest paid by a U.K. subsidiary to a U.S. parent corporation. The whole area of "thin capitalisation" and debt/equity restrictions is extremely complex at the present time under U.K. tax law and is dealt with in detail in a forthcoming article.[1] For the purpose of structuring an acquisition, the essential test is that it should be possible to demonstrate that a loan granted by a foreign parent company or other foreign group company to a U.K. subsidiary would have been granted on the same terms by an unrelated lender. To the extent that this can be shown, it should be possible to resist any challenge by the U.K. tax authorities to the deductibility of the interest for U.K. tax purposes.

Another "safe" alternative is probably to arrange financing of the U.K. group through loans from international banks which are guaranteed by the foreign parent company.

D. Tax relief for acquisition cost

It is very difficult to structure a U.K. acquisition in a way such that any future tax relief can be obtained for part of the acquisition cost. Acquisition cost will normally be regarded as a capital payment for U.K. tax purposes, and under the U.K. tax system only limited relief is available for capital expenditure. The principal categories of capital expenditure which may qualify for capital allowances include: plant and machinery, industrial buildings, hotels, scientific research, patents and industrial know-how.

Tax relief can only be obtained for these items on an acquisition if it is organised as an asset acquisition rather than a share acquisition. In practice, this is rare in the United Kingdom.

It should be particularly noted that there is no possibility of amortising for tax purposes the capital cost of acquiring such items as goodwill, customer lists, trade names and other intangible assets not within the categories described above.

There is also no tax relief in the United Kingdom for the acquisition of commercial buildings which are not industrial buildings, hotels, or used in scientific research, except where the building is located in certain small areas scheduled for particular development known as "enterprise zones".

E. Stepping up tax basis of assets acquired

Generally, it is only possible in the United Kingdom to step up the tax basis of assets acquired by making a direct asset acquisition. It is not normally possible to achieve any step up in the tax basis of assets where a shareholding in a U.K. corporation is acquired for a consideration in excess of the book value of the underlying assets. Even if the target company is liquidated, U.K. tax rules will normally prevent any stepping up in the tax basis.

F. Leveraged acquisitions

There are possibilities under the U.K. tax system for structuring an acquisition of a U.K. company or group such that the interest cost in relation to acquisition debt can be offset against future profits of the U.K. group. This could be achieved, for example, by establishing a U.K. holding company which borrowed to fund the acquisition of the U.K. company or group.

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1. Tomsett, E., "Treaty Shopping and Debt/Equity Ratios in the United Kingdom" will appear in the March 1990 issue.

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Following the acquisition, the U.K. holding company and the target group would represent a tax group for the purposes of the offset of profits and losses under the U.K. group relief provisions, and this would generally enable interest paid by the holding company to be offset against taxable profits of the target group by means of a group relief surrender.

Another alternative would be to liquidate the target group into the U.K. holding company following the acquisition such that interest expense in the holding company could be directly offset against future profits of the target business. Such structures are at some risk from anti-tax avoidance provisions in the United Kingdom designed to deny interest relief where the sole or main purpose of a structure is to obtain such relief. Certain problems may also arise under corporate legislation prohibiting companies from providing finance to purchase their own shares.

G. Restrictions on loss relief and ACT set-off

Important restrictions may apply to the carry over of loss reliefs and the availability of ACT paid for offset against corporation tax liabilities following an acquisition.

If within the 3 years before or after the date of an acquisition there is any major change in the nature or conduct of the trade of any of the companies in the target group, any trading losses which the U.K. company have available for carry-over which arose prior to the acquisition may not be offset against profits of the periods after the acquisition.

A major change in the nature or conduct of the trade for this purpose includes major changes in the type of property dealt in or services of facilities provided or a major change in customers, outlet or markets of the trade.

A similar rule applies in relation to ACT paid prior to the acquisition such that, if the conditions apply, it may not be offset against corporation tax liabilities for periods after the acquisition. This includes the benefit of ACT which has been surrendered to a subsidiary for offset there.

These restrictions on the carry-over of trading losses and ACT represent a major constraint in the restructuring of loss-making groups which are acquired. If major changes are made to the way in which they conduct their business, this may result in the benefit of the losses acquired on the acquisition being cancelled.

H. Stamp duty and value added tax

A stamp duty of 0.05% payable by the purchaser normally applies on the acquisition of a U.K. company. It is difficult to structure a transaction to avoid this tax although there are certain little used schemes which might be successful.

On an asset acquisition, assets such as real estate and goodwill may be subject to a 1% stamp duty.

Value added tax (VAT) does not apply to the sale of shares in a U.K. company, but if the acquisition is made through a U.K. company, there may be a restriction on the VAT that this company is able to offset against its VAT on its own supplies in so far as the VAT incurred relates to costs associated with the share acquisition.

On an asset rather than a share acquisition VAT may have to be charged by the vendor on the assets acquired. However, where a business is transferred as a going concern, an exclusion from VAT may be available.

II. FOREIGN DISPOSAL OF U.K. COMPANY OR GROUP

A. Capital gains on disposal

Where the disposal of a U.K. company or group owned by a foreign corporation, such as a U.S. corporation, proceeds through a share sale, no U.K. tax will normally apply on the sale as generally the United Kingdom does not tax foreign resident shareholders on the disposal of shares in U.K. resident companies. The principal exceptions to this rule are as follows:

(1) where the assets of the company disposed of consist of U.K. real estate capital gains arising on the disposal of the shares could be subject to U.K. taxation under a complex anti-avoidance provision relating to property transactions where the sole or main purpose of the transaction is to realise again in respect of U.K. real estate acquired with the object of making a gain on a disposal;

(2) where the assets of the company relate to the exploration or exploitation of certain U.K. mineral rights, such as North Sea Oil and Gas.

Except in the above cases, therefore, it is relatively easy to avoid U.K. taxation on the disposal of a U.K. group owned by a foreign corporation simply by structuring the sale as a sale of shares owned by foreign corporations.

Where an asset sale is unavoidable, U.K. taxation will normally apply to the sale of the assets. This will include capital gains on the sale of capital assets and the claw-back of tax depreciation. However, such gains are now charged to corporation tax at the same rate so that the differences relate to technical matters such as the availability of loss offsets.

If a business is carried on in the United Kingdom through a branch of a foreign corporation, capital gains arising on the disposal of the business will be subject to U.K. corporation tax as foreign residents are chargeable to U.K. tax on capital gains in respect of assets situated in the United Kingdom which relate to a trade carried on through a branch or agency in the United Kingdom.

Until 1989 there used to be planning opportunities where a foreign corporation carrying on a trade in the United Kingdom was seeking to dispose of the assets. If the trade was terminated in one fiscal period and the assets not disposed of until a later fiscal period, tax on capital gains arising could be avoided. Another way of avoiding U.K. taxation on such gains was by claiming to "roll over" the gain on the disposal of the assets against future asset acquisitions of the same corporation occurring within a period commencing 12 months before and ending 3 years after the date of the disposal. This used to apply to assets, wherever situated, of the foreign corporation such that capital gains on the disposal of U.K. branch assets could be "rolled over" into acquisitions of assets located outside of the United Kingdom which were outside the scope of U.K. taxation.

New legislation has been introduced in the 1989 Finance Act applying from 14 March 1989 which prevents U.K. tax on capital gains being avoided in this way. Under U.K. tax principles, the taxation of capital gains (where applicable) is calculated on the full amount of the gain (i.e. disposal proceeds less costs), but after the deduction of inflation indexing of cost, based upon movements in the retail price index. There is no calculation based upon the earnings and profits of the subsidiary company sold.

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B. Impact of group structure

The original U.K. group structure chosen can be of importance in relation to the taxation on capital gains arising on the disposal of U.K. companies.

If several U.K. companies have been established, they will normally be grouped such that one company owns the others or a common U.K. holding company has been established to own them all. Where the U.K. holding company has at least 75% ownership of the other U.K. subsidiaries, it is possible to offset profits and losses arising in the companies for U.K. tax purposes by means of the surrender of group relief. There are also certain advantages, such as the opportunity to transfer capital assets between the companies without the immediate realisation of any capital gain. These advantages may, however, be outweighed by a serious disadvantage if it is desired to sell some of the U.K. companies whilst retaining others. In these circumstances, capital gains arising on disposal of the companies will be within the scope of U.K. corporation tax as the disposal will have been made by a U.K. holding company. Thus, the gross gain less inflation indexing allowance will be chargeable to U.K. corporation tax at 35%. This may be a severe disadvantage as compared to the position where the U.K. companies were owned directly by a foreign corporation as then their shares could normally be realised without U.K. tax on the capital gain being payable as a foreign corporation is not generally chargeable to U.K. tax on capital gains. It is not normally possible to extract subsidiaries from a U.K. group without realising the tax on capital gains based upon a market valuation of the U.K. companies.

If, however, the U.K. companies are not arranged under a U.K. holding company, there is no possibility of offsetting profits and losses of the companies for U.K. tax purposes. It is necessary therefore to weigh the advantages of potential offset of profits and losses for U.K. purposes against the U.K. taxation arising on future disposals of subsidiaries if part only of the U.K. group is to be sold.

C. Stamp duties

On the sale of shares in a U.K. company, stamp duty of 0.5% will be payable. This is chargeable on the purchaser and is therefore not normally a problem for the selling group.

III. U.K. GROUP ACQUIRING A FOREIGN GROUP

A. Maximising tax basis on acquisition

Where a U.K. group of companies is engaged in a transaction whereby it acquires a foreign company or group, established in the United States or elsewhere, it will be important to structure the acquisition so that the capital gains basis for U.K. tax purposes of the U.K. group in the companies acquired is maximised. This is because on a future disposal of the shares in the companies acquired any gain arising will be subject to the full rate of U.K. corporation tax of 35%.

There are some important differences in the rules for determining the tax basis for U.K. tax purposes as compared to those which apply in the United States.

In order to be deductible against the proceeds in computing a future capital gain on disposal of the foreign companies acquired, the costs incurred by the U.K. companies must represent expenditure incurred wholly and exclusively for the acquisition of the shares or wholly and exclusively for the purpose of enhancing the value of the shares, including incidental costs of acquisition and expenditure in preserving or defending title to or right over the shares.

If the U.K. company increases the capitalisation of the foreign group as part of the acquisition, or subsequently, it is important to note that a capital contribution to a foreign subsidiary is *not* regarded as expenditure relating to its shares such that it will not rank as part of the tax basis in computing future capital gains on disposals. Accordingly, U.K. companies do not normally utilise capital contributions when capitalising subsidiaries but instead seek to subscribe funds for actual increases in share capital. This is, of course, very different to the rules in the United States.

B. Financing the acquisition

Where a U.K. parent company borrows funds to acquire foreign subsidiaries, the interests or other financing cost of the funds is normally fully deductible for U.K. tax purposes. This deduction is given as a charge on income, deductible only in the period in which it is paid, but available for offset against the total profits of the U.K. company for that period. It should be noted that there is no restriction in the deductibility of interest paid by a U.K. company to finance the acquisition of foreign subsidiaries even though future profits repatriated by the foreign subsidiaries may effectively not be subject to U.K. taxation because of double taxation relief allowed for foreign taxes.

Some U.K. companies have made quite extensive use of special finance companies in relation to the financing of their international acquisitions. The use of the dual resident "link" companies for U.K.-U.S. investment is, of course, well known and is dealt with by other commentators. There are, however, other structures which U.K. groups have used in order to seek to achieve an effective double deduction of interest expense. One such structure involves the establishment of a financing subsidiary company in a tax haven (places such as the Isle of Man, Jersey and Bermuda). The U.K. parent company would borrow funds to finance the foreign acquisition and inject the funds as equity share capital into the tax haven finance company. The tax haven finance company would then on lend the funds to a foreign corporation in the country where the acquisition is being made. This loan would either be direct to the foreign holding company if there was no withholding tax problem in that country on interest paid to non-residents or perhaps via an intermediary finance company in a location such as the Netherlands if treaty relief from withholding taxes was needed.

From a taxation viewpoint, the interest paid by the U.K. company on the original borrowing to finance the equity investment into the tax haven finance company is normally fully deductible from the U.K. parent company's taxable profits under U.K. tax rules. In many countries, the foreign acquiring corporation may be able to structure such that it can offset its interest expense for the acquisition against the local profits of the target companies. Thus, an effective double deduction of interest is achieved both in the U.K. parent company and in the foreign group.

The problem with this type of structure is that interest income will be flowing into a tax haven finance company which is owned by the U.K. group. The United Kingdom has only its equivalent to the U.S. Sub-Part F legislation, the "controlled foreign company" legislation since 1984. Prior to that time, this type of structure could achieve a double deduction of interest without any corresponding adverse U.K. tax consequences.

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Since the introduction of the controlled foreign company provisions in 1984, the interest income of the tax haven finance company is potentially apportionable to the U.K. parent company and taxable on that company as it arises. However, the U.K. controlled foreign company legislation is less comprehensive than the U.S. Sub-Part F provisions, and there are more opportunities for minimising its impact.

One interesting possibility arises from the fact that the apportionable profits of a controlled foreign company such as the tax haven finance company are computed under U.K. corporation tax rules. However, one of the exemptions from the U.K. controlled foreign company provisions is where the controlled foreign company pays a dividend to its U.K. parent company of at least 90% of its annual profits for a non-trading company such as a finance company. The annual profits for this purpose are not computed under U.K. tax principles, but, except where the accounting period is less than 12 months, are based upon the actual accounting profits available for dividend in the controlled foreign company.

As U.K. corporation tax principles generally assess interest income effectively only in the period in which it is received, it is possible to create wide divergences between the taxable profits subject to apportionment and the accounting profits of the tax haven subsidiary. For example, by bunching interest receipts into one particular year a very high apportionable profit can be created in a year where the accounting profits are far less. An apportionment under the controlled foreign company provisions can then be avoided simply by paying a dividend of 90% of the accounting profits. Thus, over a number of years the amount of the profits of the controlled foreign company paid out as dividends in order to satisfy the 90% requirement under the acceptable distribution exemption can be far less than 90% of the profits. Thus, the controlled foreign company provisions may well only charge to tax part of the profits of the tax haven finance company such that there are still very significant advantages to be achieved by U.K. companies through the use of this type of structure.

Another problem with the use of tax haven finance companies is, however, that certain transactions relating to the foreign subsidiaries of U.K. groups still require the advance consent of the Treasury under Sec. 765 Income and Corporations Taxes Act 1988 (formerly Sec. 485 Income and Corporation Taxes Act 1970). Where completion of the transaction is dependent upon such a Treasury consent, such consents have been refused where it was apparent that the structure was being devised primarily to avoid U.K. taxation.

C. U.K. group structure for foreign investment

There is a simple structuring point which should invariably be observed when structuring a U.K. group to make a foreign acquisition, whether of a U.S. corporation or of a company elsewhere in the world. This is that it is normally advantageous to own foreign subsidiaries through a separate U.K. holding company within the U.K. group which has no other activities at all and also which carries no borrowings (i.e. it should be financed by equity share capital).

The use of such a U.K. holding company enables double taxation relief for foreign taxes on dividends remitted from the foreign subsidiaries to be maximised. This arises because under the U.K. tax system foreign tax credit in respect of both withholding taxes and underlying corporate taxes on dividends from foreign subsidiaries is calculated on a source by source basis with limitation in each case to the U.K. corporation tax on the particular source of profits with no opportunities for carry-over of excess foreign tax credit against U.K. tax on other foreign-source income or even against U.K. tax on the same source of income in other accounting periods. Any excess foreign tax credit which cannot be immediately utilised against the U.K. corporation tax on the particular source of income for the period in question is totally lost.

The problem which can arise if shareholdings in foreign subsidiaries are not segregated into a separate U.K. holding company is that where the U.K. company owning the foreign investments claims to offset trading losses or changes on income such as annual interest payments against its profits, the claim must be for the whole amount of the losses or charges incurred which may thereby offset the foreign-source dividend income before the credit available for foreign taxes on the dividends can be offset. Thus, the benefit of the foreign tax credits is lost as the dividend income has been offset first against the losses or charges.

By segregating the foreign shareholding into a separate U.K. holding company in the U.K. group, problems of offsetting losses or changes are avoided, and if there are excess losses or charges elsewhere in the group, it is then possible to surrender them as group relief to the U.K. holding company for the foreign investment in the exact amount required to extinguish the taxable profits of that company. Unlike claims for offsets of trading losses and charges on income, a group relief claim can be made in any amount that the company desires.

If foreign subsidiary companies are not already organised through a separate U.K. holding company, they can normally be transferred into such a company without any U.K. tax liability arising, but there may be foreign taxes on capital gains or in the form of transfer duties.

D. Foreign holding companies and foreign group structure

A major issue for a U.K. group acquiring a foreign company or group is as to whether to own the investment directly out of the U.K. group (preferably through a U.K. holding company as explained) or to own it through a foreign holding company in an appropriate territory.

The United Kingdom has the most extensive network of double taxation treaties of any country, and most of these are favourable in terms of producing foreign withholding taxes on dividends repatriated to the United Kingdom. Accordingly, it is only in a few cases that there is any advantage to a U.K. company in holding foreign investments through a foreign holding company in order to minimise dividend withholding taxes on profit repatriation as the use of a foreign holding company in a location such as the Netherlands or Switzerland will itself involve a 5% withholding tax on final repatriation of dividends to the United Kingdom.

Potentially of more interest to a U.K. group is the opportunity of repatriating profits to a foreign holding company rather than directly to the United Kingdom and using the funds directly out of the foreign holding company to reinvest abroad. The advantage of the use of a foreign holding company in this way is that it avoids remittance of dividends to the United Kingdom where they would be subject to corporation tax, albeit with credit relief for direct and underlying foreign taxes.

Where a U.K. group accumulates foreign dividend income in a foreign holding company, it potentially faces problems under the U.K. controlled foreign company legislation, as

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would also be the case for a U.K. corporation under similar circumstances under the U.S. Sub-Part F provisions. However, the U.K. controlled foreign company provisions do include important reliefs for international holding companies not present in the Sub-Part F legislation. The first is the exempt activities exclusion. The holding company can avoid a controlled foreign company apportionment under this exclusion if it can satisfy the following conditions:
(i) it must have its own business establishment in the foreign territory where it is resident, i.e. normally its own office. However, the Inland Revenue do not require that the office concerned is exclusively used by the holding company, but it must be more than a brass plate;
(ii) its business affairs must be effectively managed from the foreign country, where it is resident, and it must have adequate staffing there for its activities. Again, however, such staff need not necessarily be full time;
(iii) the business of the holding company must be wholly or mainly the holding of shares or securities of companies which are either 90% or more owned local holding companies or 50% or more owned trading companies (except that a lower shareholding may be permitted if this is the maximum allowed under the law of the relevant foreign territories);
(iv) at least 90% of the gross income of the holding company during the accounting period in question must be derived directly from companies which the holding company controls and which throughout the period are either local holding companies, or companies engaged in "exempt activities" (broadly genuine trading activities with independent customers and suppliers).

A second exclusion for the controlled foreign company provisions is available for a holding company which is either:
(a) receiving dividends and interest from its overseas subsidiaries as a mere staging post in the course of the process of reinvestment of the profits concerned in the trading operations of the overseas subsidiaries concerned, or
(b) holding funds outside the source country for the purpose of reinvestment in that country because of vigorous exchange controls, inflation, exchange fluctuations or political instability and the risk of expropriation.

This second relief is a non-statutory extension of the motive test exclusion in the legislation based upon government ministerial statements.

Another potential advantage of using an international holding company for a foreign acquisition is in relation to double taxation relief on future dividend remittances. This is an advantage almost unique to the United Kingdom and arises out of the highly restrictive system of double taxation relief which applies under U.K. tax law. As indicated earlier, foreign tax credit relief is granted in the United Kingdom strictly on a source by source basis with no carry-over of excess credits against any other source of income or to any other period. This means that if a U.K. company has one subsidiary in a high tax territory such as the Federal Republic of Germany and another in a low tax territory such as Hong Kong, it will normally have excess foreign tax credits in respect of any dividends from the German subsidiary but corporation tax to pay on the Hong Kong dividend. Where both companies are owned directly by a U.K. company, there is no possibility of utilising the excess credit on the German dividend.

There is, however, a practical way of overcoming the above foreign tax credit problem. This is where companies in high tax territories and low tax territories are both owned through an international holding company. In these circumstances, when the dividend is repatriated from the international holding company to the U.K. group having been derived partly out of profits from high tax countries and partly from low tax countries, the dividends are "mixed" for foreign tax credit relief purposes such that careful planning can avoid the excess foreign tax credit problem. Such holding companies are commonly known as "dividend mixer companies".

Whilst dividend mixing works well in principle, with the reduction of the U.K. corporation tax rate to a maximum of 35%, there are now only a small number of countries which have an effective foreign tax rate below the statutory U.K. corporation tax rate. Accordingly, the circumstances where dividend mixing can in practice be used are now much more limited.

1. Gains from future disposal of investment

Perhaps the major advantage of a foreign holding company for a U.K. group is in circumstances where the foreign company or group acquired may be sold at a profit at some future time. If the foreign group is owned directly from U.K. companies, capital gains arising on the disposal will be subject to U.K. corporation tax at the normal rate (currently 35%). The capital gain will be computed as the gross gain (i.e. proceeds less cost) less an inflation indexing allowance for the cost of the investment based upon the retail price index movements over the period that the company has been owned. It should be particularly noted that there is no opportuinity under the U.K. tax system for treating a capital gain arising on the disposal of shares in a foreign subsidiary as an effective realisation of earnings and profits of the subsidiary with consequent claims for underlying foreign tax credits. Only foreign capital gains taxes charged directly on the capital gain arising from the disposal will be creditable in the United Kingdom. Accordingly disposal of shares in a foreign subsidiary directly by a U.K. company can be very expensive in terms of U.K. taxation of the gain arising.

A relatively easy way of avoiding the U.K. taxation on disposing of shares in a foreign subsidiary is by arranging for the shares to be owned on acquisition through a foreign holding company. A particular feature of the U.K. controlled foreign company provisions is that they do not apply to capital gains at all. Accordingly, capital gains arising from the disposal of subsidiaries through a foreign holding company are completely outside of the scope of the controlled foreign company provisions. This is, of course, in total contrast to the position under the U.S. Sub-Part F provisions. There is a potential problem if the U.K. group is closely owned, as in these circumstances a separate anti-avoidance provision (Sec. 15 of the Capital Gains Tax Act 1979) can apply to apportion the capital gain arising in a foreign holding company to its U.K. parent company; however, this provision can be relatively easily avoided by establishing the foreign holding company in certain territories which have an appropriate double taxation treaty with the United Kingdom, e.g. the Netherlands or Switzerland. The capital gains articles of the double taxation treaties with these countries override Sec. 15 of the Capital Gains Tax Act 1979 by reserving the right to tax the capital gains to the country of the holding company's residence.

2. Is an international holding company desireable to own an investment in a U.S. group?

Looking specifically at a U.K. group acquiring a U.S. corporation or group the question frequently arises as to whether the U.S. group should be owned directly or through a foreign holding company. As U.K. companies already enjoy

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a reduction in the 30% U.S. dividend withholding tax to 5% on dividends from a substantial shareholding in a U.S. corporation, no dividend withholding tax advantage can be achieved through owning the investment via a foreign holding company as the United States does not grant any greater reduction in its dividend withholding tax under any other treaty. Also, at current tax rates it will rarely be necessary to utilise a foreign holding company to accumulate dividend income from a U.S. corporation in order to avoid U.K. corporation tax on repatriating dividends to the United Kingdom. The combined rates of U.S. federal corporate tax, dividend withholding tax and local state taxes will generally mean that the foreign tax credits attached to a U.S. dividend to a U.K. parent company will extinguish the U.K. corporation tax on the dividend.

It will therefore only be potentially advantageous to own a U.S. subsidiary of a U.K. group through a foreign holding company if either the U.K. group has low tax profits in other territories which it wishes to "mix" with higher tax U.S. profits through a foreign holding company to maximise foreign tax credit relief or alternatively if the sale of the U.S. group at a profit is contemplated such that a foreign holding company will give the opportunity of deferring U.K. taxation on the gain.

3. Upstream loans

Another advantage that a U.K. group enjoys through the establishment of a foreign holding company, not available to U.S. groups in comparable situations, is the ability to loan back accumulated profits from the foreign holding company to the U.K. group without a tax penalty. There are no provisions under U.K. tax law which treat such loans as effectively taxable income as may occur under the U.S. Sub-Part F provisions. A foreign holding company which has enjoyed exclusion from the controlled foreign company provisions can therefore effectively repatriate its funds to the U.K. group through such upstream loans without incurring the U.K. tax charge which would apply to dividend payments.

4. Holding company location

The most popular holding company location for U.K. groups is the Netherlands, at least where double taxation treaty advantages are needed.

Where treaties are not important, the Isle of Man offers a useful location as holding companies there are completely tax-free, and there are opportunities for establishing the necessary local management and staffing necessary to avoid a controlled foreign company charge under the exempt activities exclusion. Similar opportunities are not so easily available in the Channel Islands of Jersey or Guernsey.

IV. U.K. GROUP DISPOSING OF A FOREIGN GROUP

A. Minimising U.K. tax on disposal

As explained above, if disposal of a foreign company or group at a substantial profit is contemplated, it is usually advantageous for the U.K. group to own the foreign investment through a foreign holding company in order to avoid the U.K. capital gains charge. If, however, the foreign company or group is already in the ownership of U.K. companies at the time the disposal is contemplated, it will not normally be possible to transfer them at that stage to a foreign holding company without incurring the U.K. tax charge on the current value of the companies transferred.

As also indicated earlier, the U.K. tax system taxes the full gross gain arising on the disposal of the shares in a foreign subsidiary with an allowance only for inflation indexing of the cost of the shares. On such a disposal, no foreign tax credit relief is available for foreign taxes incurred on the accumulated profits of the foreign subsidiary from which the value of the company may have been derived. However, a way often utilised to obtain effective foreign tax credit relief in such circumstances is to pay up the maximum possible dividend from the foreign subsidiary company out of its reserves to the U.K. parent company prior to the disposal. If the foreign profits have been charged to tax at rates comparable or higher than those applying in the United Kingdom, such repatriation of dividends will normally be tax-free, but the value of the foreign subsidiary will be reduced such that the gain on ultimate disposal will be smaller. Where, however, a capital loss will be created, the use of this loss can be restricted.

B. Reinvesting the profits

Where a U.K. group realises a profit on the disposal of a foreign company or group through an international holding company, there is considerable flexibility in the opportunities available for reinvesting the proceeds without incurring a further U.K. tax charge. There are no exchange controls in the United Kingdom requiring repatriation of foreign profits, although in some cases past Treasury consents, under what is now Sec. 765 Income and Corporation Taxes Act 1988, may have imposed a profit remittance requirement on the foreign holding company as a condition of the granting of Treasury consent on its establishment or the transfer to it of certain investments.

Another possibility will be to loan the funds back to U.K. group companies. If interest is charged on such loans, it is normally possible to arrange that full corporation tax relief is obtained in the United Kingdom for the interest payment. No Treasury consent is needed for such upstream loans and no U.K. tax charge arises in respect of the loan itself.

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UNITED STATES:

U.S. Tax Considerations Related to Acquiring and Disposing of a U.K. Business

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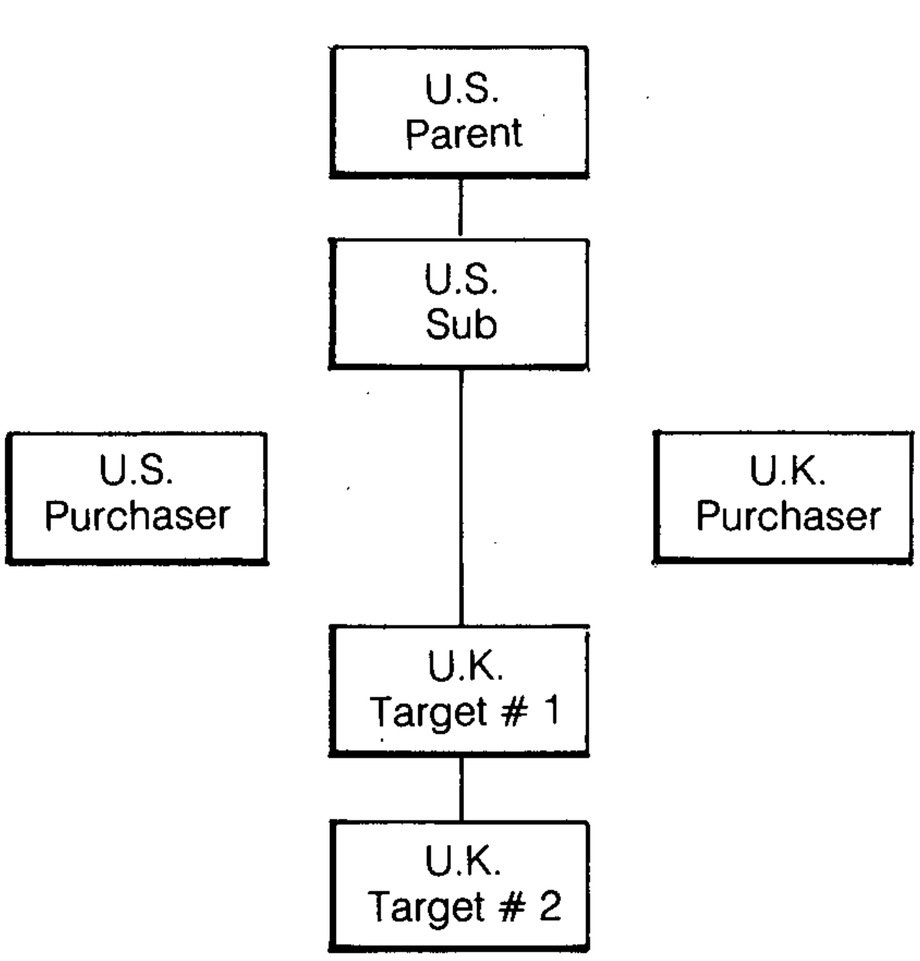
I. INTRODUCTION

The subject for discussion is extremely broad, and cannot be treated in full in an article. The focus will be on acquisitions and dispositions in a variety of basic circumstances, involving two common aspects: (1) the purchaser will be a corporation (U.S. Purchaser or U.K. Purchaser) unrelated to the seller that will pay cash for the acquisition, and (2) the U.K. "target" will be the wholly-owned subsidiary of another corporation and will not be engaged in a U.S. trade or business. The special aspects involved in the acquisition of a publicly held U.K. corporation, or in the use of stock as consideration for an acquisition, are beyond the scope of this article.

The model ownership structure referred to throughout (see diagram) will have a U.S. top company (U.S. Parent) owning a U.S. subsidiary (U.S. Sub) that in turn owns a U.K. subsidiary (U.K. Target #1) that owns another U.K. Subsidiary (U.K. Target #2).



II. U.S. TAX CONSIDERATIONS INVOLVED IN THE ACQUISITION OF U.K. TARGET #2 BY U.S. PURCHASER

A. U.S. Purchaser acquires stock of U.K. Target #2 from U.K. Target #1

1. U.S. tax consequences on seller's side

a. Gain realized by U.K. Target #1 on the sale of stock of U.K. Target #2 will be Subpart F[1] income that passes through to U.S. Sub, because U.K. Target #1 is a controlled foreign corporation (CFC) and gain from the sale of stock by a CFC is a type of foreign personal holding company income that qualifies as Subpart F income.[2]

Unless the gain is de minimis to U.K. Target #1 (less than 5% of gross income and under $1 million), U.S. Sub will be taxed on the gain as ordinary income at a 34% rate.[3] If the gain is large enough (more than 70% of U.K. Target #1's gross income for the year), it could convert all of that company's income into Subpart F income.[4]

Overriding all of the foregoing is the so-called "high tax" exception. If it can be shown that the gain was subject to an "effective rate of tax" in the U.K. that is greater than 90% of the U.S. rate (i.e. greater than 30.6%), the gain will not pass through to U.S. Sub under Subpart F.[5]

b. The Subpart F income generated by U.K. Target #1 will pass through to U.S. Sub on the last day of the taxable year, assuming U.K. Target #1 continues to be owned by U.S. Sub for the balance of the year. Some portion of the income so passed through will be attributable to U.K. Target #2's accumulated earnings and profits that were previously subjected to U.K. tax. Thus, double taxation of those earnings effectively will occur, with no opportunity to mitigate that result through the use of U.K. Target #2's foreign tax credits.

U.S. Sub should consider some preliminary steps:

(1) Have U.K. Target #1 distribute the stock of U.K. Target #2 to U.S. Sub, thereby positioning U.K. Target #2

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1. Subpart F refers to those sections of the U.S. Internal Revenue Code which provide for the taxation of controlled foreign corporations. Basically, Subpart F provides for the taxation of certain income of foreign corporations in the hands of their U.S. owners rather than after it has been distributed to shareholders.
2. Internal Revenue Code (IRC) Sec. 954(c)(1)(B).
3. IRC Sec. 954(b)(3)(A).
4. IRC Sec. 954(b)(3)(B).
5. IRC Sec. 954(b)(4).

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for a sale by U.S. Sub. The purported benefit here (subject to appropriate basis adjustments) would be in allowing U.S. Sub to enjoy dividend treatment (and attendant foreign tax credits) under Sec. 1248 (discussed more fully below) with respect to its gain on the sale.

This approach will not provide the desired results, however, unless the distribution can qualify as a tax-free spin-off under Sec. 355. If it does not so qualify, the distribution itself will trigger full gain to U.K. Target #1 under Sec. 311(b) that will be taxable to U.S. Sub under Subpart F, in addition to producing normal dividend consequences to U.S. Sub. The prospect of the distribution qualifying as a tax-free spin-off is remote for two reasons: lack of a business purpose and the likelihood that the prearranged sale of U.K. Target #2 would cause a lack of the requisite "continuity of interest" by U.S. Sub following the spin-off. In addition, the case of Basic, Inc.[6] might be relied upon to disregard the distribution altogether.

(2) Have U.K. Target #2 pay a cash dividend through U.K. Target #1 up to U.S. Sub in advance of the sale. No Subpart F income should result at the U.K. Target #1 level by virtue of the "same country" exception, and no U.K. tax should be imposed on the intra-group dividend. U.K. withholding taxes would have to be considered, of course, and the Waterman Steamship line of cases (treating such a dividend as additional purchase price) could potentially be relevant if U.K. Target #2 were required to borrow in order to pay the dividend.

(3) Have U.K. Target #2 make a taxable Sec. 956 loan directly to U.S. Sub would make credits available under Sec. 960, but there would be no compensating basis adjustment with respect to the stock of U.K. Target #2 held by U.K. Target #1. As a result, full gain would then still be realised on the sale of U.K. Target #2.

c. The gain that passes through under Subpart F will be treated as foreign-source passive income of U.S. Sub for foreign tax credit purposes.[7] Any U.K. tax imposed on the gain will be available to be claimed as a credit by U.S. Sub under Sec. 960.

d. The amount that passes through to U.S. Sub will constitute "previously taxed income" in the hands of U.K. Target #1[8], and will result in an increase in U.S. Sub's basis in the stock of U.K. Target #1.[9] The amount is thus available for future distribution to U.S. Sub with no further tax, but with a corresponding reduction in U.S. Sub's basis in Target #1's stock.

2. U.S. tax consequences on purchaser's side

a. U.S. Purchaser will take a cost basis in the stock of U.K. Target #2 acquired from U.S. Sub.

b. U.S. Purchaser will be in a position to make an election under Sec. 338(g) (an "express election") to step up the basis of the assets held by U.K. Target #2, to reflect their fair market value as evidenced by the price paid for the stock.

3. Considerations relating to Sec. 338(g) election

In general, the effect of a Sec. 338(g) express election is to treat the target corporation (old target) as having sold all of its assets to itself (new target) at their respective fair market values immediately after the stock purchase (i.e. on the acquisition date), with the price paid for the stock then being allocated to the assets in accordance with their respective values, grouped by class. Any amount paid over and above the values assigned to the various designated classes of assets other than goodwill and going concern value is allocated to that residual class of intangibles.[10]

One reason for making a Sec. 338(g) election is that since U.S. corporations must compute the earnings and profits of their CFCs pursuant to U.S. standards, a step-up in asset basis and its resulting higher depreciation deductions should produce a smaller pool of earnings and profits from which to withdraw dividends. Assuming basis is not also stepped up for local tax purposes, the result should be that a correspondingly greater proportion of foreign taxes paid will be attributed to any dividends distributed, as a percentage of the reduced earnings pool.

The deemed asset sale produces income to the target company to the extent of any appreciation in value of the assets deemed sold, just as if they had actually been sold. However, assuming none of U.K. Target #2's assets are of a type that would themselves produce Subpart F income, no immediate adverse U.S. tax consequences should result from U.S. Purchaser making a Sec. 338(g) election, because U.K. Target #2 would not be subject to U.S. tax on the sale of its assets.[11]

The deemed asset sale also results in a complete fresh start for the target company, eliminating its entire tax history (including its historic tax basis in assets, its earnings and profits, potential foreign tax credits, etc.).

If U.S. Purchaser does not wish to make a Sec. 338(g) express election to step up the basis of the assets of U.K. Target #2, it should make a "protective carryover election", under Treas. Reg. Sec. 1.338-4T(f)(6). That election would preserve the existing basis in U.K. Target #2's assets, as well as the remainder of its current tax history. If the protective carryover election is not made and if U.S. Purchaser engages in certain other transactions with U.S. Sub or other members of its affiliated group during the so-called "consistency period" (a period running from one year before to one year after the acquisition period during which the stock of U.K. Target #2 was purchased), e.g. by purchasing other assets from U.S. Sub during the consistency period, U.S. Purchaser would enable the Internal Revenue Service (IRS) to trigger a deemed asset sale election under Sec. 338(e)(1) with respect to its acquisition of U.K. Target #2.

A "deemed election" under Sec. 338(e)(1) is discretionary with the IRS, and cannot automatically be triggered by the taxpayer.[12]

B. Purchase of assets rather than stock of U.K. Target #2

1. If U.S. Purchaser acquires the assets of U.K. Target #2 rather than its stock, the only immediate tax consequences

6. In *Basic, Inc. v. United States,* 549 F.2d 740 (Ct. Cl. 1977), the court refused to respect the distribution by a parent company of its wholly-owned subsidiary to the parent's shareholder in advance of a sale of both companies by the shareholder to a third-party purchaser. The purpose for the distribution was to give the shareholder the benefit of a basis in both companies in computing its gain on the sale. The court was influenced by the fact that negotiations had already begun for the purchase of the two companies in their original parent-subsidiary configuration before the decision was made to distribute the subsidiary and create a brother-sister relationship.

7. IRC Sec. 904(d)(3)(B).

8. IRC Sec. 959.

9. IRC Sec. 961.

10. Treas. Reg. Sec. 1.338(b)-2T.

11. Treas. Reg. Sec. 1.338-5T(f).

12. Treas. Reg. Sec. 1.338-4T(f)(6).

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to U.S. Sub are possible exposure to Subpart F income to the extent U.K. Target #2 has any assets of a type that give rise to such income (e.g. the stock of other companies). Otherwise, as in the case of a "deemed sale" of assets resulting from a Sec. 338 election, any gain on the asset sale would belong to U.K. Target #2, and thus would not be subject to U.S. tax.

Gain realised on the asset sale will create earnings and profits that will remain with U.K. Target #2 as a member of its old group. However, a subsequent dividend of the sales proceeds by U.K. Target #2 to U.K. Target #1 would not constitute Subpart F income that would pass through to U.S. Sub, provided that the requirements of the "same country" exception set forth in Sec. 954(c)(3)(A) are satisfied.

2. With a direct asset purchase, U.S. Purchaser may be able to secure a more favourable allocation of purchase price to specific assets than it could under a Sec. 338(g) election, if U.K. Target #2 were to agree in the contract of sale to precise allocations of price to particular assets and the parties had adverse tax interests.

III. U.S. TAX CONSIDERATIONS INVOLVED IN THE ACQUISITION OF U.K. TARGET #1 BY U.S. PURCHASER (IN LIEU OF U.K. TARGET #2)

A. U.S. Purchaser acquires stock of U.K. Target #1

1. U.S. tax consequences on seller's side

Gain on sale of stock by a U.S. corporation (here U.S. Sub) is typically taxed as capital gain, currently at 34% rate. Capital gain realised by a U.S. corporation on the sale of stock of a foreign corporation is treated as U.S.-source income, unless, in general, the stock is of an affiliate that derives more than 50% of its gross income from the carrying on of an active business in a foreign country and the stock is sold in that country.[13]

If the foregoing test is satisfied and the sale is treated as giving rise to foreign-source income, the gain will fall in the seller's passive income basket for foreign tax credit purposes, unless it is taxed at a higher rate in the foreign country than in the U.S., in which case the so-called "high-tax kickout" will shift the gain (and accompanying excess credits) to the seller's general limitation basket.[14] (Note that the level of foreign tax required here is higher than that required under the "high tax exception" in Subpart F.)

A further exception permits the taxpayer to invoke a treaty sourcing rule to secure foreign-source treatment for gain from the sale of stock of a foreign corporation.[15] However, in such a case the gain is placed in its own separate basket for foreign tax credit purposes.[16] If the gain is treated as U.S.-source income, the related credits will be assigned to the seller's passive basket in any event, a result that is sometimes preferable.

In light of Sec. 865(j)(1), pending the issuance of new regulations, a loss on the stock sale may currently be "sourced" by reference to Treas. Reg. Sec. 1.861-8(e)(7).

Again, some portion of the gain will be attributable to U.K. Target #1's (and U.K. Target #2's) accumulated earnings, which have previously been subjected to U.K. tax. Thus, the potential for double taxation exists. Here, however, since the seller is U.S. Sub (a U.S. corporation) and since U.K. Target #1 is a CFC, Sec. 1248 will apply to convert some portion of all of U.S. Sub's capital gain into a deemed dividend. The amount taxed as a dividend would be equal to the amount of the previously untaxed earnings and profits of both U.K. Target #1 and U.K. Target #2 (per Sec. 1248(c)(2)) that were accumulated while U.K. Target #1 (and #2, where appropriate) were owned by U.S. Sub, but in no event in excess of the amount of gain actually realised by U.S. Sub on the sale.

When stock of a CFC is sold during a taxable year, the amount of its current year earnings and profits attributable to the selling shareholder under Sec. 1248 will be that portion of the current year's total earnings (less any distributions from such earnings during the year and less any undistributed Subpart F income that may have passed through to the selling shareholder for the year) that bears the same ratio to such total earnings as the number of days during the year that the seller owned the stock bears to the number of days in the full year.[17] Thus, there could be uncertainty regarding the total amount of the Sec. 1248 deemed dividend the seller must report, until the year of sale ends and the proper calculation can be made. The seller may well require contractual protection regarding post-acquisition distributions and other matters if it is seeking a particular result.

Any amount of earnings taxed as a dividend under Sec. 1248 will become "previously taxed income" of U.K. Target #1 (and U.K. Target #2 where appropriate), and thus will tentatively be available for subsequent withdrawal by U.S. Purchaser without further tax.[18] This produces an obvious benefit to the purchaser.

While a "Sec. 1248 dividend" from a foreign corporation would be taxed to the purchaser at the same 34% rate as a capital gain, it brings with it all attendant Sec. 902 foreign tax credits. A dividend attributable to the Sec. 1248 earnings of a U.K. operating company would be treated as foreign-source general limitation basket income for foreign tax credit purposes under the "look through" rules of Sec. 904(d)(3), rather than passive basket income as would be the case for a capital gain. Thus, if U.S. Sub has excess foreign tax credits in its general limitation basket, it might be able to use those credits as well as the Sec. 902 credits the Sec. 1248 dividend itself would pull up to offset some portion of the U.S. tax imposed on its deemed dividend. To that extent, it would enjoy a benefit that would not be available if the gain on the stock sale were taxed as capital gain and U.S. Sub had insufficient credits in its passive basket to offset the U.S. tax on the gain.

2. U.S. tax consequences on purchaser's side

Same results as in the case of a purchase of the stock of U.K. Target #2. U.S. Purchaser will take a cost basis in the stock of U.K. Target #1, and will have the ability to make a Sec. 338(g) express election to step up asset basis.

3. Additional considerations relating to the making of a Sec. 338 election in this setting

a. If U.S. Purchaser were to make a Sec. 338(g) express election following the purchase of the stock of U.K. Target #1, the result would be a deemed sale of the assets of Target #1, including the stock it owns in Target #2, and of the

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13. IRC Secs. 865 (a) and (f).
14. IRC Secs. 904(d)(2)(A); 904(d)(2)(F).
15. U.S.–U.K. Taxation Treaty, Art. 23(3).
16. IRC Sec. 865(h).
17. Treas. Reg. Secs. 1.1248-2(d)(1) and 1.1248-2(e)(2).
18. IRC Sec. 959(e).

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assets of Target #2, under the consistency rules of Sec. 338(f)(1).[19] The income generated by the resulting deemed sale of assets would be included in the "enhanced earnings and profits amount" of U.K. Target #1 (and #2) for purposes of applying Sec. 1248.[20] Such deemed income would therefore enlarge the pool of earnings which supports dividend treatment to U.S. Sub on its gain from the stock sale.

This might have provided even greater potential benefit to a seller with excess credits in its general limitation basket, by maximizing dividend treatment on the sale. However, the new Sec. 338(h)(16) now prevents any such result, by recharacterising and resourcing that portion of the target's earnings "enhanced" by the deemed asset sale in this situation, so that such amount generally is treated as attributable to the sale of stock for foreign tax credit purposes. The result generally will be that an appropriate portion of the Sec. 1248 dividend amount, while still taxed as a dividend, will nevertheless be placed for foreign tax credit purposes in the seller's passive income basket, where excess credits are less likely to be found, unless the "high-tax kickout" shifts the entire gain to the general limitation basket.

It does not seem appropriate to conclude that because Sec. 338(h)(16) produces the result described above, it could be interpreted as causing the "enhanced" amount of the target's earnings (i.e. the amount considered realised on the deemed asset sale) to have been realised after the acquisition by U.S. Purchaser.

b. Additional complications arise where, as here, the target owns stock of a subsidiary corporation, (i.e. U.K. Target #1 owns the stock of U.K. Target #2). The deemed sale of assets by U.K. Target #1 will necessarily include a deemed sale of the stock of U.K. Target #2, which would likely give rise to Subpart F income to U.S. Sub. (Under Treas. Reg. Sec. 1.951-1(f), U.S. Purchaser is not deemed to be the owner of the stock of U.K. Target #1 until the day after the acquisition date, any Subpart F income thus would belong to U.S. Sub as the U.S. shareholder on the last day of "old" U.K. Target #1's existence.[21] Depending on the foreign tax credit situation of U.S. Sub, such Subpart F income may or may not bear full U.S. tax, but U.S. Sub will receive a full increase in its basis in the stock of U.K. Target #1 by virtue of the pass-through.[22]

The possibility for a mismatching of gain and loss thus exists, if the amount of Subpart F income passed through to U.S. Sub is greater than the gain it would realise on the actual sale of the stock of U.K. Target #1. (Assume U.S. Sub sold for 500 the stock of U.K. Target #1 in which it had a basis of 100, thereby realising an actual gain of 400. If the Subpart F income generated by Target #1's deemed sale of the stock of Target #2 was 450 and if U.S. Sub received a full basis increase in the Target #1 stock as a result, U.S. Sub would end up reporting Subpart F income of 450 and a capital loss of 50 on the transaction as a whole).

In addition, by virtue of the Sec. 338(g) express election, all of the assets of "old" U.K. Target #2 will also be deemed to have been sold by it to "new" U.K. Target #2. It is not possible to make a "regular exclusion election" to eliminate Target #2 from the scope of the Sec. 338(g) express election.[23] However, since U.K. Target #2 is not itself subject to U.S. taxation, any possible second tax on the same appreciation in value (in addition to the tax on the Subpart F income separately passed through to U.S. Sub by virtue of the deemed sale of the stock of U.K. Target #2) should be avoided.

The IRS has indicated that it is reconsidering the extent to which Subpart F income should be triggered under certain circumstances in the case of certain Sec. 338 elections, and may accordingly allow an extension of time for making such an election.[24]

c. As previously noted, if a Sec. 338(g) express election is made, the target company and its affiliates covered by the election take on a completely fresh tax history after the deemed asset sale is accounted for. This means, among other things, that any "previously taxed income" amounts will be eliminated and the corresponding tax-free distribution opportunities with respect to such amounts will be lost to U.S. Purchaser.

B. U.S. Purchaser acquires assets of U.K. Target #1

Same results occur as in the case of a purchase of the assets of U.K. Target #2. No U.S. tax consequences should arise, except for possible Subpart F income taxable to U.S. Sub as a result of the actual sale by U.K. Target #1 of the stock of U.K. Target #2. Also, the same opportunity exists for a more favourable purchase price allocation (as discussed above).

IV. U.S. TAX CONSIDERATIONS INVOLVED IN THE ACQUISITION OF U.K. TARGET #1 BY U.K. PURCHASER

Question: If U.S. Purchaser and U.K. Purchaser both offer the same price for the stock or assets of U.K. Target #1, does it make any difference from a U.S. taxation standpoint whether U.S. Sub sells to one or the other?

A. Sale of stock of U.K. Target #1

U.S. Sub will have Sec. 1248 deemed dividend treatment with respect to any gain on the stock sale, no matter which company is the purchaser. As noted, any portion of the gain that is converted into a dividend under Sec. 1248 will become "previously taxed income" under Sec. 959(e). It will therefore tentatively be available for withdrawal by the purchaser without further tax.

If U.K. Target #1 is acquired by U.K. Purchaser, it will cease to be a CFC as a result of the acquisition. Any Subpart F income it may have will then pass through to U.S. Sub, as its U.S. shareholder on the last day of its year when it was a CFC. The "previously taxed income" withdrawal opportunity resulting from the application of Sec. 1248 and Subpart F will simply be wasted because U.K. Purchaser gets no benefit from it.

If U.S. Purchaser acquires U.K. Target #1, the company will continue to be a CFC even after the acquisition. U.S. Sub will not have to recognize any Subpart F income, because all such income will pass through to U.S. Purchaser as the U.S. shareholder of the company on the last day of U.K. Target #1's current tax year.

An interesting question is presented if U.K. Target #1 had a limited amount of undistributed earnings that were not previously taxed, and its entire income for the year was Subpart F income. If a sale of its stock during the year caused a portion of its current earnings to support dividend

19. Treas. Reg. Sec. 1.338-4T(c)(3).
20. Treas. Reg. Sec. 1.338-5T(g)(3).
21. Priv. Ltr. Rul. 8938031.
22. Priv. Ltr. Rul. 8938036.
23. Treas. Reg. Sec. 1.338-5T(c)(2).
24. Priv. Ltr. Rul. 8938011.

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treatment to U.S. Sub under Sec. 1248, that amount would become "previously taxed income" (PTI) subject to later withdrawal by the purchaser on a tax-free basis. If the entire year's income turns out to be Subpart F income that is taxable to U.S. Purchaser on the last day of the year, the full amount of such income would also become previously taxed income. Can U.S. Purchaser therefore treat more than the full year's earnings as PTI eligible for tax-free withdrawal in a subsequent year, because of a double counting of the same earnings?

(If on 1 July, U.S. Sub sold the stock of U.K. Target #1 with a basis of 10 for a price of 50, it would have a gain of 40. Assume U.K. Target #1 had 45 of undistributed earnings not previously taxed, and also had 100 of earnings for the current year, all of which was Subpart F income. Under Sec. 1248, 50 (i.e. one-half) of the current year's earnings would be attributable to U.S. Sub's period of ownership, and would therefore convert the full 40 of U.S. Sub's gain into dividend income. The same 40 would become PTI in Target #1's hands. Since the 100 of Subpart F income would be passed through and taxed to U.S. Purchaser on the last day of the year, it too would become PTI in Target #1's hands. What amount of earnings can U.S. Purchaser subsequently withdraw tax-free, 100 or 140?)

Secs. 959 and 1248 do not seem to answer the question. Perhaps the correct answer should be that if the entire earnings for the year constitute Subpart F income, and therefore will pass through to the purchaser on the last day of the year, no part of them should be used to support dividend treatment under Sec. 1248 with respect to the mid-year stock sale. The statutory language in Sec. 1248 does not call for that result, however, and Sec. 959(e) does not address the point squarely.

U.S. Purchaser could trigger Subpart F income to U.S. Sub by making a Sec. 338(g) election and causing a deemed sale of the stock of U.K. Target #2 by U.K. Target #1. U.K. Purchaser is unlikely to cause such a result because the election would be of no significance to it (unless it anticipates that U.K. Target #1 and/or U.K. Target #2 might later become subject to U.S. tax). Thus, U.S. Sub maybe "safer" in selling to U.K. Purchaser than to U.S. Purchaser, unless it is able to secure adequate contractual protection or a price adjustment from either purchaser to reflect any potential Subpart F exposure from a Sec. 338 election.

B. Sale of assets of U.K. Target #1

A sale of most of the assets of U.K. Target #1 would avoid U.S. tax consequences for U.S. Sub because U.K. Target #1 is not a U.S. taxpayer. Such is not the result, of course, with respect to those assets of U.K. Target #1 that would produce Subpart F income to U.S. Sub (i.e. the stock of U.K. Target #2). However, Subpart F income would result to U.S. Sub no matter which purchaser acquired the assets of U.K. Target #1.

V. U.S. PURCHASER ACQUIRES STOCK OF U.S. SUB FROM ITS U.S. PARENT

A. Tax consequences to U.S. Parent

Sec. 1248(a) would not on its face appear to be applicable to this transaction because the sale by U.S. Parent would involve stock of a U.S. corporation, not stock of a CFC. However, by its terms, Sec. 1248(e) might apply to trigger the application of Sec. 1248(a), if it could be shown that U.S. Sub was "formed or availed of principally" to hold the stock of U.K. Target #1. However, in Notice 87-64, the IRS suspended the application of Sec. 1248(e) (which it described as an "anti-abuse" provision), because of the current absence of a rate differential in the tax on capital gains and dividend income.

As a result, normal capital gain treatment would be afforded U.S. Parent on the sale of the stock of U.S. Sub. (This would be true whether the purchaser were a U.S. or a U.K. corporation). If the Sec. 1248 benefits are significant, consideration should be given to having U.S. Sub sell U.K. Target #1 before U.S. Purchaser sells U.S. Sub. If the two sales are respected as separate transactions, Sec. 1248(a) would apply to the sale of U.K. Target #1.

B. Tax consequences to U.S. Purchaser

U.S. Purchaser will take a cost basis in the stock of U.S. Sub, and will now have certain options regarding a possible Sec. 338 election to step up asset basis.

1. U.S. Purchaser could make a Sec. 338(g) express election.
Any gain deemed recognised by U.S. Sub as result of the fictional asset sale will be taxable to U.S. Sub, which must file its own separate "deemed sale return". By acquiring the stock of the U.S. corporation that owns U.K. Target #1 and #2 and making a Sec. 338(g) election at that level, U.S. Purchaser has taken on the economic burden of some potentially adverse tax consequences in exchange for basis step-up benefits.

2. U.S. Purchaser could make a "regular exclusion election" with respect to the foreign affiliates of U.S. Sub (U.K. Target #1 and U.K. Target #2), excluding them from the scope of the Sec. 338(g) express election.[25] A regular exclusion election will preclude deemed sale treatment (and stepped-up basis) for the assets of U.K. Target #1 and #2, though not for the stock of Target #1 owned by U.S. Sub. The regular exclusion election thus will prevent a Subpart F pass-through to U.S. Sub attributable to gain on what would otherwise have been a deemed sale by Target #1 or Target #2 of assets giving rise to such income, i.e. a deemed sale of the stock of Target #2 by Target #1.

If an "invalidation event" (e.g. the direct acquisition by U.S. Purchaser of the stock of another CFC owned by U.S. Parent) occurs after the making of a "regular exclusion election", the election will be invalidated retroactively, and the excluded foreign affiliates will become subject to the deemed sale rules, unless the IRS chooses to disregard the invalidation event.[26]

As noted, the stock of U.K. Target #1 cannot be excluded from deemed sale treatment at the U.S. Sub level when an express election is made. Any gain attributable to the deemed sale of that stock by U.S. Sub would be converted into a dividend under Sec. 1248(a), in accordance with the discussion above.

3. U.S. Purchaser and U.S. Parent could make a Sec. 338(h)(10) joint election, which requires that the purchaser and seller together agree on "deemed asset sale" treatment with different tax consequences than a Sec. 338(g) express election. Under a Sec. 338(h)(10) election, the actual sale of the target's stock to the purchaser and the deemed sale of the stock of any domestic target affiliates are ignored,

25. Treas. Reg. Sec. 1.338-5T(c)(2).
26. Treas. Reg. Sec. 1.338-5T(c)(2).

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and only the deemed sale of the assets of the target and such affiliates (other than any such stock) is taken into account. Any gain realised on the deemed sale of such assets is reportable by the "selling consolidated group". Here, that means that such gain must be reported in the consolidated return of U.S. Parent that includes the date of the sale of U.S. Sub to U.S. Purchaser. Following the deemed asset sale, the target (and each domestic target affiliate) is deemed to have been liquidated into its parent under Sec. 332.

Unless a regular exclusion election is made, a sale of the stock of any foreign target affiliates will be deemed to have occurred. This will not only give rise to Subpart F income (with respect to the stock of the foreign target affiliate), but will also result, under the consistency rules of Sec. 338(f)(1), in deemed asset sales by each of the foreign target affiliates as well. Such deemed asset sales could produce additional Subpart F income, and could also (by reason of new earnings and profits at each foreign target affiliate level) affect the application of Sec.1248 with respect to the gain realised by U.S. Sub on its deemed sale of the stock of U.K. Target #1.

A Sec. 338(h)(10) election is desirable where the selling group has losses or other tax benefits (e.g. foreign tax credits) that would offset some or all of the gain realised on the deemed asset sales; however, the purchaser is likely to be required to "pay" for any such use of the selling group's tax benefits.

VI. FINANCING CONSIDERATIONS RELEVANT TO U.S. PURCHASER

If the U.S. Purchaser borrows to make its purchase, it has several choices regarding the placement of its debt:

1. U.S. Purchaser may borrow and make the purchase directly;
2. U.S. Purchaser may form U.K. Newco and arrange for it to borrow to make the purchase (with U.S. Purchaser's guaranty);
3. U.S. Purchaser may borrow in the U.S. (or U.K.) and then lend the funds to U.K. Newco, which would then use the funds to make the purchase.

The critical factor from a tax standpoint should be finding the most tax-efficient "location" for the interest deductions to be generated by the borrowing. Use of dual-resident companies to maximize interest deductions may no longer be a suitable option, except perhaps in particular circumstances. The foreign tax credit situation of U.S. Purchaser therefore becomes critical. The objective, of course, is to avoid having the interest expense reduce foreign-source income, so that credit usage can be maximized.

If U.S. Purchaser borrows and makes the purchase directly, its interest expense will be allocated and apportioned between foreign-source income and U.S.-source income on the basis of its asset mix – foreign assets v. domestic assets.

If U.S. Purchaser has U.K. Newco borrow directly, it will have ensured that the interest expense associated with the acquisition will reduce foreign-source income, but at the same time it will have taken steps to achieve an absolute reduction in foreign tax liability. (If U.K. Newco is thinly capitalised, with its borrowing therefore being attributed to U.S. Purchaser under Rev. Rul. 79-4[27], the result for foreign tax credit purposes should be the same as the situation described above, where U.S. Purchaser borrows and makes the purchase itself.)

If U.S. Purchaser borrows and then lends the proceeds to U.K. Newco, interest deductions would be claimed by both corporations, but U.S. Purchaser would also receive foreign-source interest income from U.K. Newco on the on-loan.

Under the modified "netting rule" now in effect[28], the interest expense incurred by U.S. Purchaser may not be allocated exclusively on the basis of asset mix. Rather, such interest expense could be required to be allocated directly against U.S. Purchaser's foreign-source interest income received from U.K. Newco. In general, if the third-party debt-to-asset ratio of U.S. Purchaser's U.S. group of companies as a whole is disproportionately greater than the aggregate third-party debt-to-asset ratio of the CFCs owned by its U.S. group (i.e. if the CFC group's outside leverage ratio is less than a specified percentage (65% for 1989, 80% beginning in 1990) of the U.S. group's outside leverage ratio), the U.S. group's interest expense must be allocated directly against interest income received on what is called the "excess related party indebtedness" of the CFC group (i.e. such portion of the CFC group's indebtedness owned to the U.S. group that would eliminate the disproportionate leverage between the two groups).

If U.S. Purchaser has excess foreign tax credits in its general limitation basket, and if the interest income from U.K. Newco would otherwise have fallen in that basket under the look-through rules (thereby being in a position to be brought home tax-free), application of the "netting rule" could upset that result and cause U.S. Purchaser's interest deductions effectively to be wasted.

No U.S. tax benefit would be derived from U.S. Purchaser's interest expense because its interest deductions would not reduce U.S.-source income. While the deductions would be allocated to foreign-source income, that income would have gone untaxed in any event because of the excess foreign tax credits available to offset the tax liability it would otherwise have produced. Therefore, no net benefit results, only a displacement of excess credits.

Use of "hybrid securities" to finance the acquisition A variation on the foregoing would have U.S. Purchaser borrow from a third party and use the funds to purchase a hybrid security issued by U.K. Newco – a security that is subordinated to all debt, with no fixed maturity date, and with its payments geared to earnings. Such a security is designed to qualify as debt in the U.K., but as equity in the U.S. Its viability is currently uncertain.

Under the "netting rule", even though such hybrid securities do not generate interest income for U.S. tax purposes, if the U.S. group is over-leveraged relative to the CFC group it controls, but the CFC group does not have enough true related party indebtedness to permit the "netting rule" to operate properly, any such hybrid securities issued by the CFC group will be recharacterised as related party indebtedness. Fictional interest income from such securities will then be imputed to the U.S. group, so that its U.S. interest expense can be allocated directly against such income, rather than reducing U.S.-source income.

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27. Rev. Rul. 79-4, 1979-1 C.B. 150, involved a situation where a thinly-capitalised corporation had borrowed funds on the strength of its shareholder's guaranty; the debt was treated as debt of the shareholder rather than as debt of the corporation.
28. Treas. Reg. Sec. 1.861-10T (e). The term "netting rule" as used in this context refers to the requirement that interest expense be allocated (i.e. "netted") against a particular category of interest income.

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UNITED STATES:

Tax Aspects of Business Acquisitions

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I. INTRODUCTION

This article presents a discussion of the tax objectives in planning and completing an acquisition of a business after the Tax Reform Act of 1986 (the "1986 Act"), the Revenue Act of 1987 (the "1987 Act") and other recent tax legislation. The first section of this article discusses generally the tax objectives of the buyer and seller. The second and third sections describe the basic structural alternatives for effectuating the taxable or tax-free acquisition of stock or assets of a business, and the consequences to the buyer and seller of each structure. The article later describes some additional planning opportunities in situations where employment contracts, covenants not to compete, or other elements may be involved. The remaining sections discuss some other selected problems. This article is intended to constitute a checklist of tax issues involved in acquisitions, and is not intended to constitute an exhaustive discussion of all tax aspects of acquisitions. In addition, this article does not discuss the special problems of transactions involving foreign parties.

Throughout this article, the term "Target" is used to refer to the acquired business. "Seller" refers to the shareholders of Target, and "Parent" refers to the Target's corporate parent (if the Target is a subsidiary of another corporation). "Buyer" is used to refer to the entity that is acquiring Target. Buyer may be an existing corporation or a newly-formed entity. References below to tax consequences to Buyer should be read where appropriate to refer to the consolidated group of which Buyer is a member (the "Acquiring Group"). Except as otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

II. TAX OBJECTIVES

A. In general

The general tax objectives of any acquisition may be summarized as follows:

(1) minimize taxes payable by Seller – make the deal as attractive as possible to Seller;
(2) minimize the taxes payable by Buyer after the acquisition – provide the best after-tax return on investment;
(3) be sure that adequate provision is made for any tax liabilities inherited from the acquired business, including tax liabilities arising from the acquisition.

Objectives 1 and 2 will often (but not always) conflict; that is, steps taken to improve Buyer's after-tax return may make the deal less attractive to Seller. Sometimes, however, structures may be adopted which will be mutually beneficial to both sides and improve the overall economics of the transaction. As discussed below, the present tax rate structure enacted as part of the 1986 Act often enhances the parties' ability to plan in this area. The parties' objective should be to identify factors in the transaction which will result in such an improved overall tax position, and to strike the balance between the parties' objectives that creates the most value. The principal concerns and objectives of Seller and Buyer are summarized in subsections B and C below.

With respect to objective 3, which is discussed in Section VIII of this article, below, the question of who bears past tax burdens of the acquired company will be a matter for negotiation. The principal goal in drafting the agreement is that there be no surprises to the Buyer resulting from past tax liability of Target.

B. Seller's tax concerns

1. How much taxable gain results from the transaction?

This question is determined by the form of the transaction (i.e. is the transaction a stock sale, an asset sale or a "deemed" asset sale under the statutory mechanism described in the next section of this article) and by the nature of the consideration received (i.e. is the transaction a taxable sale or a reorganization or incorporation which is totally or partially tax-free to Seller). Assuming a taxable sale, the amount of gain recognized will differ depending on whether stock or assets are sold. Another important factor will be whether the proceeds of an asset sale will be distributed to stockholders of Seller in a taxable liquidation. If such a distribution is contemplated, two sets of taxes will be payable by Seller: Target must pay a tax on the sale of its assets and the stockholders must pay a tax on the gain from the liquidation. This will normally burden Seller with much more tax than would have been payable had they sold the stock of Target.

2. How much of the gain is capital gain and how much is ordinary income?

Sellers have historically desired to plan the transaction to maximize the amount of gain which receives capital gain treatment. This is because of the preferential treatment historically accorded capital gains. Under the 1986 Act, maximum tax rates for ordinary income were reduced to the same rates as the maximum rates on capital gains. This change generally eliminated Seller's historical aversion to ordinary income treatment. It should be noted, however, that a preferential tax rate for capital gains could well be reinstated in the future.

3. When does Seller pay the tax?

There are a number of ways of deferring Seller's tax liability. Since it seems unlikely that capital gains rates will increase above their 1990 levels (although ordinary income rates will probably not fall any lower than they are in 1990, and may rise in the future), deferral methods are likely to again be an important part of transaction planning, although in many cases interest must be paid on the deferred tax liability. Some of those methods are described in Section VI.D below.

C. Buyer's tax concerns

1. What tax benefits may be achieved through a write-up of assets?

A transaction resulting in a stepped-up asset basis will provide tax benefits to Buyer only to the extent that the increased basis may be allocated to depreciable or amortizable assets. This requires a judgement (preferably supported by a valuation report issued by a credible appraisal firm) concerning the value of these assets compared to non-amortizable assets such as goodwill. With respect to intangible assets, amortization will be available only if a reasonably definite useful life and ascertainable value can be established for the asset. Tax benefits will be maximized to the extent that values can be allocated to assets which may be depreciated over shorter periods (i.e. equipment). Typical items which can be "written up" to acquisition cost and will thereby produce additional depreciation or amortization deductions are:

a. equipment (3 to 20 years, depending on the type of property);

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b. buildings (31.5 years for commercial, 27.5 years for residential);
c. patents (remaining life of patent);
d. copyrights, including copyrighted software (remaining life of copyright or a shorter life if obsolescence is expected);
e. covenant Not to Compete (life of covenant); and
f. valuable leases, contract or other rights (over the remaining useful life, if a sufficiently definite life can be established).

See Section V below, for a further discussion of the allocation of basis among various acquired assets.

2. What is the additional cost of an asset write-up?

If Buyer acquires assets, or is deemed to have acquired assets pursuant to a statutory election, it will have a cost basis for all assets. In such a situation, gain will be taxable to the Target measured by the difference between the Target's basis in its assets and the value thereof. This tax will be borne by Seller or Buyer depending on the form of the transaction chosen, as discussed in the next Section of this article. If the transaction has been structured as an asset purchase (or deemed asset purchase), the basis step-up will add value only if the present value of tax benefits resulting from the step-up exceeds the tax liabilities resulting from the asset sale. As a result of the repeal of the *General Utilities* rule by the 1986 Act, the "toll charge" for a write-up of assets has been increased dramatically in most situations. Accordingly, there are limited situations in which a write-up is economically viable. However, a number of opportunities still exist.

3. Are there other tax attributes of Target which can be preserved and which may be beneficial to Buyer?

Target may have certain attributes which may be preserved only by a stock acquisition in which there is no write-up of assets. Examples are (1) a net operating loss or credit carry-forward, which could be used to offset income generated by Target after the acquisition and (2) assets with a high tax basis relative to market value, which will generate substantial depreciation or amortization deductions. In this case, a stock acquisition will be beneficial to both Buyer and Seller. However, a buyer's ability to utilize carry-forwards or "built-in" deductions of an acquired business are significantly restricted under certain rules that are summarized in Section III. B below.

4. How much of the purchase price is deductible when paid?

Certain payments made as part of the transaction may be deductible by Buyer when paid or accrued. Examples are payments for compensation, royalties and interest. Planning possibilities in this area are outlined in Section VI below.

III. BASIC STRUCTURAL ALTERNATIVES – TAXABLE TRANSACTIONS

Set forth below are the basic alternatives available to Buyer and Seller in structuring the taxable purchase of stock or assets of a business. The list is not exhaustive; many variations are possible depending on the facts of each situation.

A. Purchase of assets

Buyer buys assets of Target; Target may or may not liquidate.

1. Tax results

a. Buyer has a stepped-up basis in Target assets equal to the amount paid for the assets, plus the amount of liabilities assumed.

b. Target retains its tax attributes such as net operating loss carry-forwards. There is no transfer of these attributes to Buyer.

c. Target recognizes gain equal to the difference between the purchase price and its basis in its assets. Gain will ordinarily be capital gain except to the extent of "recapture" items, described below. Gains may be offset by any loss or credit carry-forwards of Target. If Target is a corporate subsidiary and Seller's group has losses, those losses may ordinarily be used to offset Target's gains from the asset sale.

d. Gain attributable to "recapture" items, such as depreciation recapture and certain other items, will result in ordinary income rather than capital gain.

e. Except in the case where Target is an "80% or more" owned subsidiary of Parent, a liquidation of Target following the sale will result in a second tax payable at the shareholder level. This tax will be imposed on the gain measured by the proceeds received by the shareholder (which will be reduced by the taxes payable by Target described in (c) above) less the shareholder's basis in his Target stock. This gain will usually be capital gain.

2. Comments

a. Buyer will benefit from the basis step-up to the extent it can sustain an allocation of a substantial part of the purchase price to depreciable or amortizable assets. As part of the asset sale agreement, Target and Buyer may agree as to allocation of purchase price among various assets. The Internal Revenue Service (the "Service") has historically respected such an agreement, if the parties have adverse interests. As discussed in Section VI below, however, some interests which have historically been adverse may no longer be so as a result of equivalent tax rates on capital gains and ordinary income. Also, the allocation will be subject to the allocation rules described in Section V below.

b. The "double" tax incurred by Target and its shareholders when Target sells assets and then liquidates in a transaction taxable to the shareholders will frequently make this structure prohibitively expensive from the Seller's point of view.

c. A sale of assets may be undesirable for non-tax reasons. Seller's loan arrangements, franchise agreements or similar items may restrict asset transfers or place undue burdens upon asset transfers. An alternative transaction, which may satisfy non-tax objections to an asset sale, would be a forward merger of Target into Buyer (or a subsidiary of Buyer) in exchange for cash and/or Buyer notes. This transaction is treated for federal income tax purposes as a sale of Target's assets to Buyer, followed by a liquidation of Target.[1] The same results can also be achieved by a stock purchase followed by an election under Sec. 338(h)(10), as discussed in Subsection D below.

B. Purchase of Target stock by Buyer; no Sec. 338 election

Buyer simply buys the Target shares, either directly or

1. Rev. Rul. 69-6, 1969-1 C.B. 104.

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through a reverse cash merger. Buyer avoids either an actual or deemed election under Sec. 338.

1. Tax results

a. Carry-over basis of Target assets – no step-up. Target simply remains an ongoing corporation, and maintains its historical asset basis for tax purposes.

b. Tax attributes of Target continue (but the availability of loss and credit carry-forwards may be limited under Secs. 269, 382 and 383).

c. No recapture or other corporate-level taxes are payable by Buyer or Seller – sellers recognize gains or losses measured by the difference between the purchase price received by the sellers and their basis in their stock. In most cases the gain will be a capital gain.

2. Comments

a. This technique is useful where corporate-level taxes are too high in relation to tax benefits of step-up, or where it is desirable to retain tax attributes of Target. Sellers may insist on a stock sale because of the high burden of a double tax.

b. For Federal income tax purposes, a merger of a transitory subsidiary of Buyer into Target in exchange for cash and/or Buyer notes is treated as a purchase of Target stock by Buyer.[2] This method will be useful where it is not possible to negotiate separately with all Target stockholders or where minority shareholders must be squeezed out and "stock purchase" treatment is desired for Federal income tax purposes. Also, Buyer could acquire some Target shares directly, and some through the reverse cash merger. This is a typical pattern in a two-step acquisition.

c. Utilization of net operating loss or credit carry-forwards is limited when a corporate change of ownership occurs. The Buyer's ability to utilize the carry-forwards is subject to an annual limitation determined by multiplying the value of the loss corporation's stock at the time of the ownership change by an interest rate prescribed by statute. Numerous technical rules, which could further restrict carry-forward utilization, also apply.[3] Utilization of built-in losses (i.e. losses attributable to depreciation, amortization or depletion deductions, or resulting from dispositions of assets, to the extent attributable to the excess of the tax basis of the assets over fair market value at the time of the ownership change) is generally subject to the same limitation. In addition, a corporation generally cannot receive a Federal income tax refund resulting from the carry-back of net operating losses that are attributable to interest expense on debt incurred to acquire a majority of the stock of another corporation or to make an extraordinary distribution to shareholders, to the extent the losses are carried back to a taxable year prior to the year in which such a transaction occurred.

In some cases where Target has a loss carry-forward which would be subject to substantial limitation under this formula (or has a loss which would expire very soon), but has a built-in gain in its assets, it may be advantageous to structure the transaction as an asset sale or make a basis step-up election under Sec. 338 (described below) allowing the gain on the sale of assets to be absorbed by the loss carry-forwards of Target. Utilization of Target's loss is not limited for purposes of absorbing gains generated by the deemed asset sale.

Sec. 384 restricts the ability of a loss corporation (or consolidated group) to use its "pre-acquisition losses" to shelter "built-in gains" of a corporation (or of assets acquired in certain asset acquisitions), unless the loss corporation owned at least 50 % of the stock or assets for five years prior to the acquisition (or, if shorter, the entire period the gain corporation was in existence). Built-in gains are gains recognized within five years after the acquisition date that result from dispositions of assets which had a fair market value in excess of their adjusted tax basis at the time of the acquisition. Built-in gains can also include certain types of income properly attributable to the period before the acquisition date.

d. A stock purchase without a tax write-up of assets may result in a lower tax basis in assets of the Target for tax purposes than for accounting purposes. Generally, this is not a desirable situation.

C. Purchase of Target stock by Buyer, followed by a Sec. 338 election

The method of acquisition is the same as in "B" above, but Buyer makes an election under Sec. 338 with respect to Target.

1. Mechanics of a Sec. 338 election

a. *Requirements for a Sec. 338 election*

i. Buyer must acquire stock of Target having at least 80% of the voting power and at least 80% of the value of all classes of Target stock (except non-voting preferred) within a twelve-month period, beginning with the first purchase of stock.

ii. The acquisition of the requisite amount of stock must be made by "purchase". Buyer will have "purchased" Target stock, provided:

(a) the basis of Target stock in the hands of Buyer is not determined (1) in whole or in part by reference to the adjusted basis of Target stock in the hands of Seller or (2) under the fair market value rules of Sec. 1014(a) relating to property acquired from a decedent;

(b) Target stock is not acquired in connection with a tax-free contribution to a controlled corporation (Sec. 351), in a tax-free reorganization (Sec. 354, 355, 356) or in any other transactions (to be specified by Treasury Regulations) in which the transferor of Target stock does not recognize the entire amount of gain (or loss) on the transaction;

(c) Target stock is not acquired from related parties other than certain related corporations.

iii. The election must be made by Buyer (unless it is treated as made under the consistency requirements discussed below in subsection 1.c.iii.) by the 15th day of the 9th month after the month in which 80% of the stock was purchased.

b. *Temporary regulations and Sec. 338*

Under Temporary Regulations, liquidation of Target into Buyer will not affect Buyer's ability to make a Sec. 338 election with respect to Target's assets. The liquidation may occur immediately after the acquisition of stock.[4]

c. *Other factors*

There are a number of complicating factors in Sec. 338 transactions, discussion of which is beyond the scope of this article.

i. Acquisition of less than all of the stock of Target by purchase. The statute contains complicated rules governing

2. Rev. Rul. 73-427, 1973-2 C.B. 301.
3. See Sec. 382.
4. Temp. Treas. Reg. Sec. 5f.338-1(f)(5).

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basis step-up in a situation where Buyer acquires more than 80%, but less than all of the stock of Target by purchase. Buyer has a number of alternatives in dealing with this situation.

ii. Target is the parent of a group of subsidiaries. In general, an election as to Target requires an election as to any subsidiary of Target. There are special rules for foreign corporations and certain other corporations.

iii. Special rules apply to require consistency with respect to the purchase of assets and/or stock from the same affiliated group. In general, if Buyer makes a Sec. 338 election with respect to Target, Buyer (or an affiliate of Buyer) will be deemed to have made a Sec. 338 election with respect to the stock of any affiliate of Target acquired by Buyer (or an affiliate of Buyer) within a specified period of time. Similarly, if Buyer purchases the assets of Target and the stock of an affiliate of Target during the requisite period, a Sec. 338 election will be required with respect to the affiliate (or alternatively, Buyer will be required to take a carry-over basis in the purchased assets).

2. Tax results

a. The results to Sellers are the same as in "B" above.

b. Target is treated as having sold all of its assets at fair market value at the close of the acquisition date. After the acquisition date, Target holds the assets at a stepped-up basis. Where Buyer has acquired 100% of Target stock, the basis of Target's assets after the step-up is the amount Buyer paid for the stock, plus liabilities of Target assumed (including taxes incurred by Target as a result of the deemed asset sale).

c. As a result of the deemed "sale" of assets, Target recognizes gain as though it had sold all of its assets for their fair market value. This liability is a separate tax liability of Target, and may not fall on a consolidated return of either Parent or Buyer. Because Buyer owns the Target stock, the economic burden of this tax falls on Buyer.

d. Target's prior tax attributes (carry-overs, earnings and profits account, etc.) disappear.

e. Target may make new elections concerning items such as accounting methods.

3. Comments

a. Buyer has 8½ months following the month in which the acquisition occurred to make an election under Sec. 338. It can therefore delay a determination of whether a step-up is desirable (i.e. it can choose between the results in "B" and "C") until well after the acquisition is completed. This provides a chance to review Target's books after ownership is obtained, and analyze Target's actual performance before a decision must be made.

b. A Sec. 338 election subjects Target to full taxation on the difference between the basis of its assets and their fair market value. Thus, a Sec. 338 election is now desirable only in very limited circumstances. For example, if Target has a net operating loss carry-over that would be otherwise rendered substantially unusable under Sec. 382 or would expire in the near future, the gain on a Sec. 338 election could be offset by the net operating loss carry-over, and Target could benefit in the future from the step-up in the basis of its assets.

c. The consistency requirements described in I.c.iii above are a dangerous trap for the unwary. Careful planning is needed to avoid actions which could cause an inadvertent "deemed Sec. 338 election", resulting in a large unexpected tax liability from a deemed asset sale, or which could cause an unwanted carry-over basis in acquired assets, resulting in lower tax benefits than expected. An inadvertent deemed election may generally be avoided by filing a "protective carry-over election" pursuant to Temp. Reg. Sec. 1.338-4T(f)(6) which, as the term implies, causes the basis of assets in the hands of Buyer to continue to be determined as they were in the hands of Target. If Buyer makes a qualified stock purchase of the stock of Target, Buyer should either make an express Sec. 338 election or a protective carry-over election for Target and its subsidiaries, if any, depending on whether or not Buyer wants a stepped-up basis in the assets of Target and its subsidiaries.

D. Purchase of Target stock by Buyer and election under Sec. 338(h)(10)

This option is available only where Target is owned by a corporate shareholder ("Parent") with which it files a consolidated return. The 1986 Act amended Sec. 338(h)(10) to allow regulations that will permit an affiliated group of corporations that includes Target to make an election under Sec. 338(h)(10) even when the affiliated group does not file a consolidated return. However, Treasury Regulations required to implement this provision have not yet been promulgated. The acquisition structure is the same as "C" above (and the requirements for a Sec. 338 election apply) but Parent and Buyer make a further election under Sec. 338(h)(10). The effect of the election is that Target is treated as though it had sold all of its assets in a single transaction.

1. Tax results

a. Target obtains a basis step-up as in the ordinary Sec. 338 situation.

b. All gain on the deemed asset sale is recognized, but such gain falls on Parent's consolidated return. Gain or loss from the sale of Target stock is disregarded. The transaction thus has the same tax effect as a sale of assets by Target, followed by a tax-free liquidation of Target into its corporate Parent.

2. Comments

a. The Sec. 338(h)(10) election is very desirable in a number of situations, and indeed is now the only beneficial application of Sec. 338, except in very unusual circumstances.

b. The Sec. 338(h)(10) election is very desirable where the Parent group has loss or credit carry-forwards not likely to be utilized in the near future, since carry-forwards of the Parent group generally may offset income from the deemed asset sale. Thus, Buyer may be provided a stepped-up asset basis at little or no tax cost to the selling Parent. In addition, because "deferred intercompany gain" resulting from dispositions of assets to other group members is not required to be included in income as a result of a stock disposition coupled with a Sec. 338(h)(10) election, but is required to be included in income as a result of a stock disposition without a Sec. 338(h)(10) election, a Sec. 338(h)(10) transaction may be beneficial in disposing of a subsidiary that has substantial deferred intercompany gain. Also, an "excess loss account" with respect to the stock of a subsidiary will not be required to be taken into income upon a disposition of the stock of the subsidiary coupled with a Sec. 338(h) (10) election, even though that amount would be required to be taken into income in the event of a regular disposition of the stock of the subsidiary. An "excess loss account" is the excess of the net negative adjustments to the basis in the

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stock of the subsidiary that are required under the consolidated return regulations over the sum of the initial basis in the stock and the net positive adjustments to the basis of the stock.

c. Also, if Parent's "outside" basis in Target's stock is not substantially higher than the subsidiary's "inside" basis in its own assets, a better tax result for the deal may be achieved by effecting a stock sale subject to a Sec. 338(h)(10) election rather than a stock sale without such an election. Target will be treated as having sold assets, and Parent will not be treated as having sold stock, perhaps resulting in a slightly higher tax to the Parent group. But, if the election is made, Buyer receives a stepped-up basis, the value of which may far outweigh the Parent's increased tax. Buyer should be willing to pay more for this benefit.

IV. BASIC STRUCTURAL ALTERNATIVES – TAX-FREE TRANSACTIONS

Acquisitive tax-free transactions, including reorganizations and incorporation, generally provide parties to the transaction with a deferral of gain recognition on the transaction (coupled with a carry-over or substitute basis in the stock or securities received in the transaction) until the consideration received in the transaction is disposed of in a taxable transaction. Since taxable corporate asset dispositions (whether by sale or liquidation) are now subject to a high tax cost (approximately 52% in a taxable liquidation or a sale of assets followed by a liquidation), the use of tax-free acquisition techniques is becoming more popular.

A. Tax-free transactions – general principles

1. Permissible consideration

In reorganizations and incorporation, permissible consideration is generally limited to stock or securities (long-term debt) of Buyer (or in some types of reorganizations, Buyer's Parent). The receipt of other consideration ("boot") will be taxable, and the amount of boot that can be received in a reorganization is limited.

2. Transaction by transaction determination

The tax-free status of a transaction is determined on an overall basis. If a transaction is held to be taxable (e.g. because it fails to qualify as a "reorganization" under Sec. 368), all shareholders will be taxed on their gain, even those who receive only Buyer stock in exchange for their Target stock, and in some types of transactions, such as "C" reorganizations, standard mergers and forward subsidiary mergers, Target will also be taxable.[5]

B. Treatment of parties to a tax-free transaction

1. Treatment of shareholders of Target and transferors of assets to a newly-formed corporation (Newco)

a. *General*

Target's shareholders do not recognize gain or loss on the exchange of their Target stock for Buyer stock "in pursuance of the plan of reorganization". Sec. 354(a)(1). Transferors of assets to Newco in a transaction qualifying under Sec. 351 do not recognize gain or loss on the transfer of assets to Newco in exchange for Newco's stock.[6] Holders of Target securities will not recognize gain or loss on the exchange of Target securities for stock or securities of Buyer, except that if the principal amount of the Buyer securities received in the transaction exceeds the principal amount of the Target securities given up, the excess constitutes boot.[7]

b. *Receipt of boot by Target shareholders*

If a Target shareholder or transferor of assets to Newco receives boot in a reorganization or Sec. 351 transaction, he will be required to recognize the gain realized on the exchange of his Target stock or the transfer of assets to Newco, but not in excess of the amount of cash (or the fair market value of other boot) received in the transaction.

Sec. 356(a)(2) provides that the gain recognized upon the receipt of boot is taxed as a dividend to the extent it has the effect of a dividend. Under the Supreme Court's decision in *Comm'r v. Clark*, – U.S. – 109 S. Ct. 1455 (1989), whether the receipt of boot should be taxed as a dividend is to be tested by hypothesizing a redemption after the reorganization.

c. *Basis of Target shareholders in property received from Buyer*

i. *General*

Under Sec. 358(a)(1) Target shareholders (and, in the case of a Sec. 351 transaction, the transferors of assets to Newco) will have a basis in any Buyer or Newco stock or securities received in the transaction equal to their basis in the property exchanged for such stock or securities, reduced by (1) the fair market value of any other consideration (other than money) received in the transaction, (2) the amount of any money received and (3) the amount of any loss recognized in the transaction, and increased by (1) the amount treated as a dividend and (2) the amount of gain on the transaction (not including any amount treated as a dividend). Boot received in the transaction takes a fair market value basis under Sec. 358(a)(2).

ii. *Basis consequences of the assumption of liabilities*

With certain minor exceptions, Sec. 358(d) provides that if one party to a reorganization, as consideration for the transfer of property, assumes the liability of another party to the reorganization, or acquires property subject to a liability, the assumption or acquisition (in the amount of the liability) will be treated as the payment of money to the party relieved of the liability. This would result in a reduction in the basis of property received in the transaction under Sec. 358(a)(1).

2. Treatment of Target, where Target transfers assets

Sec. 361 governs the treatment of corporations that are parties to a reorganization. Under Sec. 361(a), Target will recognize no gain or loss on the transfer of its assets for property, except to the extent that Target receives boot and does not distribute boot to its shareholders as part of the transaction.

a. *Receipt or distribution of boot by Target*

In general, Target does not recognize gain or loss on the distribution of property to its shareholders pursuant to the plan of reorganization.[8] Target must recognize gain (but not loss) upon the distribution of property other than "qualified property" (i.e. stock (or rights to acquire stock) or obligations of Target, or of Buyer) if received by Target in the exchange. Sec. 361(c)(2). Note that "qualified property" is

5. See, e.g. May B. Kass, 60 T.C. 218 (1973), *aff'd mem.*, 491 F.2d 749 (3d Cir. 1974).
6. Sec. 351(a).
7. Secs. 354(a)(1) and 354(a)(2).
8. Sec. 361(c)(1).

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more broadly defined than "stock or securities". Note also that Target will take a fair market value basis in boot received from Buyer, and will thus recognize gain only to the extent of post-acquisition appreciation.[9]

Sec. 311 and the liquidation provisions of Subchapter C do not apply to distributions by Target.[10] A transfer of boot to creditors of Target in connection with the reorganization is treated as a distribution pursuant to the plan of reorganization, and thus presumably governed by Sec. 361(c). A transfer of qualified property by Target to its creditors in connection with the plan of reorganization is treated as a distribution to shareholders pursuant to the plan of reorganization, and thus presumably tax-free.[11]

Target can transfer short-term notes of Buyer, as well as stock and/or securities of Buyer, to its creditors without recognizing gain. However, Target apparently cannot sell stock or securities of Buyer and use the proceeds to pay liabilities, without recognizing gain. If Target does not transfer all of its assets to Buyer, it will be taxed on the distribution of the retained assets, even if they are distributed to an 80% distributee, which would be tax-free in a liquidation under Secs. 332 and 337 if those provisions were not made inapplicable by Sec. 361(c)(4).

3. Treatment of Buyer or Newco

Under Sec. 1032, Buyer (or Newco) will recognize no gain or loss on the receipt of Target stock or assets in exchange for its stock, whether or not pursuant to a reorganization. The transfer of property by Buyer or Newco other than its stock or securities (such as the stock of Buyer's parent corporation) should result in the recognition of gain or loss, unless the transfer is specifically protected by the reorganization provisions. See the discussion of triangular mergers at Section IV.D.2.

a. *Basis in assets or stock received*

Under Secs. 362(a) and 362(b), Buyer's (or Newco's) basis in the assets received in the transaction will be the same as the transferor's basis in such assets, increased by any gain recognized by the transferor in the transaction. In a reverse subsidiary merger, Buyer's basis in Target's stock is the same as Target's basis in its assets, plus the basis in Buyer's subsidiary prior to the transaction and the basis of any property transferred to the subsidiary as part of the transaction but not distributed to Target's shareholders.[12]

4. Assumption of liabilities in a reorganization

Sec. 357(a) provides that, in general, if a taxpayer receives stock and securities in a reorganization or Sec. 351 incorporation, and as part of the consideration in the transaction, another party to the transaction assumes a liability of the taxpayer or acquires property from the taxpayer subject to the liability, the assumption or acquisition will not be treated as boot, and will not disqualify the transaction as a reorganization or Sec. 351 incorporation. For special rules regarding the assumption of liabilities in reorganizations, see Sections IV.D.4 and IV.F.3.b.

a. *Tax avoidance purpose*

Sec. 357(b) provides that if the principal purpose of the taxpayer with respect to the assumption of liabilities or acquisition of property subject to liabilities was to avoid Federal income tax on the exchange, or was otherwise not a bona fide business purpose, the amount of the liability assumed or taken subject to in the exchange will be treated as money received by the taxpayer in the exchange.

b. *Liabilities in excess of basis*

Sec. 357(c) provides that, with certain exceptions generally not relevant to acquisition transactions, in the case of a Sec. 351 incorporation or a reorganization described in Sec. 368(a)(1)(D) (not discussed in this article because it is generally not used in acquisitions), if the sum of the liabilities assumed by the transferee ("Newco"), plus the sum of liabilities to which the contributed property is subject, exceeds the total of the adjusted basis of the property transferred, the excess is considered gain on the sale or exchange of the transferred property. The amount of the excess is treated as gain, regardless of the relationship of the fair market value of the property to its adjusted basis. In addition, Sec. 357(c) can apply to the transfer of property to Newco subject to indebtedness even if the transferor remains personally liable on the indebtedness.[13] Under Sec. 357(c)(3), liabilities are excluded for purposes of computing Sec. 357(c) gain if the payment of the liability would give rise to a deduction.

C. General requirements to qualify as a reorganization under Sec. 368

1. Continuity of interest

Under this judicially created doctrine, shareholders of Target must retain a proprietary interest in Target's business by acquiring an equity interest in Buyer. Continuity of interest cannot be achieved by receipt of cash or securities, but can be achieved by receipt of preferred stock, which, except for statutory restrictions in certain instances, can be non-voting, non-participating and non-convertible.

The Service's ruling guidelines require that at least 50% of the consideration received by Target's shareholders, as a group, must be Buyer's stock.[14] However, the courts have found sufficient continuity of interest where a smaller percentage of the consideration received was stock.[15] It is not clear how long a shareholder must hold stock after the exchange to meet the continuity of interest requirement.[16]

2. Continuity of business enterprise

In order for a transaction to qualify as a reorganization, Buyer must either continue Target's "historic business" or use a "significant portion" of Target's "historic business assets".[17]

3. Business purpose

The reorganization must have a valid business purpose. This rather murky concept is derived from *Gregory v. Hel-*

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9. Secs. 358(a)(2) and 358(f).
10. Sec. 361(c)(4).
11. Sec. 361(c)(3).
12. Treas. Reg. Sec.1.358-6(c).
13. David Rosen, 62 T.C. 11 (1974), *aff'd mem.*, 515 F.2d 507 (3d Cir. 1975).
14. Rev. Proc. 77-37, 1977-2 C.B. 568.
15. See *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (sufficient continuity of interest existed where 38% of consideration was preferred stock, 62% was cash).
16. See *McDonald's Restaurants of Illinois, Inc. v. Comm'r*, 688 F.2d 520 (7th Cir. 1982) (no continuity of interest; former Target shareholders intended at the time of the exchange to sell Buyer stock, and did sell the stock approximately 6 months thereafter); *Robert A Penrod*, 88 T.C. 1415 (1987) (continuity of interest existed where former Target shareholders sold Buyer stock 8 months after exchange due to subsequent change in circumstances).
17. Treas. Reg. Secs. 1.368-1(b) and 1.368-1(d).

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vering.[18] Treas. Reg. Sec. 1.368-1(b) states that reorganizations are concerned with "readjustment of corporate structures ... required by business exigencies"; and Treas. Reg. Secs. 1.368-1(c) and 1.368-2(g) elaborate further, but do not necessarily illuminate further.[19]

D. Types of reorganizations

1. Statutory merger or consolidation

This type of reorganization is described in Sec. 368(a)(1)(A), and is commonly referred to as an "A" reorganization. In the standard "A" reorganization (e.g. a merger of Target into Buyer) the transaction must qualify as a merger or consolidation under state law. The transaction must meet the continuity of interest requirement, but there are no statutory requirements regarding the consideration that can be received in an "A" reorganization. Under Sec. 368(a)(2)(C), Buyer can transfer part or all of the assets received in the merger to a subsidiary.

2. Triangular mergers

The Code provides for two types of reorganizations which are mergers in which Target shareholders receive stock of Buyer in exchange for their Target stock, but Target is merged with a subsidiary ("Sub") of Buyer. Unless Sec. 368 specifically permits use of stock other than stock of the corporation with which Target is merged or which acquires Target's stock or assets, the transaction will not qualify as a reorganization, because the stock received must be that of a "party to the reorganization".[20]

a. *Forward subsidiary merger*
Sec. 368(a)(2)(D) provides that a transaction will qualify as an "A" reorganization if Target merges into Sub, with Sub surviving, and the shareholders of Target receive stock of Buyer in the transaction. The general requirements of an "A" reorganization must be met (however, unlike in a standard "A" reorganization, stock of a non U.S. corporation can be used as consideration), and no Sub stock can be used in the transaction. Sub must obtain "substantially all the properties" of Target in the transaction, which is defined by the Service for advance ruling purposes as 70% of the gross value of the assets unreduced by liabilities and 90% of the value of the assets net of liabilities.[21]

If Target disposes of unwanted assets before the merger, the "substantially all the properties" requirement may not be met. If the transaction fails to qualify as a reorganization, Sub may be taxable on the exchange of Buyer stock (in which Sub has a zero basis) for Target assets and Target would be taxable on the transfer of its assets to Sub. In addition, Target shareholders would be taxable on the exchange of their Target stock for Buyer stock. Further, state and local sale taxes could apply to the transfer of Target's assets in the merger, even though it qualifies as a tax-free reorganization for Federal income tax purposes.

b. *Reverse subsidiary merger*
Sec. 368(a)(2)(E) provides that a transaction in which Sub merges into Target, with Target surviving, and Target shareholders receive stock of Buyer, will qualify as an "A" reorganization if after the transaction Target holds substantially all of its properties (70% of gross assets and 90% of net assets) and those of Sub (other than Buyer stock transferred to Target shareholders) and the Target shareholders exchange an amount of Target stock constituting "control" of Target (i.e. 80% of voting stock and 80% of other classes of stock, Sec. 368(c)) for voting stock of Buyer. (Note that in a straight or forward subsidiary merger the Buyer stock need not be voting stock.) Like a forward subsidiary merger, and unlike a straight merger, stock of a non-U.S. corporation can be used as consideration.

i. It is not always clear what constitutes voting stock. For example, the Buyer stock received by Target shareholders may have diluted voting rights.

ii. Buyer must acquire stock constituting control (as defined in Sec. 368(c)) of Target in the reorganization. Previously acquired Target stock does not count toward control.

iii. Disposition of unwanted Target assets (including by a distribution to Buyer or a Buyer affiliate), either before or after the transaction, may cause Target to fail to hold substantially all of the Target and Sub assets.

iv. Stock of Buyer's parent cannot be used in a reverse subsidiary merger. However, if no consideration other than voting stock of Buyer's parent is used, the transaction may qualify as a "B" reorganization under Rev. Rul. 67-448, 1967-2 C.B. 144.

v. If the transaction does not qualify as a reorganization, Target shareholders will recognize gain or loss on the exchange of their Target stock for Buyer stock, but there should be no adverse tax consequences to Sub or Target.

3. Stock for stock reorganization

Under Sec. 368(a)(1)(B), an exchange of Target stock solely for voting stock of Buyer (or Buyer's parent) will qualify as a reorganization (commonly called a "B" reorganization) if Buyer is in control (as defined in Sec. 368(c)) of Target immediately after the transaction. Unlike a reverse triangular merger, if Buyer owned Target stock before the transaction, that stock will count in determining whether the control requirement is met. Thus "creeping control" is permissible in a "B" reorganization. Sec. 368(a)(2)(C) permits the transfer of part or all of the stock acquired in a "B" reorganization to a subsidiary of Buyer.

Because the consideration must be solely voting stock of Buyer, any other consideration will cause the transaction to fail to qualify. For example, contingent stock arrangements or excessive compensation to Target shareholder/employees may constitute impermissible consideration.

If Target has more than one class of stock, it may be difficult to determine if Buyer has obtained control of Target, unless all of Target's stock is acquired. If Buyer acquires Target stock in more than one transaction, and has paid consideration other than its voting stock for Target stock, the Service may argue that the transactions must be aggregated, resulting in impermissible consideration being paid in the acquisition.

4. Stock for asset reorganization

Sec. 368(a)(1)(C) provides that if Buyer acquires substantially all of Target's assets solely for voting stock of Buyer (or Buyer's parent) (with additional consideration permitted in some circumstances) the transaction will qualify as a reorganization (commonly called a "C" reorganization). Buyer may assume any amount of Target's liabilities. Up to 20% of the consideration may be other than Buyer (or Buyer's parent) voting stock, but this amount is reduced by

18. 293 U.S. 465 (1935).
19. Bittker, "What is "Business Purpose" in Reorganizations?", 8 NYU Inst. on Fed. Tax'n 134 (1950).
20. See Secs. 354(a) and 361(a); *Groman v. Comm'r,* 302 U.S. 82 (1937); Rev. Rul. 67-326, 1967-2 C.B. 143.
21. Rev. Proc. 77-37, 1977-2 C.B. 568.

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the amount of Target liabilities assumed by Buyer, so if Buyer assumes Target liabilities amounting to over 20% of the total consideration, all the remaining consideration must be voting stock.[22] Target is required to liquidate as part of the transaction.[23] Sec. 368(a)(2)(C) permits the transfer of part or all of the assets acquired in a "C" reorganization to a subsidiary of Buyer.

Disposition of unwanted Target assets may cause the transaction to fail the "substantially all the assets" test (70% of gross assets and 90% of net assets, according to the Service's ruling guidelines). The asset transfer may be subject to state and local taxes, even though tax-free for federal income tax purposes.

E. Use of Sec. 351 in acquisitive transactions

1. Requirements of Sec. 351

One or more persons must transfer assets (which may include cash) to a new corporation ("Newco") in exchange for stock of Newco. The transferors of the assets, as a group, must be in control of Newco (owning 80% of voting power and 80% of all non-voting stock) after the transaction.

2. Differences between Sec. 351 and the reorganization provisions

a. The receipt of boot in any amount will not disqualify the transaction as tax-free, although the transferors of the assets will be required to recognize gain or loss to the extent of the boot received.
b. There is no continuity of business enterprise requirement.
c. The transferors must control the acquiring entity, unlike most reorganization provisions.

3. Acquisition situations in which Sec. 351 is useful

a. *The "National Starch" transaction*[24]

In this situation, a large group of Target shareholders ("Group A") wishes to receive cash for their Target stock, and a small group of shareholders ("Group B") (too small to qualify for continuity of interest in a reorganization or to meet other reorganization requirements) wishes to avoid gain recognition on the transaction. Buyer and Group B form Newco in a transaction qualifying as tax-free under Sec. 351. Buyer contributes cash for Newco common stock and Group B contributes Target stock for Newco preferred stock. Newco acquires the remaining Target stock from Group A with the cash transferred to it by Buyer. In a change to its prior position, the Service approved this type of transaction in Rev. Rul. 84-71, 1984-1 C.B. 106.

b. *Leveraged buy-outs using Sec. 351*

Target shareholders in a leveraged buy-out transaction can receive stock of the acquiring corporation tax-free. Newco is capitalized with cash by Buyer. Newco forms Sub by contributing cash to it, and Sub borrows additional cash. Sub is merged into Target. Target survives the merger and becomes a subsidiary of Newco, and also assumes the liability for Sub's borrowings. Target's shareholders receive cash and Newco stock. For tax purposes, provided the formation of Newco and the acquisition of Target are treated as part of a single transaction, Target shareholders and Buyer will be treated as having transferred Target stock and cash, respectively, for Newco stock in the case of Buyer, and in the case of Target shareholders, for Newco stock and cash, in a transaction qualifying under Sec. 351. Target shareholders will be required to recognize gain on the transaction to the extent of cash received from Newco.

If Target shareholders own 50% of the voting power or value of both Target and Newco, Sec. 304 will treat the distribution of cash to Target shareholders as a distribution in redemption of their Target stock, which must be tested for dividend equivalence under Sec. 302(b). If cash derived from borrowings secured by Target's assets is paid to the Target shareholders, the payment is also treated as a redemption by Target of a portion of its stock. To the extent Target stock is treated as being redeemed by Target, rather than transferred to Newco for Newco stock and cash, Target shareholders can offset their basis in the Target stock against the cash received in the transaction, and thus defer a portion of the gain that would otherwise be recognized on the transaction.[25]

F. Special problems in tax-free transactions

1. Types of consideration

It is not always clear what constitutes "stock" or "voting stock" or "securities" for purposes of the reorganization provisions.

a. *Definition of "stock"*
Generally, stock will be held to be stock and not debt when the payment of dividends and the possibility of redemption is subject to local law limitations (e.g. the existence of surplus) and the stock is subordinated to claims of creditors.[26] The commitment of the issuer to redeem the instrument within a short period may indicate that purported stock is debt. A five-year period is generally regarded as safe.[27]

b. *Definition of "voting stock"*
Stock is generally held to be voting stock if its holders may vote for directors.[28] The effect of diluted voting rights is unclear.[29]

c. *Definition of "securities"*
Short-term notes do not generally qualify as securities.[30] As a rule of thumb, notes payable in less than five years have a high risk of not qualifying as securities, those payable in ten years or more are likely to qualify.

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22. Sec. 368(a)(2)(B).
23. Sec. 368(a)(2)(G).
24. National Starch and Chemical, 93 T.C. 7 (1989).
25. See Private Letter Ruling (LTR) 8634066 (28 May 1986); LTR 8546110 (21 August 1985); LTR 8540219 (18 July 1985). See generally Bowen, "The Reach of Section 351", 59 *Taxes* 926 (1981).
26. *Zilkha & Sons, Inc.* 52 T.C. 607 (1969), acq. 1970-1 C.B. xvi; *Ragland Investment Company,* 52. T.C. 867 (1969), *aff'd per curiam,* 435F.2d 118 (6th Cir. 1970) (shareholder guarantee of redemption).
27. See Rev. Rul. 66-23, 1966-1 C.B. 67.
28. *Rudolph Wurlitzer Co. v. Comm'r,* 81 F.2d 971 (6th Cir. 1936), *cert.* den., 298 U.S. 676 (1936); *Erie Lightinq Co. v. Comm'r,* 93 F.2d 883 (1st Cir. 1937); Rev. Rul. 63-234, 1963-2 C.B. 148 (right to vote for 2 to 12 directors).
29. See LTR 8222058 (4 March 1982) (stock with ⅖ of a vote per share held to be voting stock).
30. See Treas. Reg. Sec. 1.371-1(a) (5) (short-term purchase-money notes not securities); *Bradshaw v. United States* 683 F.2d 365 (Ct. Cl. 1982) (installment notes payable in 2½-6½ years not securities). Longer-term debentures generally do qualify as securities. See *United States v. Hertwig,* 398 F.2d 452 (5th Cir. 1968) (12½ year installment notes securities); *Camp Wolters Enterprises, Inc.,* 22 T.C. 737 (1954) *aff'd* 230 F.2d 555 (5th Cir. 1956) *cert. den.* 352 U.S. 826 (1956) (notes payable in 5-9 years were securities; term of debt not exclusive factor, degree of participation, risk, similar factors also important).

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2. Contingent stock

Buyer may issue additional stock in a reorganization contingent on Target's performance after the reorganization. The courts have held that the right to receive contingent stock is not boot that could disqualify or be taxable in a reorganization.[31] The Service has agreed to follow *Hamrick* but not *Carlberg* because the contingent stock rights in *Carlberg* were negotiable.[32]

The Service will rule that payments of contingent stock constitute stock, rather than boot, if certain tests are met:[33]

i. there must be a business purpose, such as an inability to determine value, for the delayed issuance of stock;
ii. the contingent stock must be paid within 5 years;
iii. there must be a limit on the total number of shares that may be issued;
iv. at least 50% of the total number of shares of each class that can be issued must be paid at the outset;
v. the rights to contingent shares may not be freely marketable;
vi. the rights can give rise only to the receipt of additional stock;
vii. the event that triggers the transfer of additional shares may not be within the control of the Target shareholders and may not be the payment of additional tax or a reduction in tax as a result of an audit by the Service;
viii. the mechanism for calculating the amount of additional stock must be objective and readily ascertainable.

Note that contingent stock payments can give rise to imputed interest under Sec. 483.[34]

3. Pre-reorganization dividends and other cash payments to Target shareholders

If the character of certain cash payments to shareholders is not respected, and is treated as part of the reorganization consideration, the transaction may fail to meet the "solely for voting stock" requirement of "B" and "C" reorganizations, or the continuity of interest requirement.

a. *Pre-reorganization dividends*

Generally, the payment of a dividend by Target will be treated as a dividend, and will not be treated as reorganization consideration.[35] However, if Target pays the dividend with borrowed funds and Buyer provides Target with funds to repay the loan, the purported dividend will be treated as consideration paid by Buyer to the shareholders of Target.[36] A large pre-reorganization dividend (or in the case of a reverse subsidiary merger, a large pre- or post-reorganization dividend) may cause a failure to meet the "substantially all the assets" test of "C" reorganizations or the triangular reorganizations.

b. *Payment of reorganization expenses*
The Service has ruled that the acquiring corporation can assume or pay expenses of Target and its shareholders that are "solely and directly related to the reorganization".[37] Permissible expenses are only those directly related to the transfer of Target's property or the Target shareholders' equity interest, such as legal and accounting fees, appraisal and administrative expenses.

The payment of personal expenses of Target shareholders that are not directly related to their transfer of Target stock, such as expenses relating to investment or estate planning advice, or advice regarding individual participation in the transaction, will not be protected under Rev. Rul. 73-54, and will be treated as additional consideration for Target stock.

The payment of cash by Buyer to Target shareholders to enable them to pay their reorganization expenses is treated under Rev. Rul. 73-54 as paid for their Target stock.

In a Sec. 351 incorporation, the assumption of the transferors' expenses by the newly-formed corporation does not disqualify the transaction and does not constitute boot.[38]

c. *Compensation payments to Target shareholders*
If salaries or consulting fees paid by Buyer to Target shareholders are reasonable compensation for the services performed, the character of the payments should be respected. However, if the payments are excessive for the services performed, or bear no real relationship to the performance of services, the Service could assert that the payments constitute payments for Target stock, rather than payments of compensation.

G. Disposing of unwanted Target assets

If Target has businesses or assets that Buyer does not want to acquire, Buyer may require Target to dispose of the unwanted assets or businesses before the acquisition. Alternatively, Buyer may dispose of the assets after the acquisition of Target, but would prefer to minimize the taxes payable on such a disposition. Target may wish to avoid gain recognition on the disposition of these assets, if possible, and the parties will want to ensure that the disposition does not jeopardize the status of a tax-free acquisition of Target by Buyer.

1. Disposition techniques

Possible disposition techniques include the following:

a. *Tax-free spin-off to its shareholders under Sec. 355*
If the requirements of Sec. 355 are met – most importantly, that both the distributing and the distributed corporations conduct active businesses which have not been acquired (directly or indirectly through another corporation) in a taxable transaction within 5 years prior to the spin-off – Target can distribute its unwanted businesses tax-free to its shareholders prior to its acquisition by Buyer in a reorganization. Alternatively, Target can retain its unwanted assets, and spin off to its shareholders the businesses Buyer wishes to acquire, and Buyer will acquire the distributed corporation from the shareholders of the distributing corporation in a reorganization.[39]

Changes made to Sec. 355 as part of the 1987 Act have made it nearly impossible for Target to spin off unwanted businesses tax-free after being acquired by Buyer, unless Buyer acquired Target in a wholly tax-free transaction with no

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31. *Carlberg v. United States,* 281 F.2d 507 (8th Cir. 1960); *James C. Hamrick,* 43 T.C. 21 (1964).
32. Rev. Rul. 66-112, 1966-1 C.B. 68.
33. Rev. Proc. 77-37, 1977-2 C.B. 568; amplified by Rev. Proc. 84-42, 1984-1 C.B. 521.
34. See generally Walter & Strasen, "Contingent and Adjustable Stock in a Public Context", 65 *Taxes* 439 (1987).
35. Rev. Rul. 68-435, 1968-2 C.B. 155.
36. Rev. Rul. 75-360, 1975-2 C.B. 110.
37. Rev. Rul. 73-54, 1973-1 C.B. 187.
38. Rev. Rul. 74-477, 1974-2 C.B. 116.
39. See *Comm'r v. Morris Trust,* 367 F.2d 794 (4th Cir. 1966); Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Rul. 75-406, 1975-2 C.B. 125. See generally, Walter, "Unwanted Assets in Taxable and Tax-Free Corporate Acquisitions: Old Wine in New Bottles", 63 *Taxes* 897 (1985); Handler, "Variations on a Theme: The Disposition of Unwanted Assets", 35 *Tax Law Rev.* 389 (1980).

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boot, or did not acquire "control" of Target.[40] Regulations recently promulgated under Sec. 355 have also made it more difficult to spin off businesses tax-free in other contexts.

b. *Taxable dispositions*

If Target has net operating losses, or if a disposition of assets cannot qualify under Sec. 355, Target may dispose of its unwanted assets in taxable sale or distribution. Although technically Target could retain some assets in a "C" reorganization, the requirement that Target liquidate as part of the transaction effectively requires a distribution of the unwanted assets to Target's shareholders in a taxable transaction. If Buyer has a net operating loss, new Sec. 384, added by the 1987 Act, may limit the use of that net operating loss to shelter gain on the disposition of unwanted Target assets after Buyer acquires Target.

2. Effect of dispositions on "substantially all the assets" requirement

The disposition of unwanted assets by Target may result in the failure to meet the "substantially all the assets" requirement of the "C" reorganization and the forward and reverse subsidiary mergers.

Transactions in the ordinary course of business, such as sales of inventory (Rev. Proc. 77-37, 1977-2 C.B. 568) or regular quarterly dividends (Rev. Rul. 74-457, 1974-2 C.B. 122) will not be taken into account in determining whether substantially all of Target's assets have been acquired. Conversely, transactions not in the ordinary course of business, such as a spin-off (*Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937); *cert. den.* 305 U.S. 605 (1938)) or a stock redemption (Rev. Proc. 77-37, 1977-2 C.B. 568) will be taken into account in determining whether substantially all of Target's assets have been acquired.

The effect of taxable sales of Target's asset for a fair price is unclear. Dividends or redemptions by Target before a "B" reorganization should not affect the "solely for voting stock" requirement, as long as Target did not borrow to make the distribution.[41]

V. ALLOCATION OF BASIS AMONG ASSETS

A. Purchase of assets

To maximize its tax benefits, Buyer would prefer to have the bulk of purchase price allocated to depreciable or amortizable assets. Availability of the tax benefits sought by Buyer often will depend on its ability to sustain the purchase price allocation. Target would prefer to allocate more purchase price to high basis assets and capital assets. Although there are now detailed rules for allocating purchase price among purchased assets, the relative fair market values of many assets are not easily determined, and there is room, within limits, for negotiation between Buyer and Target as to the allocation of the purchase price among the various assets that are acquired. Note that in the case of a stock purchase followed by a Sec. 338 election, unless Seller agrees to pay part of the tax resulting from the deemed asset sale, the usual adversity of interest between Buyer and Seller does not exist, because Buyer will both pay the tax and receive the tax benefits of the basis step-up resulting from this Sec. 338 election.

B. Method of allocating purchase price in an asset sale or deemed asset sale

In the case of most asset transfers, basis must be allocated under Treasury Regulations prescribed under Sec. 1060, which are nearly identical to the rules governing the allocation of basis following a Sec. 338 election. In addition, the transferor and transferee must provide certain information about the transactions to the Service. The method of allocating the "purchase" price among assets following a Sec. 338 election is also prescribed by Treasury Regulations. Under the regulations, the basis to be allocated following a Sec. 338 election includes the sum of the basis of Target's stock (adjusted where less than all of the Target stock was recently purchased), the liabilities of Target and other miscellaneous items. For other asset acquisitions, the basis to be allocated is the purchase price (including assumed liabilities) of the assets.

1. Allocation of basis among Target's assets

Under Temp. Reg. Sec. 1.338(b)-2T(b) (governing allocation of basis after a Sec. 338 election) and Temp. Reg. Sec. 1.1060-1T(d) (governing allocations of basis for other asset acquisitions), basis is allocated among the acquired assets as follows:

a. first, basis is reduced by the amount of cash, demand deposits, and similar cash-like accounts;
b. second, basis is allocated in proportion to fair market values among certificates of deposit, U.S. Government securities, readily marketable stock and securities, foreign currency, and similar items with a readily determinable fair market value;
c. third, basis is allocated in proportion to fair market values among all remaining Target assets, except for goodwill;
d. fourth, all remaining basis is allocated to goodwill (or "going concern value" which also is not amortizable).

2. Fair market value limitation

The amount of basis allocated to any asset (other than goodwill) cannot exceed the fair market value of that asset immediately after the acquisition of Target stock. The excess of basis over the aggregate fair market value of all assets other than goodwill must be allocated to goodwill (or going concern value). The regulations thus embrace the "residual" method for determining goodwill, in contrast to the "proportionate" method contained in prior law.

C. Allocation to specific items

1. Non-depreciable and non-amortizable assets

a. Cash and cash equivalents such as bank deposits, checks, money orders, accounts receivable guaranteed by a third party, and similar assets, accounts receivable, inventory, goodwill or going concern value cannot be depreciated or amortized.

b. Accounts receivable can be written down below face, but cannot be written up above face amount.[42]

c. Inventory can be written up to selling price, less cost of disposition and less reasonable profit associated with selling. The Service prescribes three other methods for valuing inventory: (1) costs of reproduction, (2) comparative sales, or (3) income method.[43] Though not depreciable, inventory write-ups may be recovered through cost of goods sold.

40. See Sec. 355(b) (2) (D) as amended by the 1987 Act.
41. See Rev. Rul. 70-172, 1970-1 C.B. 77.
42. Rev. Rul. 77-456, 1977-2 C.B. 102.
43. Rev. Proc. 77-12, 1977-1 C.B. 569.

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d. Goodwill. Under the "residual" approach, which is now required for nearly all actual or deemed asset acquisitions, goodwill equals the excess of purchase price (including liabilities assumed) over the fair market value of all other assets.

2. Depreciable or amortizable assets

Commercial real property placed in service after 31 December 1986 can be depreciated over 31.5 years using the straight-line method of depreciation. Personal property can be depreciated over depreciable lives ranging from 3 years to 20 years, using an accelerated method of depreciation.

In addition to the "usual" depreciable property, assets such as customer lists, subscription lists, insurance expiration lists, know-how, technology, contracts, leases, blueprints, plans and similar intangible assets can be allocated purchase price. The purchase price can be amortized over a useful life, if: (1) the asset's useful life is determinable, (2) the asset has an ascertainable value, and (3) the asset is distinguishable from goodwill.[44] A covenant not to compete is amortizable over the life of the covenant.

VI. OTHER PLANNING TECHNIQUES

A. Allocations to compensation payments or covenants not to compete

The acquisition of a business will frequently involve entry into employment arrangements with key employees who may also be principal stockholders, or entry into covenants not to compete with such persons. Sellers may regard payments for compensation and covenants not to compete as part of the overall package being received for the transferred business. There is therefore an opportunity, within limits, for the Buyer to pay more for these items and less for the stock or assets.

Payments for compensation and covenants not to compete generate ordinary income to sellers. Accordingly, sellers have historically preferred a greater allocation to stock or assets and less to these ordinary income items. Buyers have desired greater allocation to these items, since compensation is deductible as paid or accrued and covenants not to compete may be amortized over their lives.

Capital gains and ordinary income are now taxed at the same maximum rate. Sellers should therefore generally be indifferent to the shifting of more of the total payments for the business to compensation and covenants not to compete. Now the maximum corporate tax rate is 34% while the maximum individual tax rate is generally 28%. Thus, a deduction for payment of compensation, or a payment under a covenant not to compete will have greater value to Buyer than its tax cost to the individual Seller. Accordingly, it should be possible to increase overall value to the transaction by increasing payments for these deductible ordinary income items and decreasing the amounts paid for stock or assets.

Compensation will be deductible only to the extent it is reasonable. Compensation arrangements may be subject to "golden parachute" provisions, which, in effect, impose a higher burden of establishing that the amount paid to the employee is reasonable compensation for services performed. Payments under the covenants not to compete also must be reasonable in amount taking into account the terms of the covenant and surrounding circumstances.

B. Lease or royalty payments

A similar opportunity for rate arbitrage may be presented if some of the assets of the acquired business, such as depreciable real estate, copyrights or licenses, are held by individual owners of the business rather than in a corporation. In these cases, it may make sense for Buyer to lease the real estate or pay royalties for license rights under patents, for example, rather than purchasing the underlying asset, if the rental or royalty deductions would be greater than the depreciation or amortization deductions available with respect to these assets. The lease or royalty arrangement may maximize the amount which will be deductible to Buyer (compared to the amount which could be depreciated or amortized if the asset were purchased).

C. Interest on deferred payments

Payments of interest will also generate ordinary income to Seller and an ordinary deduction to Buyer. An interest factor will be imputed unless interest is provided for at an adequate rate. The parties may again benefit from the spread between corporate and individual rates by providing for a higher rate of interest, and reducing the overall purchase price of the business.

D. Deferral techniques

There are a number of ways to achieve a deferral of tax liability, which could be as valuable to Seller as tax-free treatment of the sale.

1. Installment sales

Gain will be deferred to the extent the purchase price is paid in non-tradeable notes of Buyer. The deferred gain will be recognized only as the notes are paid (unless recognition is accelerated as described below). This treatment will apply to contingent as well as fixed payments (e.g. payments received under an "earnout" formula). An interest factor will be imputed. However, in many circumstances the benefits of a deferral of gain are severely limited by provisions recently added to the Code. A taxpayer is required to pay interest on the deferred tax liability resulting from installment sales of any property with a sales price in excess of $ 150,000, with certain limited exceptions, to the extent the taxpayer holds installment obligations which arose in the taxable year and are outstanding at the end of the taxable year, with an aggregate principal amount in excess of $ 5 million. Also, the receipt of proceeds of borrowings secured by a pledge of such installment obligations are treated as payments with respect to those obligations, triggering the recognition of deferred gain. The installment method also cannot be used for sales of publicly traded stock or securities, or other publicly traded property specified by regulations. In addition, in an asset sale, all depreciation recapture is due in the year of sale, whether or not it would otherwise be reportable under the installment method.

If an installment note is distributed, transmitted, sold or otherwise disposed of, the deferred gain must be recognized by the person disposing of the installment note. Thus, if a corporation (other than a subsidiary of another corporation) distributes to its shareholders in liquidation installment notes received by it upon sales of its assets, the liquidating corporation must immediately recognize the deferred gain as though it had sold the notes for their fair market value. If a shareholder receives an installment note as part of a liquidating distribution, he will be treated as having received

44. See Rev. Rul. 74-456, 1974-2 C.B. 65.

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the note in redemption of his stock, and will be required to recognize gain (i.e. the difference between the basis of his stock exchanged for the note and the amount payable under the note) only as payments are made on the note, provided the note was received by the corporation with respect to a sale or exchange that occurred in the 12-month period beginning on the date a plan of liquidation was adopted by the corporation, and the liquidation is completed during that period.

2. Lease/license arrangements

Although these arrangements would generate ordinary income, taxation would be deferred until payments accrue or are received (depending on Seller's method of accounting).

3. Deferred compensation payments

The timing of payments under an employment contract (or pursuant to a covenant not to compete) could be tailored to suit Seller's wishes. Although services will be performed currently, the employee will not have current tax liability if he does not have a contractual right to payment until a later year.

VII. TAX CONSIDERATIONS IN EARNOUTS

A. Purchase of assets

A contingent element of purchase price may be based upon a future earnings formula or may be tied to a specific asset (e.g. a percentage of gross receipts or profits attributable to a patent). Except in the case of contingent payments for certain intangible assets, as described below, contingent payments must be allocated among the assets as described in Section V.B.1 above, based on the fair market value of the assets at the time of the purchase. The major tax considerations are as follows:

1. A portion of each contingent payment will be treated as interest (except where the contingent payment is for certain transfers of patents). Such interest will be currently deductible by the payor (Buyer) and, unlike the remainder of the contingent payment, will not be added to the basis of the assets acquired. The interest element will be includible in income of Seller (or Target where it sells its own assets); the remainder of the contingent payment will be additional consideration for the assets and will be characterized as capital gain or ordinary income in the same manner as previous payments for the assets.

2. Contingent payments for Accelerated Cost Recovery System (ACRS) property will increase the depreciable basis of the property in the year payment is made, and the increased basis will be recovered over the remaining ACRS recovery period for the asset. Continent payments made in years after the end of the ACRS recovery period would be expense as paid.[45]

3. Contingent payments for intangible assets such as patents are generally added to the purchaser's basis in the year paid, but not in excess of the fair market value of the asset as determined on the date the contingent payment is earned, and amortized over the life of the asset. But in some cases the cost of the intangible asset may be recovered by a deduction in the amount of the payment during the year of payment.[46]

4. Contingent payments with respect to franchises, trademarks and trade names are deductible when paid by the payor if the payments are substantially equal in amount or payable under a fixed formula, and are payable not less frequently than annually during the entire period of the use of the franchise, trademark or trade name. Other payments must be capitalized, and can be amortized over the 25-year period beginning on the date of the transfer of the franchise, trademark or trade name.

5. The applicability of the installment sale rules regarding the payment of interest on deferred tax liability, described in Section VI.D.1 above, to contingent payments is not clear.

B. Purchase of stock

If stock is purchased and no Sec.338 election is made, then the contingent payments will simply be treated as additional payment for the stock (except for the imputed interest element in each contingent payment). If a Sec. 338 election is made, then presumably the contingent payment will be allocated to the assets in the same manner as in a purchase of assets. It is recommended that the contingency be identified with specific assets in the sale contract.

VIII. TAX LIABILITIES INHERITED FROM THE ACQUIRED BUSINESS

A. Stock purchase

If a transaction is structured as a purchase of stock, or as a merger into a company controlled by Buyer, and the Target is not a subsidiary in a consolidated group, Buyer will inherit any outstanding tax liabilities of Target. If this form is used, a number of steps may be taken to reduce Buyer's exposure:

1. Warranty

Seller warrants that all tax returns have been properly filed and that the liability of Target will not exceed an amount provided for in the financial statements (alternative weaker language: that adequate provision has been made for all tax liability.) This warranty should survive the closing until the applicable statutory periods of limitation for taxes have expired.

2. Indemnity

Sellers agree to indemnify Buyer if inherited tax liabilities exceed certain levels. Is Buyer willing to rely on an indemnity?

3. Holdback

Holdback includes tax liabilities exceeding a certain level within the scope of any holdback provision (a provision requiring that a part of the purchase price be retained by Buyer or held in escrow to pay for Seller's indemnities until a specified amount of time has passed). A letter of credit or similar security arrangement may also be used.

B. Purchase of a member of a consolidated group

If the transaction is structured as a purchase of stock, and Target is a subsidiary of a corporation and included in its consolidated return, the Seller's group will be primarily liable for federal income taxes due during the period in

45. See Proposed Treas. Reg. Sec. 1.168-2(d)(3).
46. See *Associated Patentees, Inc. v. Comm'r,* 4 T.C. 979 (1945), *acq.*, 1959-2 C.B.3.

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which Target joined in the consolidated return. However, Target will remain liable for such taxes, including taxes incurred by other members of the affiliated group, and the corporate seller would normally indemnify Target against any tax liability for such period. There may, however, be outstanding liabilities between Target and the corporate seller as a result of "tax sharing agreements" entered into between Target and Seller. The purchase agreement (or a separate agreement) should clarify the obligations of Seller and Target under such agreements (or specify any obligations if there are no such agreements) and otherwise provide for the orderly separation of Target from Seller's consolidated group. In particular, the possibility of carry-backs from Buyer's Group to Seller's Group should be addressed and compensation provided therefor.

C. Asset purchase

If the transaction is structured as a purchase of assets, Buyer will not inherit tax liabilities of Seller. If Buyer is particularly concerned about the existence of contingent tax obligations (or other contingent obligations), the asset sale structure may be preferable for this reason.

NOTE: The costs of State sales and use taxes must also be considered. In addition, in many States a buyer of assets may be liable for State tax obligations of the Seller unless statutory notification procedures are followed.

IX. INTEREST DEDUCTION LIMITATIONS

A. Subordinated convertible acquisition debt

No interest deduction is allowed to a corporation for interest which exceeds $ 5 million paid or incurred during a taxable year on obligations which have certain equity characteristics and (1) are issued to provide, directly or indirectly, consideration for the acquisition of stock or assets of another corporation; (2) are subordinate to trade creditor claims or any substantial amount of unsecured debt; (3) are convertible into stock; and (4) the corporation has a debt equity ratio in excess of 2:1 as of the end of the taxable year. Issuance of such subordinated instruments should be avoided.

B. High yield original issue discount obligations

Ordinarily, original issue discount (the excess of the amount payable upon the maturity of a debt instrument over the issue price of the debt instrument) is accrued and deducted by the issuer over the life of the instrument using a constant-yield method, and is taken into income by the holder on the same basis. However, if a debt instrument (1) "has a maturity date more than five years after the date of issue"; (2) has a yield that exceeds the "applicable federal rate" (a rate derived from U.S. Government obligations of a similar maturity) in effect for the month in which the debt instrument is issued by more than 5 percentage points; and (3) has "significant original issue discount", the issuer will not be able to deduct the original issue discount on that debt instrument until it is paid. A debt instrument has "significant original issue discount" if (1) the amount of original issue discount that accrues (and is not payable) during the period before the close of any "accrual period" ending more than five years after the issue date exceeds (2) the product of the yield and the issue price of the debt instrument. In the case of a debt instrument with a single payment due at maturity, an "accrual period" is any six-month period ending on a day that corresponds either with the maturity date or the date six months before the maturity date, and in the case of a debt instrument that pays or compounds interest on dates occurring at regular intervals of one year or less, the "accrual periods" correspond to such intervals. In addition, to the extent the yield on such a debt instrument exceeds the applicable Federal rate by more than 6 percentage points, the deduction for original issue discount in excess of that yield is disallowed (although all current payments of "coupon" interest remain deductible). That amount will be treated as a dividend solely for purposes of determining whether the recipient qualifies for the dividends-received deduction if that amount would have been treated as a dividend had it been an actual distribution with respect to the issuer's stock.

C. Interest paid to a related person not subject to U.S. tax

If a corporation has, at the close of any taxable year, a ratio of debt to equity greater than 1.5 to 1 (measuring total assets by tax basis rather than by fair market value), an amount of its interest expense paid or accrued to a related person (including a corporation related to the debtor corporation by more than 50% common ownership) that does not exceed its "excess interest expense" will not be deductible if the recipient of the interest is not subject to Federal income tax with respect to the interest income. If the recipient is taxed at a lower rate pursuant to an income tax treaty, that amount will be deductible only in part. "Excess interest expense" is the excess of the corporation's net interest expense over the sum of (1) 50% of the corporation's taxable income, computed without taking into account deductions for net interest expense, net operating loss carry-overs and depreciation, amortization and depletion and (2) the "excess limitation" carried over to the taxable year. The "excess limitation" carried over to the taxable year is the amount which 50% of the corporation's taxable income (adjusted as described above) exceeded its net interest expense in the three prior taxable years, to the extent not previously utilized. Any interest disallowed under this provision is carried forward and treated as incurred in the next taxable year.

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UNITED STATES:

The Sec. 482 White Paper and Superroyalties:

Existing and Proposed Transfer Pricing Methods

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I. INTRODUCTION

A. Overview

The Tax Reform Act of 1986 (the "1986 Act") amended Sec. 482 of the Internal Revenue Code by providing that, in the case of any transfer of intangible property between related parties, the income allocated to the transferor with respect to such transfer be "commensurate with the income" ("CWI") attributable to the intangible. Outlined below are the pricing approaches suggested by the United States Treasury Department for implementing the CWI standard together with observations thereon.

B. Background

Pursuant to Sec. 482, the Internal Revenue Service (IRS) is granted broad authority to allocate income and deductions between commonly controlled business taxpayers in order to properly reflect the income of such businesses. The pertinent regulations state that the purpose of Sec. 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of the controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[1]

Present regulations list a number of factors to be considered in the case of transfers of intangible property between controlled parties. No attempt is made to assign any relative importance to any listed factors in the absence of a comparable existing license between unrelated parties.[2] In an actual intangible property licensing negotiation between unrelated parties, critical factors in determination of royalty payments are the anticipated profits to be derived from exploitation of the intangible property and the risks associated with generating the anticipated profits. Such risks generally may include the cost of bringing the product to market, market acceptability, costs of marketing, possible present and future alternative competing technologies and products, quality of intangible property protection, the manufacturing and marketing capacity of the prospective licensee, governmental requirements and restrictions on marketing the product, currency fluctuations, actual manufacturing costs, inventory obsolescence, product liability, license exclusivity and the durability of profits. Thus, assumption of risk past, present and future is the essential linchpin for negotiations between unrelated parties in dividing prospective profits from the use of intangible property.

As a very general rule-of-thumb starting point, many commentators consider a 75%-25% profit split between licensee and licensor to be typical. The shared profit percentage of a licensor may be enhanced by its assumption of present and future risks such as protection of intangible property rights, product performance assurances and substantial technical assistance costs in transferring the intangible property. A licensor may also receive a somewhat higher royalty where high sustained profits may be accurately forecasted, e.g. a generic patent has been granted and the licensor has already entered the market. Yet, an unrelated licensee usually shares two-thirds to three-quarters (or more) of anticipated pre-tax profit because present and future risk in the form of plant and equipment investment and sunk marketing costs are generally more valuable to sharing than the past locked in research and development costs of a licensor.

In an actual unrelated party licensing negotiation, the parties may differ greatly in their perceptions of the amount and duration of anticipated profits and risks. Not surprisingly, both the IRS and taxpayers have had similar difficulties of "perceptions" of anticipated profits and risks both on audit and in litigation, in the absence of a comparable unrelated party transfer of an intangible. Moreover, in the past, IRS auditors encountered difficulty securing taxpayer documentation contemporaneous with intangible transfers which detailed the reasons for the arm's length consideration of the amounts flowing between the related parties for

1. Treas. Reg. Sec. 1.482-1(b)(1).
2. Treas. Reg. Sec. 1.482-2(d)(2)(iii).

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the intangible transfer. The latter problem was particularly acute with respect to transfers of so-called unique (high profit) intangibles.

Congress responded to the foregoing concerns, as well as perceived undesirable tax avoidance motives in the case of certain transfers of intangibles to foreign low-tax jurisdiction manufacturing subsidiaries of United States multinational corporations by insertion of the CWI standard in Sec. 482 to add to or clarify the arm's length standard. The Conference Report accompanying the legislation strongly urged the IRS to conduct a study of intercompany pricing rules with a view to whether existing regulations ought to be modified in any respect. In response, on 19 October 1988, the Treasury released a "White Paper" titled "A Study of Intercompany Pricing" for public comment. For tax practitioners, the critical portions of the study are primarily contained in Chapters 11 and 13 which respectively discuss arm's length methods for evaluating transactions involving intangible property and cost sharing. The Appendix attached to the end of this article is also significant as it contains examples of how the Chapter 11 arm's length standards would be applied under differing circumstances.

II. STUDY EVALUATION METHODS

A. Introduction

The study introduces four separate approaches to allocate intangible income. There are no specific safe harbors offered by the study. Selection of the most appropriate method for a particular transfer depends on the presence or absence of one or more of the following factors: comparable transactions with unrelated parties; potential and actual profit associated with the intangible; uniqueness of the intangible; actual risks assumed by each party related to bringing the product to market and marketing the product; the substantiveness of functions performed by each of the related parties; and, in some cases, the terms of the transfer.

A further factor, not specifically considered in the study, is the presence of the transferee, especially a manufacturing transferee, in a low-tax jurisdiction. The Treasury has indicated that it will give prime audit emphasis to intangibles transferred to manufacturing subsidiaries in low-tax jurisdictions.

The four evaluation methods suggested by the study are titled as: (1) the exact comparables method (EC); (2) the inexact comparables method (IC); (3) the basic arm's length return method (BALRM); and (4) the BALRM method coupled with a profit split (BALRM-SPLIT). In theory, any of the four methods employed, if appropriate to the transaction, should result in a traditional arm's length consideration for the transfer. However, in practice, the results may vary widely due to the requirement of periodic adjustment of the consideration, the documentation available to the taxpayer essential to make the necessary adjustments in arriving at a traditional arm's length consideration, the approach taken in the study regarding "contract" manufacturing subsidiaries located in low-tax jurisdictions and the potential different treatment of risk assumption contained in the study in contrast to a traditional arm's length approach.

B. Exact comparables (EC) method

1. General rules

To be exact, a comparable transaction must involve the same intangible licensed to an unrelated party when external and internal standards surrounding it and the related party transfer are the same or similar. Under the external standard, the related party arrangement must take place in substantially economic circumstances. Similar economic circumstances means substantially similar markets and similar economic risks. Further, an exactness regarding collateral matters also must be met.

Example: Cross licensing arrangements with third parties may be enough to fail the similar economic circumstances test. It is not unusual in some industries to cross license a large percentage of developed technology (e.g. computers, chemicals and automobiles).

The internal standard requires contractual aspects of the transfer agreement to be substantially similar in important respects, in particular the elements of the transaction which can exercise a significant bearing on income realized by unrelated parties to a license or related party transaction.

Examples:

a. the amount and form of compensation for the transferred intangible;
b. the specified level of technical assistance the related and unrelated parties are to receive;
c. lack of internal comparability, i.e. where one agreement called for the licensee to perform significant marketing or product development functions, while in the other agreement the licensor performs the marketing function.

The EC method *must* be used if available.

Application and analysis

The EC qualifying standards are so strictly drawn that only a small portion of technology transfers are likely to fall within the EC category. The principal difficulty is the exactness required in meeting the internal and external requirements. For instance, competitors are unlikely to exchange license agreements and supply information on market size and product profitability. Also, cross licensing is common in some industries. Generally, in the real world exactness is not subject to the precision suggested in the study.

Even if an exact comparable exists initially, exactness may wane over time unless the contingency clauses in the transfer agreements provide for substantially the same types and amounts of adjustments for changing circumstances and the related parties execute the adjustments as unrelated parties would do. See Appendix, Example 1. Note, the example varies from the text of the study which indicates year-to-year equality is not essential if it is reasonable to conclude the long-term results will be comparable.

The EC method would be more realistic if it were available with adjustments for different risks or factors such as cross licensing if either de minimis or quantifiable in terms of increased or decreased attributable royalty. As presently constructed, the EC method would seldom be available due to substantial ongoing documentation requirements and other limitations such as size and sophistication of markets as well as functions performed by each party. The EC method ought to turn on only two factors: same technology transferred and same prospective and actual profitability (which is actually an amalgamation of all the presently listed factors).

C. Inexact comparables (IC) method

The IC method can be used if the pricing situation involves an intangible very similar, but not identical to the intangible transferred to the related party. In assessing whether a comparable is inexact, a functional analysis may be used.

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The following requirements are necessary for use of the IC method:

a. the EC method must not be available;
b. the same or similar intangibles transferred must be of comparable profitability and both parties must perform the same economic functions;
c. the IC method is not available for transfer of unique intangibles;
d. the differences between the inexact comparable transfers must be ascertainable, that is quantifiable in terms of increasing or decreasing the consideration for the transfer to appropriately reflect the differences. See Appendix, examples 2 and 3;
e. the IC method is not to be given priority over the BALRM method. If both methods are potentially applicable, the taxpayer must accumulate the appropriate documentation to calculate the result under both methods.

The study suggests the list of factors contained in the current Regulations as factors which may be appropriate in determining arm's length where a sufficiently similar intangible property transfer involving an unrelated party cannot be found. Although no attempt is made to weigh all the factors, prospective profits would appear to move to the head of the list. By contrast, prevailing industry rates may not be relied upon unless the transferred intangible is average in terms of profitability.

In selecting inexact comparables, the internal and external standards should parallel those in the transaction at issue as closely as possible.

Application and analysis

Potentially, the IC method is of wide application. Its structure is excellent inasmuch as it is a facts and circumstances approach which should generally appropriate an arm's length arrangement between unrelated parties.

Related parties are precluded from use of the IC method if there are differences in the economic functions performed by related and unrelated party licensees. It would seem more appropriate, however, that such differences should not be fatal, as long as they can be quantified in terms of an adjustment in the allocation of the intangible income or can be accounted for via another Sec. 482 adjustment (e.g., services).

D. The basic arm's length rate of return (BALRM) method

The BALRM method uses an arm's length return analysis instead of looking for a comparable transaction. It is applicable in conjunction with the IC method under the following conditions:

a. no exact comparable transactions with unrelated parties are present; and
b. the related transferee owns no significant self-developed manufacturing or marketing intangibles which are employed in the exploitation of the transferred intangibles.

The BALRM method will receive priority where the above factors are present and the intangible transferred is a unique high profit intangible. The study states that the BALRM method probably will be appropriate for most manufacturing affiliates as well as many distribution and marketing affiliates.

The BALRM method is applied as follows:

a. perform a functional analysis, i.e. break down a relevant line of business into its component activities or functions and measure the factors (generally assets) used by the party performing the simpler set of functions;
b. income attributable to those functions is determined by identifying rates of return to assets or other factors of unrelated entities performing similar economic activities and assuming similar economic risks. A comparable rate of return is then applied to the assets or other factors of the related party. The portion of the total net pre-tax income attributable to the asset rate of return is allocated to the related party performing the functions;
c. residual income (all remaining income from exploitation of the transferred intangible) is thereby effectively allocated to the related transferor. See Appendix, Examples 4, 5, 6, and 7.

Application and analysis

The BALRM method is clearly intended to apply to the big winner, high-profit, unique intangible whose owner is likely to be unwilling to transfer it to anyone other than a wholly owned subsidiary.

The study states that it should be possible to observe the rates of return on assets or ratios of income to costs that are earned by unrelated parties performing similar manufacturing activities involving similar risks and amounts of routine tangibles.[3] However, this calls for taxpayers to secure a great deal of difficult information which the Government itself has had a difficult time acquiring on an ad hoc basis for past litigation purposes.

A fairly high number of intangible transfers between related parties involve substantial risks in bringing products to market or marketing the products. The examples in the study are entirely barren of consideration resulting from risk assumption under the BALRM method. Determination of the value of risk assumption and documentation therefore will, of necessity, inject some of the same structural uncertainty found in the present Sec. 482 intangible regulations.[4]

The foregoing reasons are enough to suggest that the BALRM method ought to be used only as a screening device in selecting transactions for potential audit instead of a required method in applying the CWI standard.

E. The BALRM method coupled with a profit split (BALRM-SPLIT method)

The BALRM-SPLIT method is considered most appropriate where the transferred intangible is unique and both of the related parties own one or more significant intangibles that will be used in exploiting the transferred intangibles.

Examples of significant intangibles owned by a related transferee include:

a. research capacity to further develop uses for a product in the market assigned to the related transferee and the design to meet the needs of customers;
b. essential use of collateral patents or substantial know-how in exploiting a transferred intangible;
c. the prior development of an important trademark for marketing in the assigned market.

The BALRM-SPLIT method is applied as follows:

a. determine combined net income from the appropriate line of business;
b. apply BALRM method;

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3. White Paper, at 99.
4. See *Bausch & Lomb v. Commissioner*, 92 T.C. 33 (1989).

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c. split residual intangible income between the related parties based upon each party's unique intangibles.

Application and analysis

The likelihood is that the BALRM-SPLIT method will be the most appropriate method for a high percentage of intangible transfers between related parties, where the affiliate is more than simply an offshore manufacturing facility. Yet, the study devotes only a short paragraph to the method and describes it as the "hardest case". This description may well be accurate for those taxpayers required to make the BALRM-SPLIT calculation.

Much more work needs to be done on the BALRM-SPLIT method before it is operationally effective for taxpayer use.

III. CONCLUSION

Structurally, the exact and in comparables methods are most likely to approximate the results obtained under traditional arm's lengths methods applied by most developed countries. By contrast, the BALRM and BALRM-SPLIT methods may produce a contract manufacture's result in the case of intangible transfers to foreign affiliates in an absence of a careful realistic consideration of risk assumption on the part of each party to a transfer. Arm's length instability is introduced in all the proposed methods by the requirement of periodic adjustments which is not a common feature of unrelated 3rd party agreements. Documentation requirements for taxpayers and penalties for failure stretch the comity required in international tax administration. Yet, careful re-thinking and appropriate changes may produce viable pricing approaches for related party transfers of intangible property.

APPENDIX
EXAMPLES OF METHODS FOR VALUING TRANSFERS OF INTANGIBLES

Example 1: Exact comparable

Hydrangea Inc. is a U.S. developer, producer and marketer of business software for personal computers. It has developed a new line of specialized accounting software that it expects to sell mainly in foreign markets.

Hydrangea expects that this product will have a life cycle similar to most other products in its line. Thus, it expects that this software will have a peak productive life of three to five years. If it is moderately successful, there will be a small, declining market after that, as obsolescence sets in. If the product is very successful, Hydrangea may decide to develop an enhanced, substantially modified version after the peak period, which it would treat as a new product.

Hydrangea has decided to serve the market in country F for this software by licensing it to an unrelated country F corporation, Fleur, with which it has had satisfactory dealings in the past. Specifically, Hydrangea and Fleur have negotiated a licensing agreement with the following terms. Fleur receives an exclusive license to market Hydrangea's product in country F and agrees to pay Hydrangea 20 percent of the net selling price for each copy it sells. Fleur agrees not to market competing products while the license is in effect. Fleur will market the product under its brand name and will perform the necessary work to modify the product to integrate it into its own line of accounting software. Hydrangea agrees to provide Fleur, for free, with any corrected, revised, and enhanced versions of the software that it releases publicly during the first four years. (Fleur and Hydrangea understand that, after that period, the latter is permitted to develop an enhanced, substantially modified product and to call for new negotiations with Fleur, find another licensee, or market the new product itself.) The agreement grants Fleur a perpetual license to the current product. During the first four years, neither party can terminate without cause; after that period, Fleur can terminate with six months' notice.

Hydrangea will serve the market in country B through its wholly owned local subsidiary, Royal Hydrangea. The markets in countries F and B are substantially similar in size, sophistication, and ability to use business software intended for personal computers. Royal Hydrangea performs the same functions as Fleur relating to marketing and distribution of accounting software. Thus, it will modify the product as necessary for local requirements; it has been and will continue to be responsible for marketing its products and developing its trademark; and, it maintains a distribution network, including a sales staff. For these reasons, Hydrangea concludes the external standards for using the Fleur agreement as an exact comparable are satisfied.

Hydrangea satisfies the internal standards by including all important features of the Fleur agreement in its agreement with Royal Hydrangea. Thus, the royalty is set at 20 percent of net selling price. The provisions concerning corrections and revisions are also, therefore, included, as are the provisions concerning duration and termination.

Each year, Hydrangea reexamines its related party arrangement to determine if the exact comparable approach is still valid. Specifically, it determines whether the two markets are still similar, and whether Fleur and Royal Hydrangea still perform similar functions. If these aspects of the external standards have substantially changed, or if Fleur terminates its agreement, Hydrangea must reestablish the appropriateness of its related party transaction, which may require adjusting the royalty rate.

Example 2: Inexact comparable

Shampoo Inc., a well-known hair-care products corporation in the Unites States, plans to set up a subsidiary in country Z in order to introduce its line of products in country Z. The subsidiary will manufacture, distribute and market the products using the Shampoo trademark. When planning the appropriate transfer price for the license, Shampoo officials started with the knowledge that one of their competitors, Condition Corp., licensed a line of hair-care products to an unrelated party in country Z, Lotions, Inc.

The Condition license covers the formulas for all of Condition's hair-care products as well as the Condition trademark. The license gives Lotions the right to manufacture, distribute and market the licensed products. Terms include an exclusive license in country Z for a term of 4 years paying a royalty of 4% of the net selling price. The licensor agrees to provide the licensee with product formulations, scientific data, manufacturing know-how, marketing, public relations and related assistance. The licensee must adhere to strict quality control standards in manufacturing, distribution and marketing. The licensor has the right to inspect operations of the licensee to verify such quality. The licensee is prohibited from manufacturing, importing, or marketing competing products in country Z.

From the terms of the agreement it is clear that Lotions performs the same functions that Shampoo's subsidiary in country Z will perform. It is also clear that Condition provides the same type of services and quality control for Lotion's operations that Shampoo will provide for its subsidiary in country Z. It is anticipated that Shampoo's subsidiary will have a volume of sales similar to Lotion's once its operations are fully developed. Finally, Shampoo knows that the gross margin (net sales – cost of sales)/net sales, on sales of Shampoo's products in the United States is similar to the gross margin achieved by Condition in the United States, which indicates that their manufacturing processes and sales activities have comparable efficiencies. Therefore, it is appropriate for Shampoo to set a royalty rate of 4% of the net selling price for a 4-year term.

Example 3: Likely use of inexact comparables

Computers Inc., a U.S. software company that specializes in games, plans to acquire the rights to manufacture, market and

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distribute a new computer game, Gizmo, created by its European subsidiary. Gizmo will be an addition to Computers' existing lines of games. Computers Inc. projects that the total number of Gizmo copies distributed will be close to the industry average. Numerous third party licenses for computer software are available. Computers examines these licenses for appropriate inexact comparables and should be able to determine the appropriate royalty amount and other terms for its agreement with its affiliate from the third party agreements.

Example 4: Basic arm's length return method: U.S. importer and distributor

TravelFun is a large publicly traded foreign corporation with a U.S. subsidiary, TravelUS. TravelFun produces a unique recreational product using sophisticated and highly sought-after production technology. TravelUS imports the assembled product and distributes it under the Travel name. TravelUS has the exclusive right to develop the Travel name in the United States. Because of the importance of the intangibles, TravelUS must apply the rules governing the transfer of intangible property.

TravelFun does not license the Travel name to unrelated parties, nor does it allow unrelated parties to distribute the product. Therefore, no exact comparables are available. Similar products exist that could potentially serve as inexact comparables; however, none of them are sold to unrelated distributors. Therefore, when TravelFun sets up its policy for transfer prices of units sold into the United States for 1989 it uses the rate of return method. In order to apply the method properly, the following information is necessary: (1) a general description of the functions that TravelUS performs, (2) financial information on companies performing similar functions, and (3) analyses of appropriate rates of return.

(1) *Functions of TravelUS.* TravelUS imports the product from TravelFun and distributes it to retailers. TravelUS is responsible for developing the marketing strategy in the United States.

(2) *Companies performing similar functions.* Initially, TravelFun seeks data about publicly traded independent operators of wholesale distribution businesses. A search of the appropriate SIC categories yields a number of companies that differ in the following ways: (1) some are importers, while others acquire their products in the United States; (2) some are distributors of final products, while others distribute parts; and, (3) some apply intensive marketing, while others do not. Examination of these firms' published financial information indicates that the sample should be narrowed to 16 firms in order to reflect more clearly the functions performed by TravelUS. TravelUS is an importer that distributes final products and performs an important marketing function. Each firm in the final sample has some combination of these characteristics. Balance sheet and income data are then collected for the sample of 16 companies.

(3) *Analysis of appropriate rates of return.* The company evaluates the available information in order to determine the appropriate ratios on which to base its comparisons. Comparable asset data are not available for all firms in the sample. Therefore, an attempt must be made to determine a rate of return for TravelUS based on available cost data for the sample of firms. A number of ratios can be considered as a means of determining an appropriate return on costs. Possibilities include the ratio of gross profit to operating expenses (the Berry ratio), the ratio of operating income to the cost of sales and operating expenses, and the ratio of net pre-tax income to total expenses. The choice of the appropriate ratio will depend on the composition of the sample and the stability of the ratios over time.

For the sample of 16 companies, all of the ratios lead to similar results. TravelUS retains the information that supports this claim, but upon examination presents only the analysis using the Berry ratio. As defined above, the Berry ratio is the ratio of gross profit to operating expense:

$$\frac{\text{Net Sales} - \text{Cost of sales}}{\text{Operating expenses}}$$

Net sales are total revenue from sales less cash discounts to customers for payment within a specified time. Cost of sales is also referred to as cost of goods sold, including freight charges. Operating expenses include selling expenses such as sales salaries and commissions, advertising and marketing expenses, depreciation expenses, supplies, office salaries, and payroll taxes. The major expense not included in either cost of goods sold or operating expenses is interest expense.

For the 16 firms in the sample the average Berry ratio is 1.40 with a standard deviation of .15. (The minimum ratio was 1.17 and the maximum was 1.61.) TravelUS uses the average ratio, 1.40, in order to determine the payment that should be made to the parent. Additional information that will be necessary includes net sales, operating expenses and cost of sales that are not included in the payment to the parent for the product.

TravelUS projects sales of 20,000 units, net sales revenue for 1989 of $ 100 million and operating expenses of $ 30 million. Cost of Sales is projected to be $ 2 million plus transfer payments to TravelFun. Plugging this information into the equation for the Berry ratio yields:

$$1.40 = \frac{\$\ 100\ \text{mil.} - [\$\ 2\ \text{mil.} + 20{,}000\ \times]}{\$\ 30\ \text{mil.}}$$

Therefore, x, the transfer price paid for each unit, is $ 2,800. TravelUS will pay TravelFun $ 2,800 per unit of import and projects that it will pay TravelFun a total of $ 56 million in 1989.

Example 5: Basic arm's length return method: Foreign subsidiary serving local market

Counter Inc., a U.S. corporation that specializes in over-the-counter drugs, plans to set up a subsidiary in country X. The subsidiary will manufacture, distribute, and market Counter's products in country Z. The manufacturing process is not particularly complex. The subsidiary will set up its own distribution network, which will be of average size for the industry. Further, it will perform its own marketing; however, because the subsidiary will, in general, sell "generic" products that will sell under its customers' brand names and trademarks, its marketing activities will involve contacting drug stores and other selling concerns, and not the development of a unique, consumer-level marketing intangible.

Counter's search for unrelated party licenses for comparable products proves fruitless. The search does yield a number of licenses in which the functions performed by each party are similar. The products are not similar enough to the over-the-counter drugs to be classified as inexact comparables; however, the level of manufacturing, the type of distribution network, and the type of marketing performed in each case are similar. Therefore, Counter searches for information about the returns earned by each of these companies. Analysis of the income statements and balance sheets of the firms in the sample yields and average rate of return earned. This average can be used by Counter to determine the royalty rate to be paid by its subsidiary in country Z.

Example 6: Basic arm's length return method: Foreign subsidiary producing for U.S. market

A U.S. corporation has developed and patented the formula for a new heart drug that has fewer potential side effects than any drug in existence. The U.S. corporation plans to manufacture the drug in a foreign subsidiary to be located in country Y, which has very low labor costs. The completed product will be returned to the parent for sale in the United States. In addition, some of the manufactured drug will be shipped from the manufacturing subsidiary to a marketing subsidiary in country X for sale in Europe. The parent wishes to fashion the transaction so that a royalty will be paid by the subsidiary to the parent for the right to manufacture and sell the drug. The parent and the subsidiary in X will then pay the manufacturing subsidiary for the finished product.

The following information is known or projected:

1. The drug will sell for $ 2.00 per pill.
2. The volume of sales in the United States in 1989 will be approximately 900 million pills.
3. The volume of sales in Europe in 1989 will be approximately 600 million pills.
4. Marketing and distribution costs in the United States are estimated to be $ 14.4 million.

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5. Marketing and distribution costs incurred by the country X subsidiary are estimated to be $ 9.6 million.

6. The manufacturing subsidiary's costs will be as follows:

Cost of chemicals	$ 110 million
Operating expenses	$ 75 million
License payments	To be determined
All other expenses	$ 5 million

7. The manufacturing subsidiary will have the following assets:

Cash	$ 12 million
Factory	$ 360 million

8. The manufacturing subsidiary will have the following income:

Interest income	$ 1 million
Revenue from sale of drug	To be determined

There are no transfers by unrelated parties that would provide an inexact comparable for either the license the parent grants to the manufacturing subsidiary or for the pill that is sold to the parent and to the marketing subsidiary. There are other companies that perform similar marketing and manufacturing functions. The difficult piece to measure is the value of the patent which is held by the parent. Therefore, the parent turns to the arm's length return method as the appropriate method. The parent will find proper rates of return for the manufacturing and marketing segments of production and allocate to itself the residual profits.

A sample of manufacturers in locations with low labor costs shows that manufacturers earn an average rate of return on their manufacturing assets of 12%. The subsidiary's total manufacturing assets, the factory, cost $ 360 million. Prices should be structured so that the manufacturing subsidiary earns profits of $ 44.2 million ($ 43.2 million return on the factory asset plus the known $ 1 million return on cash).

If all of the drug were resold to the parent, the split between the cost of the final pill and the license payment would be unimportant as long as the correct amount of income remained allocated to the subsidiary. However, in this case the final product is also being sold to the subsidiary in country X, so the correct split is important.

Information on marketers and distributors of drugs shows that they earn approximately cost plus 25%, both in the United States and in country X. Based on the costs outlined above, the parent should earn net income of $ 3.6 million on its distribution and marketing activities, and the Country X subsidiary should earn net income of $ 2.4 million. Revenue from the sale of the heart drug will be approximately $ 1,800 million in the United States and $ 1,200 million in Europe. Therefore, the manufacturing subsidiary should charge $1.98 per pill.

Total revenue received by the manufacturing subsidiary will be $ 2,971 million ($ 2,970 million from sales and $ 1 million from interest income). The royalty to be paid to the parent will be a percentage of the net sale price of $ 1.98. The correct royalty rate, r, can be determined by the following equation, which shows the manufacturing subsidiaries revenues and costs:

Net income = Total revenue – Cost of chemicals
($ 44.2 mil.) ($ 2,971 mil.) ($ 110 mil.)

– Operating expenses – Other expenses
($ 75 mil.) ($ 5 mil.)

– Royalties paid
[(1,500 mil.) ($ 1.98) r]

Solving for r shows that r equals .921.

Therefore, the appropriate royalty rate is 92.1% of the net selling price of $ 1.98.

Example 7: Likely use of basic arm's length return method

A U.S. company manufactures electronic equipment for sale in the United States. The U.S. company designs the equipment and licenses the designs to its foreign subsidiary. The subsidiary assembles the circuit boards and other components for the products and sells them to the parent. For transfer pricing purposes, the parent searches for the rate of return earned by independent computer assembly operations in order to determine the amount of income that should be attributed to its foreign subsidiary.

Conference Diary

MARCH 1990

Handling Inland Revenue Investigations. London, 5 March (English):
Professionel Conferences and Training Services Limited, Ground Floor, 72 Lady Margaret Road, London NW5 2ND, United Kingdom.

The Tax Treatment of International Capital Markets Transactions. London, 12-13 March (English):
International Tax Academy, c/o International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

ITPA Benelux Seminar. Luxembourg, 14-16 March (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference liaison office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

Inspelen op Oost-Europa. Amsterdam, 21 March (Dutch):
Kluwer Seminars, Antwoordnummer 424, 7400 VB Deventer, The Netherlands.

Münchner 1990 Steuerfachtagung. München, 21-22 March (German):
Münchner Steuerfachtagung e.V., Wendelsteinstrasse 8, 8032 Gräfeling. Federal Republic of Germany.

Tax Planning with Offshore Companies. London, 28 March (English):
Professional Conferences and Training Services Limited, Ground Floor, 72 Lady Margaret Road, London NW5 2ND, United Kingdom.

APRIL 1990

The Future for Trusts in Italy, Milan, 3-4 April (English, Italian):
Ms. Elaine Hendry, Legal Studies & Services Ltd., Bath House, 56 Holborn Viaduct, London EC1A 2EX, United Kingdom.

Doing Business with the Soviet Union – Outlook for a New Decade. Moscow, 3-5 April (English):
Business International Limited, 40 Duke Street, London W1A 1DW, United Kingdom.

International Tax Planning; Leading Edge Techniques for the 1990's. Amsterdam, 5-6 April (English):
PW Business Conferences SA, Hoeschgasse 78, CH-8034 Zürich, Switzerland.

Wet Ketenaansprakelijkheid. Amsterdam, 9 April (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

The Third East-West Tax Conference. Warsaw, 19-20 April (English, German):
International Tax Academy, c/o International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

Belastingcontrole. Rotterdam, 24 April (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

De Directeur-Grootaandeelhouder. Maarssen, 25 April (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

MAY 1990

9th National Convention of The Taxation Institute of Australia. Adelaide, 4 May (English):
Ann Ewer, Convention Co-ordinator, 9th National Convention of the Taxation Institute of Australia, P.O. Box 232, Kensington Park, S.A. 5068, Australia.

Leasing – Flexible Off-balance Sheet Financing, Achieving Fiscal Advantages, Effective Sales Aid. Brussels, 8-11 May (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

ITPA 1990 Annual Conference. Venice Lido, 17-18 May (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

AUGUST 1990

44th Congress of the International Fiscal Association: I. Taxation of Cross-border Leasing; II. International mutual assistance and exchange of information. Seminars: 1. The Nordic multilateral tax treaty; 2. Double tax treaties between industrialized and developing countries, the OECD and U.S. models – a comparison; 3. The extension of tax sovereignty – especially in connection with emigration; 4. Tax reform in Scandinavia. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125, 3001 DE Rotterdam, The Netherlands.

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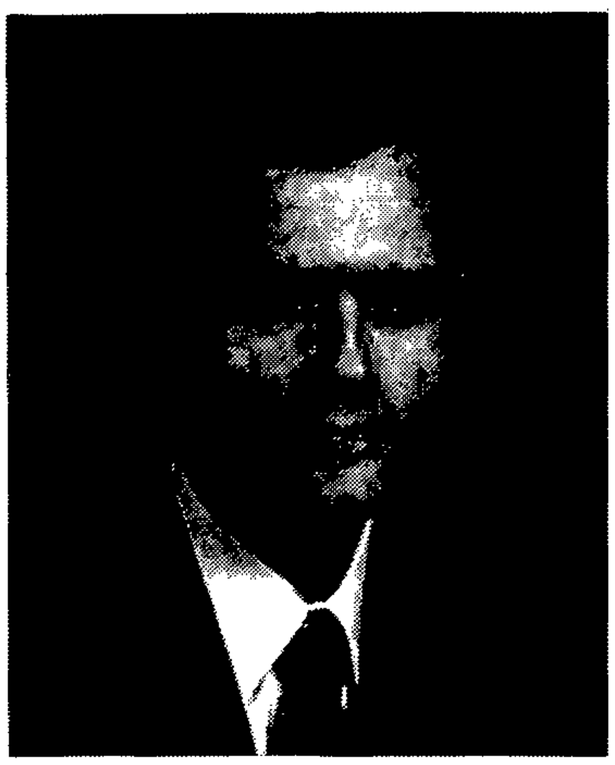

UNITED STATES:

Use of Cost Sharing and Its Effect on Intercompany Pricing

James R. Mogle

Mr. Mogle joined General Motors Corporation in 1984 and is the Chief Tax Officer responsible for all tax matters of the Corporation. Prior to joining General Motors, Mr. Mogle was a partner in the Chicago law firm of Kirkland & Ellis. He has a B.S. from Northwestern University, an M.B.A. from Stanford University, a J.D. from American University and an LL.M. (Tax) from George Washington University. He has been admitted to the bar in Virginia, the District of Columbia, Illinois, and Michigan. He is a member of the American Bar Association and the American Institute of Certified Public Accountants. He has been a participant in many international tax seminars, including most recently the 1989 International Fiscal Association U.S./U.K. Technical Seminar, the University of Southern California 40th Annual Federal Tax Conference and numerous seminars sponsored by the World Trade Institute.

I. BACKGROUND

A. Definition of cost sharing arrangements

In general, a cost sharing arrangement is an agreement between 2 or more persons to share the costs of research and development (R & D) as such costs are incurred in exchange for a specified interest in any property that is developed. Because each participant "owns" specified rights to any intangibles developed under the arrangement, no royalties are paid by the participants for exploiting their rights to such intangibles.

B. 1966 proposed Regulations under Sec. 482

The IRS issued Proposed Regulations under Sec. 482 in 1966 to deal with cost sharing arrangements. The proposed Regulations permitted any affiliate (other than one in the trade or business of producing intangible property) to participate, provided that the intangible property was intended for use in connection with the active conduct of the affiliate's business. The Regulations specifically authorized cost sharing arrangements for single projects, but did not disqualify multiple projects or continuing arrangements. Cost sharing was required to be proportional to the anticipated benefits expected by each participant, and was to be based on sales, profits or other criteria. These requirements were ultimately abandoned in favor of current Regulations.

C. Current Treasury Regulation Sec. 1.482-2(d)(4)

The current Regulations require that cost sharing agreements must be in writing and provide for the sharing of costs and risks of developing intangible property in return for a specified interest in the property that may be produced. A bona fide cost sharing arrangement must reflect an effort in good faith by the participants to bear their respective shares of all costs and risks on an arm's length basis. The terms and conditions must be comparable to those that would have been adopted by unrelated parties in similar circumstances. Bona fide cost sharing arrangements that meet these requirements are immune from reallocations by the district director under Sec. 482.

D. Cost sharing under Sec. 936(h)

After 1982, the intangible income of a domestic corporation qualifying for the possessions tax credit must be included in the income of its U.S. shareholders, unless the possessions corporation[1] either elects the cost sharing method or elects the profit split method, both of which are contained in Sec. 936(h). Under the Sec. 936(h) cost sharing election, the possessions corporation must pay its share of the affiliated group's total R & D costs based on the ratio of sales by the affiliated group of products produced in the possession to total sales by the affiliated group of all products. The cost sharing payment must be computed with respect to "product areas" rather than single projects. "Product areas" are defined by reference to the 3-digit Standard Industrial Classification codes ("SIC codes") promulgated by the Commerce Department.[2]

A possessions corporation making the cost sharing election is treated as owning the manufacturing intangibles utilized in its business, and the income from such intangibles then becomes eligible for the possessions tax credit. Intercompany pricing between the possessions corporation and its

1. A "possessions corporation" is a U.S. corporation meeting certain statutory requirements that may elect to take a credit against U.S. income tax equal to that portion of the tax that is attributable to taxable income earned from the active conduct of a business in a U.S. possession such as Puerto Rico, and from qualified investment income related to the possession activity.
2. The Standard Industrial Classification (SIC) system was developed for use in the classification of economic and business entities by the type of activity in which the entities are engaged, for the purpose of facilitating the uniform collection and analysis of statistical data by various agencies of the U.S. Government.

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domestic affiliates must still meet the requirements of Sec. 482.

The Tax Reform Act of 1986 (the "1986 Act") amended Sec. 936(h) so that a possessions corporation making the cost sharing election must pay the greater of 110% of the pre-1986 statutory cost sharing amount or the royalty required to be paid to the developer of the intangibles under the "commensurate with income standard" of Sec. 482, as also amended by the 1986 Act.

E. Cost sharing and the 1986 Act

The legislative history to the 1986 Act clearly states that bona fide cost sharing arrangements continue to be permitted "as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision, that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each".[3] The Conference Report also highlights 3 areas of particular concern in cost sharing arrangements: selective inclusion of high profit intangibles in the arrangement, measurement of contributions to the arrangement and proper compensation to parties that "buy in" to an existing arrangement or make use of intangibles already developed outside the arrangement.

1. Selective inclusion of high profit intangibles

The Conference Report states that "the cost sharer would be expected to bear its portion of all research and development costs, on successful as well as unsuccessful products within *an appropriate product area,* and the cost of research and development at all relevant development stages would be included" (emphasis added).[4]

2. Measurement of contributions

The Conference Report states that "it is envisioned that the allocation of R & D cost sharing arrangements generally be proportionate to profit as determined before research and development".[5]

3. The buy-in problem

The Conference Report states "to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to effectively reflect its investment".[6]

II. COST SHARING AND THE SEC. 482 WHITE PAPER

The Treasury Department's White Paper on intercompany pricing released in October 1988 took note of these Congressional concerns in the 1986 Act and expanded its discussion of cost sharing arrangements into 9 principal areas. In general, the White Paper's interpretation of the continuing role for cost sharing arrangements is quite restrictive, which, if implemented in Regulations, would create new problems for planning and compliance.

A. Defining "an appropriate product area"

The White Paper noted the potential for abuse if the products covered by a cost sharing arrangement are grouped either too broadly or too narrowly. If too many products are included in a cost sharing arrangement, the potential benefits of the arrangement may not be proportionate to the participants' sharing of costs, especially if foreign owned U.S. corporations obtain deductions in the United States for cost sharing payments from which they have no reasonable prospect of benefit. If, on the other hand, the product grouping is too narrow, cost sharing may be employed only for high profit potential intangibles, so that foreign affiliates of U.S. multinational groups acquire the rights to such intangibles without bearing the cost of research related to low profit potential intangibles and unsuccessful research. These abuses are particularly acute when participants in the arrangement are based in low tax jurisdictions.

The White Paper concludes that the 3-digit SIC code product areas "would seem to be the appropriate scope of most cost sharing arrangements".[7] However, the White Paper would allow both the government and taxpayers the opportunity to rebut this presumption and demonstrate another appropriate grouping in particular circumstances.

B. Proportionality between cost shares and benefits

According to the White Paper, it is axiomatic that the underlying principle of bona fide cost sharing arrangements is that the costs borne by each of the participants should be proportionate to the reasonably anticipated benefits to be received over time by each participant from exploiting intangibles developed under the cost sharing arrangement.[8] The analysis of the White Paper extracts from this axiomatic principle several unjustifiably restrictive conclusions about who may participate in a cost sharing arrangement and under what terms.

1. Assignment of exclusive geographic rights

The White Paper states that "it is virtually impossible to (predict what benefits each of the participants will derive from a cost sharing arrangement) unless the participants are assigned specific exclusive geographic rights to intangibles developed under the arrangement".[9]

Moreover, the White Paper asserts that "if research activities are not common to the various types of intangibles produced under the arrangement, then the research related to each type of intangible should be charged to the specific affiliate that will receive the rights to that type of intangible. This is particularly true of arrangements where one of the parties produces components".[10]

More surprisingly, the White Paper boldly asserts that U.S. geographic rights should never be permitted to be assigned under a cost sharing arrangement to a foreign person if:

(a) the participants are part of a U.S. owned multinational group;
(b) a significant portion of the research is performed in the United States; or
(c) any U.S. person participates in the arrangement.

Thus, the White Paper maintains that U.S. rights to an intangible could be acquired by a foreign person only in the case of a foreign-owned multinational group that conducts

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3. The Conference Report of the 1986 Act at II-638.
4. Id.
5. Id.
6. Id.
7. White Paper at 116.
8. White Paper at 116.
9. Conference Report at 117.
10. Id.

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the research overseas and does not include any U.S. affiliates in the cost sharing arrangement.

2. Participants must exploit intangibles by manufacturing

The White Paper asserts that "(i)n general, the benefit to be derived under a cost sharing arrangement is the right to use a developed intangible in the manufacture of a product. Therefore, the participant must be in a position to exploit the intangible in the manufacture of products".[11] Although the White Paper calls this requirement "roughly analogous" to the 1966 Proposed Regulations requirement that the intangible be used in an active business, this requirement is extremely restrictive and would seemingly prevent participants from contracting out for manufacture of products exploiting intangibles developed under a cost sharing arrangement.

3. The group of participants may not be overly broad

In keeping with the manufacturing requirement, the White Paper asserts that a manufacturing conglomerate that produces widgets and gadgets may not include in a cost sharing arrangement an affiliate that produces only gadgets. This necessarily means that not all affiliates that expect to benefit from the R & D of cost sharing arrangement may participate. In such cases, some affiliate must fund research for intangible rights to be used in manufacturing by non-participants. The White Paper concludes that "it seems appropriate" that the affiliate that performs the research should fund the research and receive the residual rights to the resulting intangible.[12]

4. Measurement of anticipated benefits

In order to share costs in proportion to expected benefits, there must be some rational basis for predicting benefits. The White Paper states that, "in many cases, estimated units of production may be an appropriate measure of benefit assuming that there is a uniform unit of production that can be used as a measuring device".[13] If such a unit is not available, then sales value may be an appropriate measure, if measured at the same level of production or distribution for all participants. However, neither unit would be appropriate if "it were apparent (or became apparent during the course of the agreement) that profitability differed substantially with respect to various participants' rights".[14] In such cases, estimated gross or net profit may have to be used, although the White Paper acknowledges that such estimates of profit may be unrealistic. If neither units of production nor sales value can be used and profitability varies greatly, the White Paper concludes that cost sharing simply should not be used.[15]

5. Periodic adjustments required

Consistent with the "commensurate with income standard", the White Paper maintains that the cost shares should be adjusted periodically, on a prospective basis, to reflect changes in the estimates of relative benefits, including a change in the measurement standard if appropriate. The White Paper notes ominously that "there is always a risk that the cost sharing arrangement could subsequently be rejected as a bona fide arrangement if the estimates of benefits derived under the arrangement proved to be so substantially disproportionate to the cost shares that the estimates of benefits cannot be considered to have been made in good faith".[16]

C. Includable costs to be shared

The White Paper states that the costs to be shared should include all direct costs of R & D, including expenses for salaries, research materials and facilities. However, the White Paper maintains that there should be a limitation on the annual inclusion of costs for depreciable assets that is consistent with U.S. tax accounting principles. Indirect costs should include a portion of the G & A expenses[17] and overall interest expense allocated and apportioned to R & D activities in accordance with normal expense allocation rules.

D. Buy-in requirements

The "buy-in problem" presents a particular paradox for cost sharing arrangements. On the one hand, one of the primary reasons for adopting cost sharing arrangements is to avoid having to value intangibles. On the other hand, if there are intangibles that are not fully developed that relate to the research to be conducted under the cost sharing arrangement, Congress believed it would be necessary to value them in order to determine appropriate compensation for the contributing party to the agreement.

The White Paper divides into 3 groups the types of intangibles subject to the buy-in requirement. First, a participant may own preexisting intangibles that will become subject to the arrangement. Second, a company may also conduct basic research not associated with any particular product. Third, a participant's research facilities may have going concern value that will be utilized under the agreement.[18]

The White Paper takes the position that fully developed intangibles are generally not appropriate for incorporation into a cost sharing arrangement because such intangibles command a full royalty at an arm's length rate under the "commensurate with income standard". However, the White Paper indicates that improvement of an existing intangible (such as computer software) may be properly the subject of cost sharing in particular circumstances.

The White Paper also asserts that the buy-in payment should reflect the full fair market value of the contributed property, not merely its cost. This principal applies to a "buy-out", where a participant withdraws and must be compensated by the other participants for the value of what the arrangement has produced to date, and to a "secondary buy-in", where a new member is admitted after a cost sharing agreement is in place by compensating the original participants for geographic rights obtained and the current values (not costs) of intangibles from which the new participant expects to benefit. The payment may be in the form of a lump sum or periodic payments.

E. Marketing intangibles

The White Paper seems to take the position that marketing intangibles are not a proper subject for cost sharing arrange-

11. Id. at 118-119.
12. Id. at 118.
13. Id. at 119.
14. Id. at 120.
15. Id.
16. Id.
17. General and administrative (G&A) exenses are those indirect costs that cannot be directly associated with manufaturing operations. These costs relate to the general administration of business activities and include general office, personnel, accounting, credit and collection, financial, and executive office expenses.
18. Id. at 121.

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ments, and thus should be governed by existing regulations under Sec. 482 dealing with related person services.[19] The White Paper does, however, solicit comment on situations in which the public believes marketing intangibles should be subject to rules other than those Sec. 482 Regulations already in place.

F. Character of cost sharing payments

The White Paper takes the position that cost sharing payments are not income to the recipient but, instead, reduce costs which are otherwise deductible in computing taxable income and earnings and profits. Since cost sharing payments are not gross income to the recipient, no U.S. withholding tax would be imposed on outbound cost sharing payments made by a U.S. person to a foreign person, and inbound payments will not be foreign-source income.

This method of characterization reduces the amount of R & D expenses of the entity performing the research that are subject to allocation under Treas. Reg. 1.861-8 and increases the amount subject to allocation by the participants making the cost sharing payments.

For various reasons, the White Paper states that the label applied to the arrangement for foreign law purposes generally would not affect its U.S. tax treatment.

G. Possessions corporations

The White Paper takes the position that the cost sharing election under Sec. 936(h) is compensation for intangibles previously developed and the Sec. 482 cost sharing payment by contract is for the cost of developing new intangibles. Therefore, both payments must be made by a possessions corporation. This effectively limits the usefulness of the Sec. 936(h) election.

H. Administrative compliance requirements

The White Paper advocates the use of a formal election and contemporaneous documentation for validation of cost sharing arrangements. Participants would have to be able to produce necessary documentation within 60 days upon request by the IRS.

I. Transitional rules

The White Paper suggests that grandfather relief generally be given to cost sharing arrangements that have been in place for more than 5 years prior to 1987 (except with respect to matters involving buy-ins that occurred prior to 6 June 1984, the effective date of Sec. 367(d)). Cost sharing arrangements that did not meet this 5-year rule and did not comport with the new rules outlined in the White Paper would not be recognized.

III. PROBLEMS WITH THE WHITE PAPER APPROACH

In general, many of the restrictions which the White Paper places on the use of cost sharing agreements do not reflect the realities of cost sharing business practices among unrelated parties, and thus are unduly burdensome for related parties and are unjustified under the arm's length standard.

A. Use of SIC Codes

The use of SIC codes to determine the proper scope of cost sharing arrangements may or may not be appropriate in a given context. The White Paper uses these categories as a starting point, and indicates that broader or narrower categories can be established by either taxpayers or the government. Whether this is indeed a workable solution will depend on the degree of flexibility shown in the administration of these rules, especially the burden of proof required for taxpayers to establish and maintain groupings other than the SIC code categories.

B. Assignment of exclusive geographic rights

It is not clear why rights to the exploitation of intangibles must be geographically exclusive. Arrangements with third parties often provide for nonexclusive licensing of intangibles. This also seems to be a particularly weak rationale for excluding from cost sharing participants which only manufacture components. More fundamentally, it is not clear why foreign persons should be prohibited from owning the U.S. rights to an intangible developed under a cost sharing arrangement in which a U.S. person participates or in which a significant portion of the research is performed in the United States. There is no clear reason why U.S. tax policy should discourage research in the United States by not allowing ownership to fall to the party (foreign or domestic) that took the research risk.

C. Requirement of exploitation by manufacturing

The requirement that participants must be in a position to exploit the intangibles developed under the cost sharing arrangement by manufacturing is extremely restrictive and does not comport with business dealings between unrelated parties. Although the White Paper terms this requirement "roughly analogous" to the active business requirement of the 1966 Proposed Regulations, it is actually very different and much more restrictive. If this restriction is in fact implemented, cost sharing arrangements could not be used for engineering and other service businesses. Related parties could not engage in contract manufacturing to exploit the intangibles developed. Moreover, it is not clear why a pure research center should be excluded from a cost sharing arrangement. Certainly, unrelated parties exploit such centers. Even if the manufacturing requirement is implemented, it is not clear how the White Paper would define "manufacturing". The definitions used under the Subpart F rules could be used, but such a decision should be subjected to particular scrutiny.

D. Prospective adjustments in cost shares

Whether the White Paper's call for prospective adjustments in cost sharing arrangements based on unexpected changes in research results will operate fairly will depend on the manner in which these adjustments are administered. Prospective adjustments can reflect the practice of unrelated parties, but adjustments by the IRS with the benefit of hindsight may be unfair, based on the expectations of the related parties at the time the cost shares were established. Moreover, disparate profitability among intangible products or geographic markets may be inevitable in the uncertain areas of basic research. Requiring profitability estimates (which are extremely difficult) or excluding such cases from cost sharing altogether simply may not be reasonable in many circumstances.

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19. Id. at 123.

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E. Buy-in problems

The White Paper's discussion of the "buy-in" problem leaves many open issues and concerns. First, the outright rejection of cost-based buy-ins may be unnecessarily restrictive. The Conference Report mandates that an "appropriate return" be charged when the buy-in occurs. This does not necessarily preclude the use of cost-based payments, especially if such payments are weighted for time value and risk already incurred.

Second, the White Paper's statement that going concern value will have to be included in the buy-in payment could be problematic. On the one hand, the buy-in may properly include some charge for the contributions of basic research. On the other hand, if this requirement is interpreted broadly, it would charge the participants for other profits from research conducted in a participant's facilities and would be at odds with the general principal that such profits are an inappropriate basis for a cost sharing arrangement.

Third, it is unclear exactly how the buy-in payment would work in practice. Presumably, under the commensurate with income standard some form of royalty should be charged which would be very low in the initial stages of development and increase as the income from the contributed intangibles increases. If a royalty is already appropriate for the contributed intangible, but the product is considerably improved or changed under the cost sharing agreement, it would seem appropriate that the royalty cease and the income be allocated under the cost sharing agreement. If such improvement or change does not occur, the royalty would continue. Many of these mechanics need clarification.

F. Marketing intangibles

Although the White Paper's exclusion of marketing intangibles from bona fide cost sharing arrangements was not definitive, it is not clear why marketing intangibles could not be the proper subject of such an arrangement. Some commentators have expressed concern that such an exclusion could result in confusion and inconsistent treatment in areas such as the development of computer software, where some marketing intangibles are protected by copyright while other related intangibles are protected by patent.

G. Relationship of contractual cost sharing to Sec. 936(h)

By defining Sec. 936(h) to cover only intangibles already developed and insisting that both Sec. 936(h) cost sharing payments and Sec. 482 cost sharing payments be charged the White Paper effectively curtails the use of Sec. 936(h) for possessions corporations. It is not at all clear that such a result was intended by the 1986 Act.

H. Grandfather treatment for existing arrangements

The grandfather treatment suggested by the White Paper is extremely restrictive and is unfair to existing cost sharing arrangements operating according to the current Sec. 482 Regulations.

The Eighth Annual Summer Program in United States Law and Legal Institutions

16 July 1990 – 17 August 1990

The Eighth Annual Summer Program in United States Law and Legal Institutions is intended to give lawyers and advanced law students from other countries intensive exposure to the basic structure of the United States legal system and to significant areas of U.S. law. The Program should give participants both a basic understanding of the United States legal system and the U.S. legal profession and ian in-depth exposure to specific areas of U.S. law that affect a broad range of commercial, investment, and personal activities. It is designed to serve as a low-cost alternative to a full-year's program in U.S. law or as a preface to advanced fromal training in the United States.

The lectures of the Eighth Annual Summer Program in United States Law and Legal Institutions will be held each morning, Monday-Friday, 16 July – 17 August 1990, on the campus of the internationally-renowned University of Wisconsin, Madison, Wisconsin, U.S.A. In addition to the regular morning sessions, there will be opportunities for the participants to learn about legal research and writing and the United States legal system outside the formal lectures. The participants also will be able to meet with practicing lawyers and members of the United States judiciary. Another unique and important attraction of the Program is that participants are able to work and socialize with practicing lawyers and legal scholars from around the world.

For more detailed information regarding the program, write to:

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Summer Program in United States Law
University of Wisconsin Law School – Room 208
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UNITED KINGDOM:

Status of Service Companies

John Fairley – Ernst & Young, London

I. INTRODUCTION

The service company is an important part of the operation of many multinational groups. It is often desirable for such groups to centralize certain administrative and service functions in a single entity. Typically, the service company will not conduct any trading activities with unrelated parties but will provide support services for the operating divisions of the group. The functions might include administration, market research, sales information or post-sales service capability.

The United Kingdom does not offer any specific incentives to encourage multinational groups to establish service companies in the United Kingdom. This applies both to the service function itself, whether carried on through the medium of a limited company or a branch, and also to the taxation of expatriates seconded to the service company. (The United Kingdom does apply the remittance basis of taxation to certain types of income received by individuals not domiciled in the United Kingdom. However, those rules apply generally and are not therefore considered further in this presentation.) Unlike some other European countries, the United Kingdom does not have published guidelines for the taxation of service companies which will, in principle, be subject to the same rules as any other commercial entity established in the United Kingdom. The Inland Revenue, however, is known to accept a mark-up basis for the taxation of service companies in certain circumstances, and I will discuss this later with some of the other alternatives which are available.

U.K. TAXATION – GENERAL

A service company which is incorporated in the United Kingdom or whose central management and control is exercised in the United Kingdom will be considered to be resident there for all the purposes of U.K. taxation and subject to U.K. corporation tax. Central management and control means the sort of authority that would normally be exercised by the Board of Directors of a company, i.e. neither the strategic direction of the company nor its day-to-day management. There is a presumption that central management and control is normally exercised by the directors but this presumption can be rebutted if it can be shown that management and control is actually exercised elsewhere. This definition of U.K. corporate residence gives rise to certain risks for non-U.K. groups with activities in the United Kingdom and these will be considered further later.

A U.K. resident company is subject to corporation tax at the normal rate of 35%. A company whose profits do not exceed £ 750,000 is entitled to a reduction of this liability on a sliding scale unless profits are below £ 150,000 where the small companies rate of 25% applies. Depending on the size of the service company's operations, it may well be that the company is entitled to some relief from the normal 35% rate of corporation tax. If a group is considering establishing a service entity in the form of a branch, relief from the full rate of corporation tax is also available to a U.K. branch under the terms of the non-discrimination article in the U.K.–U.S. tax treaty. However, in both circumstances, the small companies rate is reduced where the service company or branch is part of a larger group. In most cases, therefore, profits will be taxed at the normal rate of 35%.

For the purposes of U.K. taxation, a service company's activities will be considered to be "trading" and subject to tax under the appropriate rules for the definition of income and expenses. As I will discuss later, these may be modified to meet the special circumstances of a service company. In principle, however, a service company will suffer taxation on trading profits. Thus, particular expenditures will be disallowed, such as entertaining expenses and depreciation. Even if no subsidiary company or branch is established in the United Kingdom, trading activities carried on in the United Kingdom by a non-resident company are subject to income tax at a rate of 25%. There is a crucial distinction in U.K. law, as in that of many other countries, between trading "in" the United Kingdom and trading "with" the United Kingdom. There are a number of criteria for determining this; perhaps, the most important of which is the location of contracts. It is not enough merely to sign completed contracts outside the United Kingdom if a U.K. tax nexus is to be avoided, particularly where services are to be performed in the United Kingdom. If arrangements are substantially negotiated within the United Kingdom, then it is likely that the profits accruing to them will be within the charge to U.K. tax, even if the legal formalities are completed outside the United Kingdom. Where a service function is established in the United Kingdom, it will in most cases not be practical to argue that the entity is not carrying on a trading activity in the United Kingdom and subject to tax accordingly and it will therefore be important to ensure that the service company's activities do nothing to bring onshore the profits of other group entities.

Mention should be made of the measure of relief which may be available under double taxation agreements. The United Kingdom has one of the widest networks of double taxation agreements of any country in the world, most of which generally follow the OECD Model Treaty in the definition of "permanent establishment" and "business profits". Thus, even if a non-resident company has trading activities within the United Kingdom, a tax charge in the United Kingdom will only arise if the profits can be attributed to a permanent establishment. The treaty will also typically state that the United Kingdom may attribute to a permanent establishment "the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment". This effectively means that for the purposes of U.K. tax the service entity will be taxed on the basis that it is dealing with its head office on an arm's length basis. Clearly this can give rise to practical problems in establishing what value should be attributed to intra-group transactions which are not comparable to any transactions outside the group. As a result, it may be necessary to use a mark-up basis for taxation purposes.

The treaty also states that expenses which may be allocated to a permanent establishment in the United Kingdom can include a reasonable allocation of executive and general administrative expenses, research and development, interest payable and other expenses borne by the enterprise as a whole.

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TAXATION PITFALLS

Some of the pitfalls which are to be avoided in establishing a service function in the United Kingdom are obvious from the remarks already made. Given the U.K. definition of corporate residence, there are clearly risks in establishing a head office function in the United Kingdom because, particularly where the head office or administrative function exercises a high degree of influence or control over the activities of operating or other subsidiaries, there is a real risk that the central management and control of companies not incorporated in the United Kingdom will be exercised in the United Kingdom and the companies concerned will therefore become subject to U.K. tax. In order to avoid this, it is essential that the relationship between the service company and other group companies should be based on formal documentation which can be produced to Revenue authorities where required. In particular, there should be a formal service agreement with the foreign parent company to ensure that the service company cannot commit its parent by concluding contracts on its behalf. The service company should be independently managed by employees recruited in or seconded to the United Kingdom who are vested with sufficient authority to demonstrate that they only exercise central management and control of the service company's activities.

I have already mentioned the position under U.K. domestic law and double taxation agreements negotiated by the United Kingdom of permanent establishments situated there. In practical terms, it will not normally be possible to maintain the status of a non-taxable representative office for any length of time, and it must therefore be accepted that any substantive service or administrative activities will give rise to a tax liability in the United Kingdom. Establishing a basis for this taxation can be very difficult. There can be real problems in pricing the services provided by a service entity to other group companies around the world. If business is done through a subsidiary, the United Kingdom's transfer pricing legislation will apply. Like most other countries, this requires U.K. resident companies to do business with affiliates established elsewhere on an arm's length basis. The services provided by a service company may well be unique to that group and impossible to value on an open market basis. Mention has already been made of the treaty provisions in relation to branch profits which have a similar effect. The Inland Revenue will expect to see the services provided by the service entity remunerated on a reasonable basis. While they may be prepared to tolerate initial losses because of start up and other costs, they will not accept a loss position indefinitely.

MARK-UP BASIS

From a commercial point of view, it is often appropriate for intra-company services to be charged to the appropriate affiliates at cost plus an appropriate mark-up. Many Revenue authorities, including the United Kingdom, recognize the commercial reality of the position and will accept a mark-up basis where it produces a reasonable result. There are no published guidelines in the United Kingdom as to when a cost plus basis is considered appropriate by the Inland Revenue and what level of mark-up will be acceptable. The Revenue will accept a mark-up provided that it can be shown to be a reasonable approximation of arm's length treatment and that, in practice, the percentage mark-up usually falls between 5% and 15%. The percentage which the Inland Revenue is prepared to agree to has risen so that 10% is more likely than 5%, but agreement depends very much on the particular circumstances of the case and also on the individual Inspector concerned. The cost plus percentage method is normally agreed to at a local tax office level by the Inspector and is not generally a head office or policy matter.

The Inspector is likely to look carefully at the way in which the U.K. offices operate. He will generally want to be sure that the U.K. office is not making its own contracts or actually creating profits which would be defined without recourse to a mark-up exercise. An initial agreement with the Revenue will always be subject to review and the Inspector will usually want to look at the service company's activities in depth before agreeing to the first set of accounts submitted on the mark-up basis.

An alternative to the mark-up basis would be commission on sales. This time a fixed percentage which is based on the gross sales obtained by the parent corporation would be agreed to and applied each year to the parent sales in order to calculate a figure of notional turnover for the U.K. operation. Specific expenses incurred by the U.K. branch would then be deducted from this figure. Again, the Inland Revenue will have to be satisfied that this method is producing sensible and arm's length results. The Inspector may wish to see supporting documents such as management accounts.

If it is not possible to adopt a fixed percentage approach either as cost plus or commission on sales, the parent company will have to agree to pay a service charge for itemized services provided for it by its U.K. office. The Inspector will then want to be satisfied that the full commercial rate is being paid or credited to the U.K. office for the service it provides.

CONCLUSION

The U.K. tax environment provides no special incentives for the establishment of service companies in the United Kingdom. The United Kingdom's current public policy is to offer investors a comparatively low overall rate of corporate taxation while eliminating specific incentives and allowances in order to create as level a playing field as possible. The overall effect is that the United Kingdom does not offer some of the more tangible attractions of other countries such as Belgium (coordination centres). The practice of the Inland Revenue, however, is such that service companies established in the United Kingdom will not suffer any particular disadvantages in the taxation area relative to other companies trading in the United Kingdom. The decision as to location can therefore be taken on business and commercial principles rather than on pure fiscal factors.

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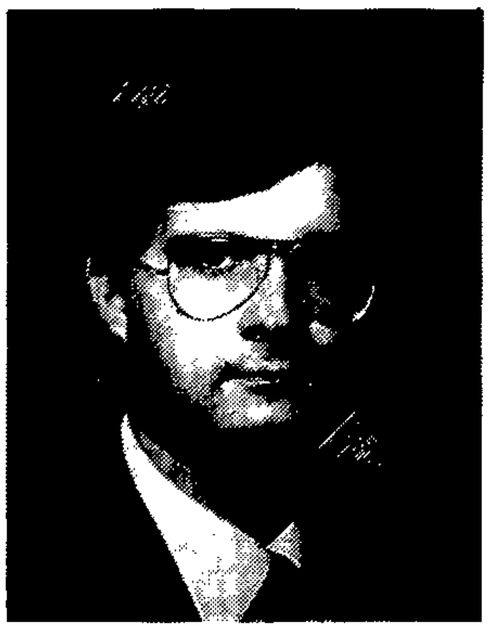

UNITED STATES:

Intercompany Dealings and the U.S. White Paper

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John Gunn is a tax partner in the Cleveland office of Ernst & Young and acts as a regional international tax specialist. Prior to his current position, he was in the Dallas office where he also acted as an international tax specialist. Before that, he worked for 2 years in Ernst & Whinney's International Tax Department in New York. Prior to joining Ernst & Whinney in 1980, he was Corporate Tax Manager for Mostek Corporation, a manufacturer of semiconductor devices, and was with Texas Instruments, also a manufacturer of semiconductors.

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He co-authored the article "Effect of New Uniform Capitalization Rules of Foreign Transaction" which was published in *The Journal of Taxation.*

WHITE PAPER

The Treasury Department and Internal Revenue Service (IRS) issued a document entitled "A Study of Intercompany Pricing" ("White Paper") on 18 October 1988. Chapter 3 of the White Paper included the following conclusions and recommendations:

1. Failure of taxpayers to document transfer pricing methodology hampers the IRS in administration of Sec. 482.
2. The Sec. 482 Regulations should be amended to require taxpayers to document transfer pricing methodology prior to filing tax returns. The Regulations should also require such documentation to be provided within a reasonable time of request.
3. Forms 5471 and 5472[1] should be revised to include summary information about how transfer prices were determined, an attestation that the documentation was available when the tax return was prepared, and a promise that such information would be made available at the start of an IRS examination.
4. The Sec. 982 summons and administrative summons procedures[2] should be more aggressively used for taxpayers that delay in producing relevant pricing information.
5. Penalties should be considered for compelling taxpayers to provide thorough and accurate information and to deter "overly aggressive" and "unjustified" transfer prices.

OVERVIEW

The contemporaneous documentation requirement and attestation requirements would be bad policy, resulting in a significant compliance burden disproportionate to the benefit, if any. In fact the information produced is likely to be of little value and will be unlikely to alter the audit process.

The approach of the White Paper appears to be that the Regulations should provide a methodology for setting prices rather than guidelines for evaluating the appropriateness of prices. This is inconsistent with existing business practice and would be extraordinarily difficult and expensive to implement.

On the other hand, the duty of the examining agent is to protect the U.S. tax revenue, regardless of the U.S. taxpayer's motives. However, such facts call into question the appropriateness of establishing difficult procedural steps for documenting prices and the potential for penalties for failure to do so, where tax avoidance was never a motivation of the taxpayer.

NON-PRODUCTION OF INFORMATION

The White Paper mentions that failure of taxpayers to document methodology used to establish transfer prices and delays or failures in supplying information hampers the IRS in administering Sec. 482.

The frustration of international examiners in dealing with this area is understandable. However, it might have been instructive to include taxpayers in the survey regarding the administration of these Regulations. Very often taxpayers cannot readily provide the information requested by international examiners because the information requested is not available to the taxpayer or does not exist. This is particularly true for information regarding comparable uncontrolled prices.

In those cases where a taxpayer has access to information and does not provide the information, penalties are appropriate. However, it is important to distinguish unavailability of information from refusal to produce information.

1. Forms 5471 and 5472 are information returns regarding non-U.S. corporations, regarding respectively, controlled non-U.S. subsidiaries of U.S. owners and controlling owners of U.S.corporations. Information required includes financial statements and a summary of intercompany transactions.
2. The administrative summons procedure is a procedure whereby the IRS requires taxpayers to produce information relevant to a tax audit, with penalties for failure to comply. Under Sec. 982, if certain requested information is not produced, evidence regarding the information may not be used by the taxpayer if produced at a later time.

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OTHER APPROACHES

The White Paper states that international examiners have failed to deal with non-compliant taxpayers through Sec. 982 summons and administrative summons. The reason is that to do so would require delaying the audit.

Where taxpayers have information regarding transfer prices and refuse to provide such information, use of these approaches is appropriate. In such cases, the non-compliant taxpayer bears the burden of the procedures. This appears more appropriate than creating an onerous new procedural requirement which would apply to both compliant and non-compliant taxpayers.

VALUE OF INFORMATION PRODUCED

It seems unlikely that information produced by a contemporaneous documentation requirement would be of great use to either the taxpayer or the IRS. Regardless of what information is supplied, the examining agent will require additional information on audit, and will need to rely on the taxpayer to provide it.

Most situations encountered by practitioners involve transactions between tax jurisdictions with similar or higher effective tax rates than those of the United States. The vast majority of taxpayers in that circumstance are not seeking to utilize transfer pricing to minimize tax liability. Providing difficult procedural requirements for determining transfer pricing and penalties for noncompliance with such procedural requirements is pointless, and may be counterproductive to other objectives, such as increasing exports.

SEC. 482 AS A METHOD TO DETERMINE PRICES

The approach of the current Regulations is not to consider Sec. 482 as providing a methodology to establish transfer prices but rather as a methodology for determining whether a transfer price, however determined, was appropriate. The taxpayer's motives on methodology should be irrelevant. If an issue is raised, it is on the basis of the appropriateness of the price actually used, as evaluated under the methods provided by the Regulations.

The White Paper appears to suggest that Sec. 482 Regulations would provide a required methodology to be used in determining transfer prices. Failure to use "appropriate" methods would result in susceptibility to penalties. However, use of appropriate methodology would not limit exposure to adjustment on audit in the highly factual Sec. 482 context. At best, potential penalties might be avoided.

The use of Sec. 482 Regulations as a required approach for establishing intercompany prices is clearly inappropriate. Many practitioners' experience is that in most cases transfer prices are established for a variety of non-tax purposes. Most commonly, such prices are established to provide management with information to manage the business and provide motivation for desired behaviour. Although tax considerations may not be a large element in determining transfer prices, the vast majority of transactions falls within acceptable ranges under existing Regulations, because of similarities in those rules to many business objectives. Under current procedure, a tax professional's typical function is to evaluate whether transfer prices are justifiable, most commonly on a general basis. To require a greater level of involvement will be difficult and expensive, particularly considering the increased compliance requirements in other international tax areas.

TAXPAYER'S MOTIVATION

It is important to distinguish abusive and non-abusive situations involving transfer pricing. In the great majority of transactions involving transfer pricing and a U.S. taxpayer, the other country involved has equivalent or higher tax rates. The taxpayer's motivation is not to avoid U.S. income tax but rather to avoid double taxation and the potential of a competent authority proceeding. In this situation, there is no motivation for reducing U.S. taxation through adjustments to transfer pricing.

Interesting issues arise if a taxpayer uses an inappropriate method to determine a transfer price, yet the transfer price is an acceptable price. Under current rules, the taxpayer should not have a problem. Under the White Paper's approach, the taxpayer would at least be potentially subject to penalties. It would not appear improbable that the IRS would use the potential for penalty as a means to extract a settlement for the issue.

The result of the change in rules is a new procedural requirement without which a taxpayer faces potential penalties. Compliance provides no protection from adjustment, and the taxpayer can expect that an audit in this area will proceed with the same degree of difficulty as in prior years.

THE ATTESTATION REQUIREMENT

The White Paper recommends an attestation on the tax return that transfer pricing documentation was available at the time the return was filed and a promise that it will be available at the start of an IRS exam.

A separate attestation for this area of the tax return seems unnecessary, particularly where similar attestation requirements do not apply to numerous other areas, such as inventory methods and depreciation methods.

The attestation requirement poses difficult issues for tax professionals who need to sign the tax return. Typically the people who establish transfer prices may be outside the tax and accounting area. Access and documentation of the thought process of the persons determining transfer prices will be extremely difficult, particularly to the degree required to have comfort signing a tax return.

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CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

We welcome the submission of articles which are of interest to tax professionals, executives and scholars to be considered for publication. The author should ensure that the significance of the contribution will also be apparent to an international readership.

The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Disketttes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

COMMUNIQUE DE PRESSE

PRIX FRANCIS LEFEBVRE DU JURISTE D'AFFAIRES

Le sept décembre 1989 a été attribué, à la Faculté de Droit de Paris II Assas, le Prix du Juriste d'Affaires FRANCIS LEFEBVRE.

Ce prix, doté par les Editions Francis LEFEBVRE, est destiné à récompenser les meilleurs étudiants en Droit des Affaires. Il a été attribué à Madame Valérie CHARRETEUR, étudiante de 3ème année du Magistère de Droit des Affaires de Paris II.

Organisée dans le Grand Amphithéâtre d'Assas, sous la présidence de Monsieur G. DURRY, en présence de plus d'un millier de personnes, la cérémonie solennelle de remise des diplômes de ce magistère, par le Professeur P. DIDIER, a permis à Monsieur Philippe PEYRAMAURE, Conseil Juridique associé du BUREAU FRANCIS LEFEBVRE, de récompenser la brillante lauréate de l'année 1989.

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Generally, a corporation will be financed by a combination of debt and equity. The proportion of debt and equity wil be determined by numerous factors based on legal, economic and tax differences. Within national boundaries, the fact that tax factors affect the decision is of no major concern to the tax authorities since all payments will fall within the tax net and revenue collection will not be impaired. However, in the international context the difference between debt and equity may be a significant concern to the tax authorities. Thin capitalisation rules are directed to the use of debt funding to reduce disproportionately the taxable income of a business entity in one jurisdiction by transferring the income into another jurisdiction by means of before-tax interest payments. This article offers an in-depth look at the Australian approach and summarizes the thin capitalisation rules in various other countries as well.

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Tax reform in developing countries has recently come to focus on restructuring tax systems towards more efficient taxes that do not distort market forces and choosing taxes that are administratively feasible. This article examines the strategy and tools of tax administrations in these countries. Although the traditional goal of tax administrations is to asses and collect taxes and to enforce a given set of legislation, the task of administrations in developing countries is not so clear-cut. The new emphasis on taxes that work, i.e. those that are administratively feasible, puts the focus on the tax administration and this means they must ally with tax policy experts to change tax structure in a desirable way while still executing their own duties of assessment and collection of revenue.

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The less developed countries (LDCs) are characterized, inter alia, by low standards of living, low levels of productivity, high rates of population growth, rising levels of unemployment and dependence on international relations. Investment and capital resources in these countries can be mobilized in various ways, i.e. savings, foreign assistance and raising taxes. This article analyzes the tax structure changes in LDCs in an attempt to understand their development efforts.

Michael W. Gordon:

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Twelve years after the United States first enacted anti-bribery and anti-boycott legislation it is apparent that these laws are enforced mainly at an administrative level, rather than through the courts. This article looks at the history of the legislation and responses in other countries and multilateral organizations.

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Brian Lawrence:

Australie: Restrictions gouvernementales sur le financement des sociétés internationales (sous-capitalisation) *118*
D'une façon générale, le financement d'une société se fait par la combinaison de créances et de fonds propres. La proportion entre créances et dettes est

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Eric Tomsett:

Treaty Shopping und das Verhältnis von Schulden und Eigenkapital in Grossbritannien *107*
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Bobby L. Burgner:

U.S.A.: Bundes-, Landes- und Gemeindesteuern bei internationalen Sachverhalten *112*
Der Artikel befasst sich mit multinationalen Steuerpflichtigen und den diesbezüglichen Schlüsselfragen bei den Bundes-, Landes- und Gemeindesteuern. Desweiteren wird aufgezeigt, inwiefern deren Tätigkeiten in den Vereinigten Staaten erschwert werden können.

Brian Lawrence:

Australien: Staatliche Beschränkungen der internationalen Finanzierung von Körperschaften (Unterkapitalisierung) *118*
Im allgemeinen werden Körperschaften durch eine Kombination von Fremd-

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fonction d'un certain nombre de facteurs reposant sur des différences légales, économiques et fiscales. Les autorités fiscales n'ont pas à se soucier de façon sérieuse d'une prise de décision influencée par les facteurs fiscaux à l'intérieur du pays, puisque tous les paiements tombent dans le filet de l'impôt et que le recouvrement n'en sera pas affecté. Il en va tout autrement au niveau international où la différence entre créances et fonds propres peut inquiéter sérieusement les autorités fiscales. Les règles de sous-capitalisation sont destinées à régir l'utilisation de la consolidation des dettes pour réduire d'une façon disproportionnée le revenu imposable d'une entité commerciale d'une juridiction en transférant le revenu dans une autre juridiction au moyen de paiements d'intérêts avant impôt. Cet article analyse l'approche australienne dans ce domaine et résume également les règles de sous-capitalisation dans d'autres pays.

Brian Lawrence et Neil Wilson:

Australie: Restrictions du gouvernement quant à la consolidation et la constitution de dettes mettant en jeu des non-résidents *130*
Les règles australiennes portant sur la constitution de dettes, prévues dans la Division 16G de la loi sur l'impôt sur le revenu australien étaient prévisibles lors de la prise des dispositions sur la sous-capitalisation et ont tout d'abord été anoncées en 1987 par le Ministre des Finances. Le premier objectif poursuivi par ces règles est d'empêcher les déductions d'intérêts réalisés par des sociétés australiennes, contrôlées pour 50% ou plus du capital social par des non-résidents, sur des emprunts effectués en relation avec l'acquisition de biens auprès de tiers apparentés. Cet article analyse le texte de l'ensemble de la législation à ce sujet.

Leonard W. Rothschild, Jr., Steven L. Mack et David M. Cordova:

Le crédit d'impôt étranger américain – Vue d'ensemble des dispositions de la loi sur la réforme fiscale de 1986 et les amendements qui ont suivi *133*
La loi sur la Réforme Fiscale de 1986 a introduit un grand nombre de nouvelles dispositions au Code des Impôts sur le Revenu, limitant ainsi les bénéfices tirés du crédit d'impôt étranger. La loi de 1988 Technical and Miscellaneous Revenue a modifié certaines de ces nouvelles dispositions. Cet article analyse à la fois les modifications introduites à l'origine et les amendements ultérieurs.

Charles Y. Mansfield:

International: Réforme fiscale dans les pays en voie de développement: Dilemme administratif *137*
La réforme fiscale dans les pays en voie de développement a récemment conduit à mettre l'accent sur la restructuration des systèmes fiscaux aux fins d'application d'impôts plus "efficaces" ne faussant pas les lois du marché ainsi que sur le choix d'impôts administrativement applicables. Cet article se penche sur la stratégie et les instruments utilisés par les administrations fiscales dans ces pays. Bien que le but traditionnel poursuivi par les administrations fiscales soit d'établir et de collecter des impôts ainsi que d'appliquer un ensemble de lois, la tâche des administrations dans les pays en voie de développement n'est pas très bien définie. Le nouvel accent mis sur les impôts "efficaces", à savoir ceux administrativement applicables, tient essentiellement compte de l'administration fiscale, ce qui signifie qu'ils doivent s'allier aux experts de la politique fiscale pour modifier les structures fiscales d'une façon adéquate sans oublier que ces derniers doivent toujours accomplir leur devoir d'imposer et de collecter l'impôt.

Mahmoud Yousefi et Sohrab Abizadeh:

International: Modifications fiscales et développement économique – Analyse critique *144*
Les pays les moins développés (less developed countries = LDCs) se caractérisent entre autres par de bas niveaux de vie, une faible productivité, un taux élevé de croissance de population, une augmentation du chômage et une dépendance au niveau des relations internationales. Les investissements et ressources en capitaux peuvent dans ces pays être mobilisés de différentes façons, à savoir: par l'épargne, l'assistance étrangère et une augmentation des impôts. Cet article analyse les modifications des structures fiscales dans les LDCs, afin d'essayer de comprendre leurs efforts en matière de développement.

Michael W. Gordon:

International: Les législations anti-corruption et anti-boycott américaines de 1977 – Douze ans après *150*
Douze ans après que les Etats-Unis ont promulgué les législations anti-corruption et anti-boycott, il semble que ces lois soient essentiellement appliquées au niveau administratif plutôt qu'à celui des tribunaux. Cet article analyse l'historique de la législation, les réactions dans les autres pays et les organisations multilatérales.

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und Eigenkapital finanziert. Das Verhältnis zwischen Fremd- und Eigenkapital wird dabei durch zahlreiche Faktoren bestimmt, die sich aus rechtlichen, wirtschaftlichen und steuerlichen Verschiedenheiten ergeben. Was den nationalen Bereich anbelangt, ist die Tatsache, dass steuerliche Faktoren die Entscheidungsfindung beeinflussen, von keinem grösseren Interesse für die Finanzbehörden, da alle Zahlungen durch die Schlussbesteuerung erfasst werden, und die Steuererhebung daher nicht beeinträchtigt wird. Der Unterschied zwischen Fremd- und Eigenkapitalfinanzierung kann jedoch in einem internationalen Zusammenhang von starkem Interesse für die Finanzbehörden sein. Bestimmungen, die die Problematik der Unterkapitalisierung regeln, richten sich gegen die Inanspruchnahme von Fremdkapital zur Finanzierung. Es soll das Missverhältnis zwischen dem steuerbaren Einkommen der gewerbetreibenden juristischen Person in einem Erhebungsbereich gegenüber einem anderen Erhebungsbereich korrigiert werden, in den das Einkommen im Wege der Zinszahlungen vor Steuern transferiert wurde. Der Artikel bietet einen grundlegenden Einblick in die Handhabung des Problems durch Australien und gibt zugleich eine Zusammenfassung der Unterkapitalisierungsregelungen in verschiedenen anderen Ländern.

Brian Lawrence und Neil Wilson:

Australien: Einführung von Beschränkungen der Finanzierung durch Fremdkapital von seiten der Regierung – Darlehen unter Beteiligung von beschränkt Steuerpflichtigen *130*
Die australischen Bestimmungen hinsichtlich der Finanzierung durch Fremdkapital, die in Abschnitt 16G des australischen Income Tax Assessment Act aufgenommen worden sind, warfen bereits zu dem Zeitpunkt ihre Schatten voraus, als zum ersten Mal Masshahmen hinsichtlich der Unterkapitalisierung vom Finanzminister angekündigt wurden. Hauptzweck der Bestimmungen ist, die Absetzbarkeit von bestimmten Zinsen durch australische Firmen zu verweigern, die von beschränkt Steuerpflichtigen kontrolliert werden, die 50% oder mehr der Stammaktien halten. Betroffen sind Zinsen aus Darlehen, die im Zusammenhang mit dem Erwerb von Aktiva von verbundenen Unternehmen aufgenommen wurden. Der Artikel untersucht ausführlich die diesbezügliche Gesetzgebung.

Leonard W. Rothschild, Jr, Steven L. Mack und David M. Cordova:

Die Anrechnung ausländischer Steuern – Ein Überblick über die Bestimmungen des Steuerreformgesetzes 1986 und die späteren Änderungen *133*
Das Steuerreformgesetz 1986 fügte viele neue Bestimmungen dem Internal Revenue Code hinzu, die die Vorteile des Anrechnungsverfahrens für ausländische Steuern beschränken. Das „Technical and Miscellaneous Revenue Act of 1988" änderte eine Anzahl dieser neuen Bestimmungen. Dieser Artikel beschreibt die ursprünglichen sowie die späteren Änderungen.

Charles Y. Mansfield:

International: Steuerreformen in Entwicklungsländern: Das administrative Dilemma *137*
Die Steuerreformen in den Entwicklungsländern konzentrieren sich neuerdings auf eine Umstrukturierung der Steuersysteme, um effizientere Steuern einzuführen, die einerseits die Bedingungen des Marktes nicht verzerren, andererseits aber administrativ durchführbar sind. Der Artikel untersucht die Vorgehensweise der Steuerbehörden in diesen Ländern und die Mittel, die ihnen dabei zur Verfügung stehen. Obwohl traditionsgemäss die Funktion der Steuerbehörden in der Veranlagung und Erhebung von Steuern als auch im Gesetzesvollzug besteht, ist ihre Aufgabe in den Entwicklungsländern nicht derartig scharf definiert. Den besonderen Wert, den man heutzutage auf eine effektive Steuererhebung legt, die insbesondere auch für die Verwaltung handhabbar ist, lenkt ein besonderes Augenmerk auf die Steuerverwaltung. In Zusammenarbeit mit den Sachverständigen auf steuerpolitischem Gebiet muss sie das Steuersystem in gewünschter Weise ändern und zugleich ihrer eigentlichen Funktion, nämlich derjenigen der Steuerveranlagung und -erhebung, nachgehen.

Mahmoud Yousefi und Sohrab Abizadeh:

International: Steueränderungen und Wirtschaftsentwicklung – Kritische Bemerkungen *144*
Die wichtigsten Merkmale der Entwicklungsländer („less developed countries" oder LDCs) sind ihr niedriger Lebensstandard, das niedrige Produktivitätsniveau, der hohe Bevölkerungszuwachs, die zunehmende Arbeitslosigkeit und die Abhängigkeit von internationalen Beziehungen. Investierungen und Kapital können auf verschiedene Weisen mobilisiert werden, d.h. durch Spargelder, Auslandshilfe und eine Steuererhöhung. Dieser Artikel analysiert die Steuerstrukturänderungen in LDCs und versucht, ihre Entwicklungsanstrengungen zu verstehen.

Michael W. Gordon:

International: Die U.S.-Antischmiergeld- und Antiboycott-gesetzgebung 1977 – Ein Rückblick auf die letzten zwölf Jahre *150*
Zwölf Jahre nachdem die U.S.A. zum ersten Mal die Antischmiergeld- und Antiboycottgesetzgebung verabschiedete, wurde es klar, dass diese Gesetze hauptsächlich von den Steuerämtern erzwungen werden, anstatt von den Gerichtshöfen. Dieser Artikel beschreibt die Geschichte der Gesetzgebung und die Reaktion in anderen Staaten und von multilateralen Organisationen.

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Treaty Shopping and Debt/Equity Ratios in the United Kingdom

Eric Tomsett*

I. INTRODUCTION

Provisions against treaty shopping and the re-characterisation of debt as equity under thin capitalisation rules represent extremely complex areas in the United Kingdom as there is a lack of statute law and case law specifically dealing with these issues. Accordingly, the law depends very much on a wide interpretation of general anti-avoidance provisions or principles with corresponding great uncertainty as to the actual position in any particular situation.

Thin capitalisation in particular is an area where it is currently impossible to give any accurate guidance on whether or not a particular capitalisation structure will be satisfactory, and it is virtually impossible to predict how the Courts would react if a case was taken before them on these issues (which has never happened so far).

II. THE GENERAL APPROACH TO TREATY ABUSE IN THE U.K.

The United Kingdom has adopted a number of different approaches for combatting the third country use of double taxation treaties and other treaty abuses.

The primary way in which the United Kingdom has sought to restrict the abuse of its double taxation treaties is through specific articles in the double taxation treaty itself and such provisions are now included in many double taxation treaties, as discussed below.

Whilst the U.K. revenue authorities do not issue public rulings of the type which are used in the United States, nevertheless some senior tax inspectors in the head office divisions of the U.K. Inland Revenue have shown considerable sympathy towards the approach adopted in the U.S. Internal Revenue Service rulings on treaty shopping using finance companies (see Rulings 84-152 and 84-153).

The most recent development, however, in combatting treaty abuse has been through the enactment of statutory provisions overriding double taxation treaties.

These areas are discussed in more detail below.

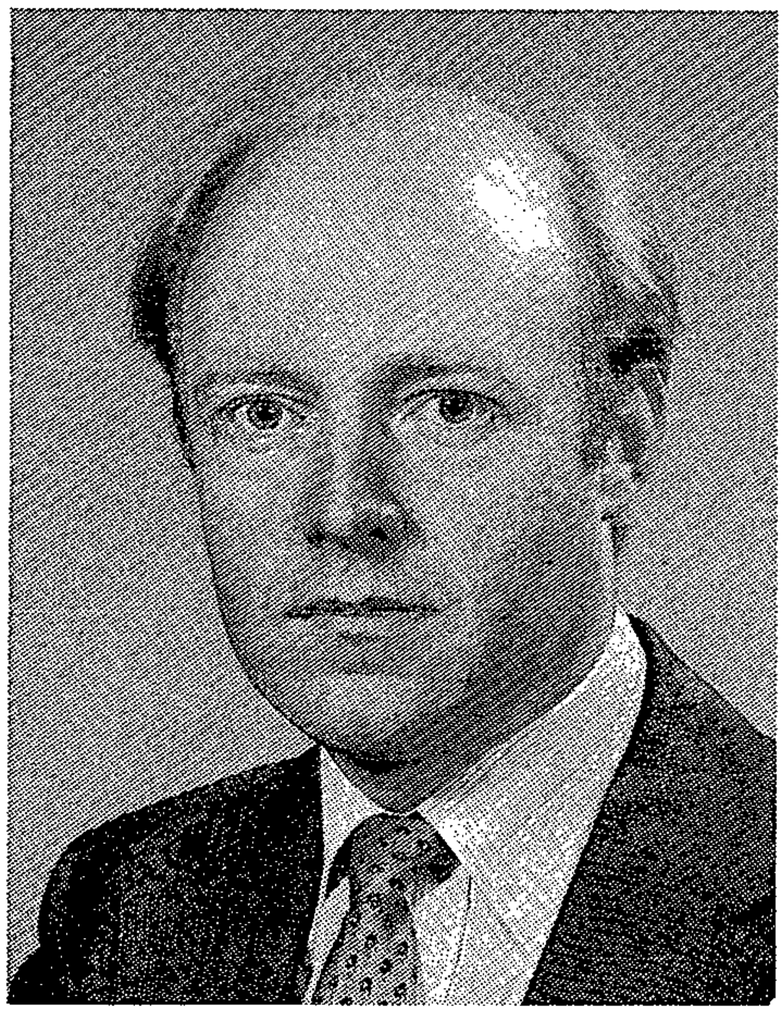
III. ANTI-ABUSE PROVISIONS INCLUDED IN U.K. TAX TREATIES

The United Kingdom has never, so far, sought to include in a double taxation treaty a general anti-abuse provision of the same nature as Art. 16 of the U.S. Model Double Taxation Convention. Instead, it has sought to include anti-abuse clauses in specific articles of the treaty to deal with particular perceived potential abuses.

Perhaps the most long-established anti-abuse provision in U.K. treaties is in the interest and royalty articles of certain treaties, such as the treaty with the Netherlands. Such articles typically contain the following wording: "The provisions of the Article shall not apply if the debt claim in respect of which the interest is paid [right or property giving rise to the royalties] was created or assigned mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons."

This provision is clearly designed to prevent treaty shopping in respect of financing and royalty structures designed to take advantage of the treaty articles. However, despite such provisions having been in the U.K.–Netherlands treaty, the former U.K.–Netherlands Antilles treaty and a number of other treaties for very many years, it is only in the last few years that the U.K. Inland Revenue has sought to actively use these provisions to attack financing and royalty structures designed to utilise favourable treaty benefits to avoid U.K. withholding taxes or treatment of interest as a dividend distribution (see thin capitalisation section below).

Another important area of treaty anti-abuse provisions has been included in recent double taxation treaties with respect to tax credit refunds.



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In this regard it has to be noted that the United Kingdom is almost unique in granting tax credit refunds under its imputation system to foreign corporate shareholders with a substantial interest in a U.K. company. The U.K.–U.S. double taxation treaty is, of course, the primary and original example of a U.K. double taxation treaty which grants such a tax credit refund to a foreign corporate shareholder with an interest of 10% or more in a U.K. company. The United Kingdom also grants this tax credit refund under 9 other treaties: Belgium, Canada, Denmark, Finland, Luxembourg, the Netherlands, Norway, Sweden and Switzerland.

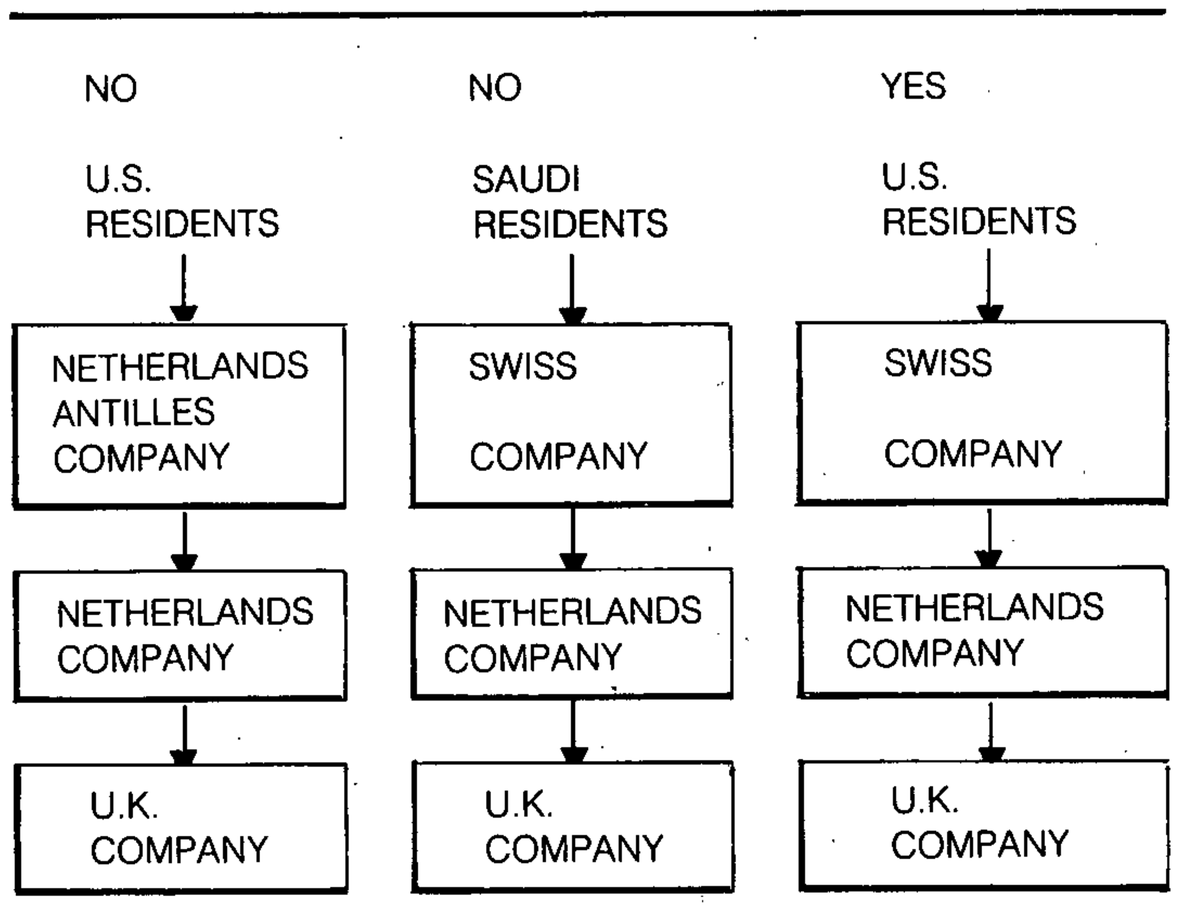
Indeed no other country is as generous as the United Kingdom in giving away tax credit refunds to foreign corporate shareholders with substantial participation under the terms of double taxation treaties.

It should be particularly noted that a number of countries with which the United Kingdom has double taxation treaties granting the tax credit refund to substantial corporate shareholders are countries commonly used in international planning structures such as the Netherlands, Switzerland and Luxembourg. Not surprisingly, therefore, international investors were quick to exploit the opportunities of organising structures to seek to obtain the tax credit refunds for investors who were not actual residents of the treaty countries listed.

Originally, such tax credit refunds could easily be obtained for almost any investor by establishing a holding company structure with a Netherlands company owning the shareholding in the U.K. company and a Netherlands Antilles company owning the shares of the Netherlands company. At that time there was a nil rate of dividend withholding tax from the Netherlands to the Netherlands Antilles such that the Netherlands company could qualify for the receipt of U.K. dividends with the tax credit refund from the U.K. revenue authorities and pass the funds on as a dividend to its Antilles parent company at a very small additional tax cost.

An anti-abuse provision was introduced very quickly to combat this type of planning through a Netherlands/Netherlands Antilles holding company structure. This was done by the inclusion of a special provision in the dividend article of the U.K.–Netherlands double taxation treaty. This effectively provided that a Netherlands company owning shares in the U.K. company would only be entitled to the tax credit refund if it was either a quoted company or was controlled (under any definition of control in the U.K. Tax Acts) by persons who would not themselves be entitled to a tax credit refund if they received the dividends from the U.K. company directly. This treaty provision immediately denied the Netherlands–Netherlands Antilles holding company structure the tax credit refund as the Netherlands company was controlled by the Antilles company which was not itself entitled to the tax credit refund.

The above provision in the U.K.–Netherlands double taxation treaty is, however, extremely complex in its application and can lead to some very interesting results as is shown by the following diagram.



When the United Kingdom decided to insert anti-abuse provisions into other double taxation treaties, it did not seek to follow the same approach as adopted in the U.K.–Netherlands treaty but instead adopted a qualitative test which denies the tax credit refund to the foreign corporate shareholder only in circumstances where the structure has been designed in order to take advantage of the tax credit. The relevant wording in the U.K.–Switzerland double taxation treaty is, for example, as follows: "The provisions of neither sub-paragraph (B) nor sub-paragraph (C) of this paragraph (i.e. the paragraphs granting the tax credit refund) shall apply unless the recipient of a dividend shows (if required to do so by the competent authority of the United Kingdom on receipt of a claim by the recipient to have the tax credit set against United Kingdom income tax chargeable on him) that the shareholding in respect of which the dividend was paid was acquired by the recipient for bona fide commercial reasons or in the ordinary course of making or managing investments and it was not the main object nor one of the main objects of that acquisition to obtain entitlement to the tax credit referred to in sub-paragraph (B) or sub-paragraph (C), as the case may be."

Similar provisions are included in the dividend articles of the United Kingdom's double taxation treaties with Belgium (proposed treaty), Luxembourg and Norway.

Another example of an anti-abuse provision in certain U.K. double taxation treaties is the clause in recent U.K. double tax treaties such as the U.K.–U.S. double taxation treaty enabling the U.K. tax authorities to argue a thin capitalisation basis for recharacterising debt as equity. This is discussed fully below.

IV. THE U.K. APPROACH TO TREATY INTERPRETATION AND APPLICATION

The U.K. tax authorities have never formalised their attitude to the interpretation of double taxation treaties. As mentioned earlier, it is not the practice of the U.K. Revenue to issue rulings of the type which are common in the United States. Nevertheless, some senior tax inspectors in the U.K. Head Office Division dealing with international issues have shown some sympathy for the approach adopted by the United States (see IRS Rulings 84-152 and 84-153) with respect to the use of Netherlands Antilles financing companies to avoid U.S. withholding tax. The U.K. Inland Revenue have never rationalised in detail their attitude toward this area, but they have indicated a possible reliance on the anti-avoidance principles recently developed by the U.K. Courts in the *Ramsay* case[1] to support their approach

1. *Editor's Note:* 1981 *Simon's Tax Cases* 174. The *Ramsay* Principle stands for the proposition that artificial avoidance schemes can be ignored for tax purposes where they consist of a series of transactions which ultimately are self-cancelling.

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here. However, the extension of the *Ramsay* Principle has been largely halted by the House of Lords decision last year in the case of *Craven v. White*[2] and the associated cases heard at the same time. It must be highly questionable, therefore, as to whether the *Ramsay* Principle can have any real application in the field of treaty abuse. There have never been any cases on this issue.

The U.K. Inland Revenue have also, in certain cases, sought to apply a very restrictive interpretation of double taxation treaties. For example, the United Kingdom's double taxation treaties with the Channel Islands of Jersey and Guernsey and the Isle of Man were drafted many years ago, before the taxing jurisdiction of the United Kingdom was extended to its Continental Shelf areas. Accordingly, the definition of the United Kingdom for purposes of the treaty is confined to the land area. This means that a company which is resident in those territories could potentially avoid U.K. taxation on certain activities within the U.K. Continental Shelf areas by claiming the benefit of the double taxation treaty and arguing that it was not carrying on business within the United Kingdom under the definition in the double taxation treaty. The U.K. Inland Revenue have, however, in many cases, declined to accept this use of U.K. double taxation treaties without putting forward strong technical arguments to support their case.

V. STATUTORY OVERRIDE OF DOUBLE TAXATION TREATIES

Again, the United Kingdom has been nowhere near as active as the United States in enacting specific statutory provisions to override particular double taxation benefits.

The United Kingdom has, however, regretably, enacted some provisions in this area. The first was not designed at all to prevent treaty abuse but indeed to provide potential benefits to U.K. companies which were suffering unitary taxation in certain U.S. states, such as California.

As a measure of retaliation against unitary taxation, the United Kingdom enacted what is now Sec. 812 of the Income and Corporation Taxes Act 1988. This overrides the tax credit refund provisions of the U.K.–U.S. double taxation treaty for certain U.S. corporations connected with U.S. states imposing taxation on a unitary basis. The provisions of the section do not, however, apply unless specifically implemented by a separate statutory instrument. This has not so far occurred.

Another example of overriding the specific benefits of a double taxation treaty is included in what is now Sec. 112(4) and (5) Income and Corporation Taxes Act 1988. This provision was designed to override a favourable court decision in the case of *Padmore v. IRC*.[3] This case established that U.K. resident partners in a Jersey resident partnership were protected by the terms of the U.K.–Jersey double taxation treaty from being taxed in the United Kingdom on the earnings of the Jersey partnership. This decision potentially opened enormous planning opportunities for use of the Jersey–U.K. double taxation treaty and similar treaties and, perhaps not surprisingly, legislation was introduced to prevent such double taxation treaties protecting U.K. partners in a foreign partnership from U.K. taxation on their profit shares.

Yet, another example of a statutory provision effectively overriding the relief available under a double taxation treaty occurs in Sec. 106 of the Finance Act 1988.

Sec. 105 of the Finance Act 1988 introduced, subject to certain exceptions, a charge to tax on capital gains at the time a company ceases to be resident in the United Kingdom on or after 15 March 1988 by deeming its capital assets to be disposed of at their market value and reacquired as at the date the company becomes non-resident.

The above provisions could, however, possibly have been avoided if whilst continuing to be a U.K. resident under U.K. domestic law, the company simultaneously became resident in a country which has a double taxation treaty with the United Kingdom generally reserving the right to tax capital gains to the country of residence of the taxpayer. In these circumstances, the double taxation treaty may have protected the company from U.K. taxation on capital gains.

In order to prevent the opportunity from arising here, Sec. 106 of the Finance Act 1988 provides that where a company continuing to be a U.K. resident under U.K. law becomes resident also in another country with which the United Kingdom has a double taxation treaty, the capital assets of the company shall be deemed to be disposed of and immediately reacquired at market value on the date the company becomes resident for tax purposes in the treaty country. Thus, the U.K. tax charge occurs just before the double taxation treaty may otherwise have given protection against U.K. taxation.

VI. THIN CAPITALISATION UNDER U.K. TAX LAW

As has been indicated earlier, there is very little statute or case law in the United Kingdom relating to the re-characterisation of debt as equity and none at all which specifically refers to thinly capitalised situations. Instead, a complex interaction of various U.K. taxing provisions potentially enables the U.K. Inland Revenue to challenge the deductibility of interest by a company in certain thinly capitalised structures.

There remains, however, enormous uncertainty in the application of thin capitalisation provisions in the United Kingdom.

VII. STATUTORY PROVISIONS – SEC. 209(2)(e)(iv) AND (v) TAXES ACT 1988

The principal provision relating to thin capitalisation is Sec. 209(2)(e)(iv) and (v) Taxes Act 1988. This section treats as a distribution for the purposes of U.K. taxation any interest (or other distribution out of the assets of the company) in respect of securities of the company where the securities issued by the company are held by a company not resident in the United Kingdom where the issuing company is a 75% subsidiary of the other company, or both are 75% subsidiaries of a third company which is not resident in the United Kingdom. The provision also applies to interest on securities issued by the company and held by a company not resident in the United Kingdom where less than 90% of the share capital of the issuing company is directly owned by a company resident in the United Kingdom and both the issuing company and the non-resident company are 75% subsidiaries of a third company which is resident in the United Kingdom.

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2. *Editor's Note:* 1988 *Simon's Tax Cases* 476. *Craven* restricts the Ramsay Principle to circumstances in which there is "a preordained series of transactions" or "one single composite transaction" and where steps are inserted purely to avoid tax.
3. *Editor's Note:* 1989 *Simon's Tax Cases* 493.

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When considering this provision, it is first essential to look at the applicable definition of a "security". This is contained in Sec. 254(1) of the Income and Corporation Taxes Act 1988 where it is stated that: "security includes securities not creating or evidencing a charge on assets, and interest paid by a company on money advanced without the issue of a security for the advance, or other consideration given by a company for the use of money so advanced, shall be treated as if paid or given in respect of a security issued for the advance by the company". What this means in practice is that interest on any type of loan may potentially be caught by these provisions, not merely interest on what would typically be considered to be a "security". It should be particularly noted that there is no distinction under these provisions between short-term and annual interest, the provisions being equally applicable to interest on short-term obligations. There is perhaps, however, some doubt as to whether the provisions would apply to interest charged on ordinary trading balances.

A moment's consideration of the above provisions would clearly reveal that they are potentially draconian in that all interest paid on loans received by a U.K. subsidiary from a foreign parent company owning 75% or more of the share capital of the U.K. company and all interest on similar loans from a fellow foreign resident subsidiary under the same common control will entirely be treated as a distribution. Under U.K. law, as set out in the statute, there is no consideration of debt/equity ratios or excessive debt, but all the relevant interest is treated as a distribution even if all of the terms of the lending are entirely on an arm's length basis.

VIII. THE IMPACT OF DOUBLE TAXATION TREATIES

The potentially draconian implications of Sec. 209(2)(e)(iv) and (v) Taxes Act 1988 are fortunately very substantially modified in some, although by no means all, U.K. double taxation treaties where the lending company is resident in the other treaty country. This modification is based upon a paragraph on the interest article of the relevant treaty. For example, Art. XI(5) of the Luxembourg–U.K. double taxation treaty states: "any provision in the law of either of the contracting states relating only to interest paid to a non-resident company shall not operate so as to require such interest paid to a company which is a resident of the other state to be treated as a distribution of the company paying the interest. The preceding sentence shall not apply to interest paid to a company which is a resident of one of the contracting states in which more than 50% of the voting power is controlled, directly or indirectly, by a person or persons resident in the other state".

The effect of this provision is that Sec. 209(2)(e)(iv) and (v) Taxes Act 1988 will not apply to interest paid by a U.K. subsidiary to a Luxembourg parent company, unless more than 50% of the voting power in the Luxembourg company is controlled by U.K. residents.

Broadly, provisions similar to that described for the Luxembourg treaty are included in the majority of the United Kingdom's double taxation treaties with major trading nations, although most treaties with other countries do not include such provisions. There are, however, certain treaties with important countries which do not include the Sec. 209 override. Examples are the current treaties with Greece, the Republic of Ireland and Italy.

At first sight, it would appear that where there is a Sec. 209 override provision in a double taxation treaty, thin capitalisation would cease to be an issue for a U.K. subsidiary of a foreign parent company. However, this is not necessarily the case as reference has to be made to another provision of the interest article of the relevant treaty. Virtually all interest articles of double taxation treaties include a paragraph which excludes the operation of the entire interest article of the double taxation treaty in certain cases where there is a special relationship between the payer and the recipient of the interest. The exclusion of the interest article would, of course, remove the protection of the Sec. 209 override and a parent/subsidiary or other group relationship would clearly be regarded as a special relationship for this purpose. The impact of these provisions does, however, vary substantially from treaty to treaty. In many of the older U.K. treaties, the provision closely follows that included in the OECD Model Convention and is of limited application. For example, in the Luxembourg–U.K. treaty, the relevant provision is Art. XI(7) which states: "where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of interest paid, 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 recipient in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In that case, the excess part of the payment shall remain taxable according to the laws of each contracting state, due regard being had to the other provisions of the Convention".

As the provision is expressed to apply "having regard to the debt claim for which it is paid", it is generally considered that this provision (and similar provisions in other treaties) can apply only in relation to the rate of interest charged on the relevant loan. Accordingly, the benefits of the interest article can only be denied where, for example, an excessive rate of interest is charged on the loan. The wording of this particular provision would not appear to allow the Revenue to argue a thin capitalisation restriction.

In more recent double taxation treaties, however, the corresponding provision is worded differently to have a potentially much wider application. Art. 11(5) of the U.K.–U.S. double taxation treaty states: "where, owing to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each contracting state, due regard being had to the other provisions of the Convention".

The crucial words here are *the amount of interest paid exceeds for whatever reason.*

The Revenue argue that treaties which include this type of wording or a wording of a similar wide scope enables them to consider as to whether the loan itself would have been made in an arm's length situation, rather than just as to whether the interest rate is excessive. In considering whether a loan from a foreign parent, or related company, to a U.K. subsidiary is arm's length, all of the terms of the loan will be considered including security, repayment, interest and other relevant terms. The Revenue will also consider the ratio of debt to equity capital in the U.K. subsidiary on the grounds that a company with a small equity capital may not be able to obtain a large loan in an arm's length situation.

As the U.K. tax authorities do not have any regulatory powers in this area, no formal guidelines for acceptable debt/equity ratios or other arm's length loan terms have

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been issued, and indeed the Inland Revenue has never made any official pronouncements of their approach in this area. Nevertheless, discussions with senior members of the Inland Revenue Technical Division have revealed certain informal guidelines which they apply when considering if a company is thinly capitalised for this purpose. They have indicated that they regard a debt to equity ratio of up to 1:1 as generally acceptable, and they also look for "cover" for the interest expense of 3:1 (i.e. pre-tax profits before interest should be at least 3 times the interest expense).

The U.K. Inland Revenue guidelines in terms of ratios are much more stringent than those applied in many countries. However, discussions with the Inland Revenue have revealed that the basis for the 1:1 ratio is somewhat dubious. It is apparently based upon statistical investigations of the average debt to equity ratios in U.K. companies which demonstrated a figure of the order of 0.6:1 of debt to equity. The Revenue have therefore indicated that they have been "generous" in allowing a 1:1 ratio. This argument, however, has little technical merit in that there is no evidence that bankers and other lenders making loans in arm's length situations are particularly concerned with the average debt to equity ratios of U.K. companies. Indeed there are, of course, very many cases where independent lenders will make loans to companies which result in a debt to equity ratio far in excess of 1:1 if they are satisfied with the security for the loan. It appears that the Inland Revenue is aware that it is on a weak ground in seeking to impose a 1:1 debt to equity ratio, and many higher ratios, often 3 or 4 to 1 or greater have been justified where the terms of the particular loan are clearly arm's length.

It should be noted that the "equity capital" for this purpose will include not only share capital but also a share premium account and reserves. The Revenue are also prepared to look at a group of companies on a consolidated basis.

IX. OTHER PROVISIONS

Where interest is paid by a U.K. company to a foreign parent company located in a country which has a double taxation treaty with the United Kingdom, including the Sec. 209 override and a "special relationship" provision in the "narrower" terms, it does not necessarily mean that the U.K. company will be safe from any thin capitalisation challenge. In such circumstances, the Inland Revenue have argued that SS770-773 Taxes Act 1988 (intercompany pricing) may be applied to deny a deduction for the interest paid on "excessive" debt, although this provision could not deem interest to be a distribution. However, there is considerable uncertainty as to whether SS770-773 can be so applied in these circumstances.

Alternatively, the Inland Revenue have argued that another provision in the double taxation treaty, the associated enterprises article, could be applied to allow them to at least deny a deduction for interest on debt in excess of that which would have been lent in an arm's length situation. The associated enterprises article of a double taxation treaty typically allows adjustments to a taxable profit in respect of transactions between companies (or other enterprises) where there is common participation in their management, control or capital if the terms of the relevant transactions are not on an arm's length basis.

The possible application of the associated enterprises article and other provisions in double taxation treaties in relation to thin capitalisation is discussed in the OECD Report of 1987 on thin capitalisation.

X. FUTURE THIN CAPITALISATION LEGISLATION

It is known that the U.K. Inland Revenue are currently reviewing the law on thin capitalisation and considering whether new legislation needs to be introduced. As can be seen from the explanation above, U.K. law on thin capitalisation is clearly unsatisfactory at the present time. In certain situations, the impact of the U.K. legislation is draconian in that all interest paid by a U.K. company to a foreign parent company not enjoying the benefit of an appropriate double taxation treaty is treated as a distribution. Clearly, there can be no equitable justification for such provisions.

In other circumstances, the challenge to thinly capitalised structures depends very largely on the terms included in U.K. double taxation treaties, often many years ago when thin capitalisation was much less of an issue.

No information is available, so far, as to the nature of any future new statutory provisions relating to thin capitalisation or indeed if such provisions will actually be introduced at all.

IFA NEWS

INDIA BRANCH

In February 1988 the India Branch of IFA hosted the First South Asia Regional Conference in New Delhi which received an enthusiastic response from countries both within and without the region. The Conference addressed the following subjects in three sessions:

1. direct taxes structure, with particular reference to provisions relating to a foreign entity doing business in or with the host country;
2. provisions in the statute relating to the avoidance of double taxation; and
3. tax incentives cum high taxes vs. no incentives cum low taxes.

Reports were presented on the tax situation in Bangladesh, Bhutan, Hongkong, India, Japan, Pakistan and Sri Lanka. These reports as well as the opening addresses and key note address by Prof. Leif Muten of the International Monetary Fund have now been published in a book entitled: *Report South Asia Regional Conference, New Delhi, 18-20 February 1988* (267 pages). The price is US$ 30 which includes postal charges, first class airmail.

The report may be ordered from:
International Fiscal Association
India Branch
10, Hailey Road, Flat No. 7
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UNITED STATES:

International Aspects of State and Local Taxation

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INTRODUCTION AND OVERVIEW

For a number of reasons, state and local taxes and tax planning have grown increasingly important in recent years, and the corporate tax climate has changed considerably. This is particularly true for multinational taxpayers that must regard each state and local jurisdiction as a separate "sovereignty" with distinct statutes and ordinances pertaining to revenues and collections. Furthermore, bilateral and multilateral tax treaties and agreements executed at the federal level generally contain no provisions addressing state and local taxation.

This article focuses on multinational taxpayers and the key state and local tax issues and opportunities affecting their operation in the United States. The article will begin by exploring the fiscal and structural factors currently effecting a tremendous change in the multinational and multistate tax environment. Second, the article will review current developments in the area of worldwide unitary taxation, a subject of continuing interest to multinational taxpayers doing business in states employing unitary combined reporting. Next the article will consider current issues in the area of sales and use taxation, with a particular emphasis on expanding legislative, judicial and administrative interpretations of "nexus" and out-of-state vendors' obligation to collect taxes from their customers. Finally, the article will provide a brief overview of the U.S. Supreme Court's 1988-89 term and the plethora of state and local taxes cases decided by the Court. This section will emphasize judicial trends and some possible future implications of decided cases.

CHANGING CORPORATE TAX CLIMATE

The corporate tax climate has changed considerably in recent years, due in large part to federal tax reform, declining federal aid to the states, and in many states, a prohibition against deficit spending. Accordingly, many corporate taxpayers are now faced with state tax burdens approaching, and sometimes exceeding, their federal income tax liability.

The tremendous growth in state tax costs is frequently obscured by the structural differences between the federal and state systems. Unlike the federal government, which derives roughly 90% of its revenues from income taxes, the states depend on a broad array of levies such as income and franchise taxes, property taxes, sales and use taxes, transfer taxes and gross receipts taxes. In fact, income taxes constitute only about 25% of total state revenues.

The states have responded to these fiscal challenges in a variety of ways. Many states have increased enforcement of taxpayer compliance by sharing information with neighboring states on multi-jurisdictional corporations and establishing audit offices around the country. California has gone one step further by requiring some large multinational companies to file detailed information regarding taxes paid to other states and the method by which income is attributed to those states. California is a trend-setting state, and it is therefore possible that other states may implement this practice in the future. Many states have also adopted the practice of sending information questionnaires to corporations they believe may be doing business within their borders.

Additionally, most states have followed the federal trend with respect to broadening the income tax base. This phenomenon naturally followed in those states which use federal taxable income as a starting point for calculating taxable income. The Tax Reform Act of 1986 repealed the *General Utilities*[1] doctrine and tightened tax accounting rules to accelerate the recognition of income for corporate taxpayers in order to achieve the federal government's base-broadening goals.

The base-broadening technique has also been employed with taxes not based on income. In 1987 Florida extended

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Mr. Burgner is a frequent author and lecturer on state tax matters. He co-presented Controversial State Income Tax Nexus Issues at the 1989 annual FTA conference and is a featured speaker at the Institute of Property Taxation 1989 Sales and Use Tax Symposium.

1. The General Utilities doctrine stands for the proposition that no gain or loss is recognized by a corporation on a distribution, with respect to its stock, of property. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). This dicision was codified in 1954 in IRC Sec. 311 (a)(2) and repealed by the Tax Reform Act of 1986.

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its sales tax to virtually all services. The law was repealed when public outcry became overwhelming. However, many states have adopted a "creeping" expansion of their sales tax bases to include enumerated services and other transactions historically exempt from sales tax. For example, computer software, formerly exempt from sales tax, is now taxable in virtually all states.

The unitary combined reporting approach to taxation is another tool which is providing some states with much-needed revenue. Basically, a unitary combined reporting system has the potential to increase state revenues by taxing the income of corporate affiliates which might otherwise extend beyond the state's jurisdiction. This is achieved by taxing a portion of the total income which would be apportioned to the state under the separate reporting method. A unitary business group can generally be defined as one evidencing centralized management, economies of scale and functional integration. Of course the existence of these factors involves highly factual issues which must be resolved in determining the proper reporting method. For instance, a single affiliated group for federal purposes may be composed of one or more distinct unitary business groups for unitary combined reporting purposes.

Such measures have had a profound effect on corporate taxpayers. Declining federal rates have resulted in higher effective state tax rates. In other words, a state tax deduction, which previously resulted in a 46% reduction in federal taxes, now saves only 34%. Thus federal rate reductions automatically resulted in a 20% increase in effective state tax rates. Companies today must therefore be cognizant of the increasing portion of tax payments demanded by the states and focus their planning energies accordingly.

In the past, state tax rates were significantly lower than federal rates. Over the last decade, however, federal rates have fallen dramatically while state rates have steadily increased. For example, the combined New York State and New York City income tax rate for 1989 is 16.85%, while the federal corporate income tax rate range is 15%-34%. This means that a company's total state tax burden may approach or even exceed its federal tax liability, particularly in those states which disallow deductions for many expenses deductible at the federal level.

Opportunities for planning and controlling state tax liabilities have grown increasingly valuable as a result of these developments. Corporations can control and reduce state taxes by locating in those states with relatively low rates. Other planning opportunities include, for example, determining and reporting the proper tax base (after state adjustments and modifications to federal taxable income), taking advantage of reporting options, and determining the proper portion of income which is subject to formulary attribution among the various states. Additionally, many states offer tax incentives to corporations which locate or do business there.

The number of flow-through entities, i.e. partnerships and S Corporations[2], has grown dramatically in response to federal tax reform, and the state tax filing burden has increased correspondingly. Take, for example, a partnership with 10 partners which is doing business in 10 states. Not only would an information return have to be filed in each state, but each partner would also have to file an individual return in each state. Approximately 110 returns would therefore be filed regarding the partnership, the cost of which can be quite substantial. Filing costs can be sharply reduced by filing composite returns in those states which will allow it. The entity simply submits a single return on behalf of its shareholders or partners, thereby eliminating the filing of many individual returns.

UNITARY TAX UPDATE

Of particular concern to multinational corporate income taxpayers is the application of worldwide unitary combined reporting. This method of taxation, which is now employed only in Alaska and California, mechanically involves the combination of unitary corporations' income (tax base) and factors. The product of these data is multiplied by the tax rate to compute the tax reported to the state. Thus the burden can be particularly onerous where foreign operations use accounting methods inconsistent with those employed in the United States.

In 1983, over the objections of a large, multinational taxpayer, the U.S. Supreme Court held that California's use of worldwide combined reporting is constitutional as applied to a unitary group with a *domestic* partner.[3] The Court expressly declined to address the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries.[4] The Court also noted that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interest.[5]

Recent developments in the area of unitary combined reporting provide analytical guidance in areas where the court expressly withheld judgment. For instance, in *Barclays Bank International, Ltd. v. Franchise Tax Bd.*[6], a California Superior Court held that worldwide combined reporting is unconstitutional as applied to a *foreign parent corporation with domestic subsidiaries*. The court concluded that worldwide combination in this situation interferes with the federal government's conduct of foreign affairs in violation of the foreign commerce clause.[7] *Barclays* is on appeal to the California Court of Appeals.

The analytical underpinnings of *Container* have recently been questioned by a trial court in California. In *Colgate-Palmolive Co. v. Franchise Tax Bd.*[8] a Judge Pro Tem of the Sacramento County Superior Court issued a final decision holding that worldwide combined reporting is unconstitutional as applied to a *domestic* parent corporation. (The judge had issued that the conditions relied on in the *Container* decision had changed.)

The U.S. Supreme Court in *Container Corp.*, supra, had found that the application of worldwide combined reporting did not prevent the federal government from "speaking with one voice" in the area of foreign commerce. First, the tax did not create an automatic asymmetry. Second, the tax was imposed on a domestic (not foreign) corporation. Finally, even if foreign nations have a legitimate interest in reducing the tax burden of domestic corporations, the tax-

2. An S Corporation is an eligible corporation whose shareholders have consented to the corporation's election to be a "small business corporation." IRC Sec. 1317 et seq. The principal feature of S Corporation status is that the corporation is not subject to the corporate income tax, and corporate income, whether distributed or not, is taxed to the shareholders.
3. *Container Corp. of America v. Franchise Tax Bd.*, 464 U.S. 159 (1983).
4. Id. at 421, n. 26.
5. Id. at 427, n. 32.
6. No. 325061 (California Superior Court (hereinafter Cal. Sup. Ct.), 16 June 1987).
7. See *Japan Lines, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-448 (1979).
8. No. 319715 (Cal. Super. Ct. 19 April 1989).

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payer was amenable to be taxed in California in one way or another, and the tax paid to California was much more a function of California's tax rate than its method of apportionment.[9]

The judge concluded, however, that post-*Container* developments altered this analysis. The judge found that the executive branch of government has clearly expressed a federal policy supporting the principle of water's edge taxation of multinational corporations[10] and disapproving the worldwide unitary method, can do so without legislative concurrence, and the legislative branch has not expressed a contrary policy. The judge relied on 4 key executive branch communications in rendering his decision.

First, the President, in a public statement, instructed the Secretary of the Treasury to pursue through legislation and the Attorney General to pursue through litigation, the federal policy that multinational corporations be taxed by states only on income derived from the United States and not on income derived from foreign subsidiaries (without distinguishing between cases involving domestic parent corporations and those involving foreign parent corporations). (Of course, California's argument has always been that the worldwide unitary approach is simply a method of apportionment used to determine the income of U.S. taxpayers.)

Second, the Secretary of State issued a letter to the Governor of California stating that "[California's] employment of the worldwide unitary method of accounting is at odds with the position of the United States and has become a source of conflict with foreign states".

Third, the Secretary of the Treasury issued a similar letter detailing the detrimental effect of the continuance of the worldwide unitary method on U.S. foreign policy.

Finally, the Attorney General has filed amicus curiae briefs on the subject in some state unitary cases and has filed a lawsuit in California seeking a determination that the unitary method is unconstitutional on the specific grounds relied on in the case at issue.

Just as important, the court rejected the state's theory that a history of legislative inaction creates a federal legislative policy. While accepting that the argument has some "cosmetic appeal", the court found that evidence presented was insufficient to support the assertion.

Evidence relied on by the state in support of its "legislative inaction" theory included the failure to consider state taxes at all in any income tax treaties with foreign countries, the absence of any provision restricting state taxes of any sort in various model income tax treaties, the absence of restrictions on state taxation in Friendship, Commerce and Navigation Treaties to which the United States is a party, the absence of enacted congressional legislation prohibiting or restricting the worldwide unitary method and, finally, failure to obtain the necessary two-thirds vote to ratify a treaty containing a provision prohibiting use of the worldwide unitary method by the states.

The court conceded that this final item of evidence, the Senate's failure to achieve a two-thirds vote to ratify the treaty with the United Kingdom prohibiting the states' use of the worldwide unitary method, is the argument most supportive of the state's position. When the negotiated treaty came before the Senate for ratification, the Senate refused ratification with that article included and ratified the treaty only after that provision was deleted. The court concluded, however, that interpretation of legislative inaction requires speculation; no policy statements can be derived. By contrast, the executive branch is monolithic and speaks with one voice in setting policy.

Colgate-Palmolive, like *Barclays,* is on appeal to the California Court of Appeals. The outcome of these appeals will likely affect the structure of multinational unitary taxation in the future.

The last of the judicial developments, *Franchise Tax Board v. Alcan Aluminum Limited and Imperial Chemical Industries PLC*[11], a case to be argued before the U.S. Supreme Court in its 1989-90 term, presents the interesting question of whether a foreign parent, whose U.S. subsidiaries have been assessed on a worldwide unitary basis, has standing to challenge the constitutionality of the tax in federal court.

The Court of Appeals for the 7th Circuit held that the foreign parent suffered independent injury from the use of worldwide combined reporting and the suit is not barred by the Tax Injunction Act[12], as the parent has no available remedy in state court.[13]

Diverse business regulations

In July 1987, the California Franchise Tax Board issued draft regulations regarding the determination of whether businesses are unitary or separate accounting entities. These "diverse business" regulations were followed in December 1987 by similar regulations dealing with holding companies.[14]

It is the Franchise Tax Board's position that the draft regulations reflect post-*Container* judicial developments regarding the unitary business determination. Thus, although the regulations remain in draft form, the concepts underlying the regulations are regularly applied on audit. Previous unitary business determinations are overturned under the regulations' rationale only where such prior determination constitute "clear error".

The overall impact of the draft diverse business regulations is to circumscribe the use of unitary combined reporting for those groups which would benefit from the method. For example, "pure" holding companies (e.g. those created to consummate debt-financed leveraged buyouts) (LBO) would generally be excluded from a unitary group. This would have the effect of isolating interest expense incurred in the LBO.[15] On the other hand, "special purpose" holding companies, such as finance subsidiaries, would generally be included in a unitary group.[16] Strong centralized management, without more, generally will not result in a unitary business determination.[17]

A unitary business is presumptively shown in 2 cases. First, where the entities are engaged in the same general line of business.[18] For example, a corporation which operates a

9. See note 2 at 195.
10. The definition of "water's-edge" is not uniform among the states. Some would include all domestic (U.S.) corporations, while others would include foreigh corporations reaching a specified level of activity in the United States and exclude domestic (U.S.) corporations whose primary business activities are conducted outside the U.S. For our purposes, we will define a water's-edge system as one excluding corporations which conduct little or no activity in the United States.
11. Review granted No. 88-1400 (17 April 1989).
12. 28 U.S. Code Sec. 1341.
13. 860 F. 2d 688 (7th Cir. 1988), *reh'g denied* (1989); *Contra Shell Petroleum N.V. v. Graves,* 709 F. 2d 593 (9th Cir. 1983), *cert. denied,* 104 S.Ct. 537 (1983); *Capital Industries – EMI Ltd. v. Bennett,* 738 F. 2d 994 (9th Cir, 1982), *cert. denied,* 102 S.Ct. 1438 (1982).
14. Prop. Cal. Admin. Code Title 20, Sec. 25120, *et seq.*
15. Id. Sec. 25120(b)(10).
16. Id. Sec. 25120(b)(10)(B).
17. Id. Sec. 25120(b)(6)(F)(ii).
18. Id. Sec. 25120(b)(7)(A).

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chain of retail grocery stores will almost always be engaged in a unitary business. And second, where the entities are steps in a vertical process.[19] For example, a group of related corporations which explore for and mine raw materials, refine the materials, and fabricate them into consumer products.

Recent developments raise doubts as to whether the diverse business regulations will survive. On 11 January 1989 the Superior Court of Los Angeles County issued a decision in *Mole-Richardson, Inc. v. Franchise Tax Bd.* holding that a unitary business existed without a discussion of functional integration, the key unitary determinant under the diverse business regulations. The significance of this decision is that the State Board of Equalization's decision in *Mole-Richardson* was one of the cornerstones of the diverse business regulations.[20] In FTB Ruling 89-110 (27 February 1989), the Franchise Tax Board announced that it would continue to require affiliated entities engaged in diverse businesses to have centralized management, economies of scale and functional integration before it will regard the business as unitary.

In *In re Newedge*[21] and *Neilson v. Franchise Tax Bd.*[22] a federal bankruptcy court held that the Triad America group of corporations owned by Adnan and Essam Khashoggi constituted a unitary business entitled to report California franchise tax liabilities on a combined basis. Although several integrating factors existed, it appears that centralized management was a key factor in the decision. The case is also notable for its reliance on traditional unitary business analysis, rather than the updated analytical model reflected in the diverse business regulations.

Tenneco West, Inc. v. Franchise Tax Bd.[23], which is pending in San Diego, is probably the most significant challenge to the diverse business regulations. *Tenneco* involves a true conglomerate whose most substantial unitary argument is centralized management. Briefs have been filed in the case and arguments are expected in the near future.

Federal legislation

On 7 June 1989, Senator William Roth, Jr. (Delaware) introduced federal legislation to limit states' use of worldwide combined reporting. A similar bill was introduced in the House in March 1989 by Representative Bill Frenzel (Minnesota).

Water's-edge election

The California water's-edge election, which allows multinational corporations to include only water's-edge members of a unitary group in a California combined report, has met with little acceptance. To date, approximately 10 taxpayers have made the election, and roughly $ 40,000 in election fees have been collected.

Franchise Tax Board attributes the low level of elections to the fact that many taxpayers will be filing in September 1989. Industry observers see other factors, however, including the rash of cases holding worldwide combined reporting unconstitutional as applied to both foreign and domestic parents (see above). These cases may create a reasonable basis position for filing under the water's-edge method without paying the election fee (generally 0.03% of California property, payroll and sales).

Additionally, pending state legislation would repeal the domestic disclosure spreadsheet filing requirement and reduce the water's-edge election contract period from 5 to 3 years. A provision to eliminate the election fee was deleted in conference.[24]

SALES AND USE TAX UPDATE

Sales and use taxation is a key area for state revenues, and the states have responded aggressively to fiscal pressures. The first response has been to expand the tax base to include services and other transactions which historically escaped the tax. The second response has been to dramatically increase the number of persons required to collect use tax by expanding the historical notions of nexus.

National Bellas Hess update-proposed federal legislation

One high profile group of potential "tax collectors" is mail order retailers. In 1967, however, the U.S. Supreme Court held that such retailers do not have sufficient nexus with market states to be required to collect use taxes.[25]

Rep. Jack Brooks (Texas) introduced HR 2230 4 May 1989 which will authorize states to require collection of state and local sales and use taxes on goods sent into the state by out-of-state mail-order companies. Practitioners have come to refer to such initiatives as the "annual" tax collection bill, such measures having been introduced annually for roughly the past 10 years.

Interestingly, Sen. Robert R. Kasten (Wisconsin) has initiated a grassroots campaign to oppose the Brooks bill and has introduced a Senate resolution in opposition to mail-order tax collection. Other groups opposing the bill include the National Alliance of Senior Citizens, the Taxpayers' Union, the Consumers' Union, the American Association of Retired Persons and the National Association of Independent Businesses. A quick reading of this list suggests that, once again, the "annual" bill is doomed politically.

Expanding statutory nexus

In view of this lack of success at the federal level, and in light of technological innovations in the marketing of products across state lines, virtually all states have adopted legislation which effectively results in statutory repeal of the *Bellas Hess* decision. Rather than confront the issue head on, however, the states have capitalized on important aspects of the decision which are frequently overlooked.

In its landmark decision, the Court took note of activities not engaged in by Bellas Hess. The court specifically noted that Bellas Hess maintained no telephone listing in the state and engaged in no local advertisement by way of newspaper, billboards, radio, or television.[26] Additionally, in his dissent, Justice Fortas emphasized Bellas Hess' use of Illinois *credit facilities* and argued that these benefits create sufficient economic nexus to require Bellas Hess to collect use taxes.[27]

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19. Id. Sec. 25120(b)(7)(B).
20. See *Multistate Tax Commission Combinability Compendium of Synopses of California State Board of Equalization Cases* (1 April 1988).
21. No. LA 87-01467-NCA.
22. No. LA 88-1821-NCA (Bankr. C.D. Cal. 12 June 1989).
23. No. 591537 (Cal. Super. Ct.).
24. A.B. 1994 (Dennis Brown R).
25. *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 743 (1967).
26. Id. at 754.
27. Id. at 760-66 (Fortas, J., dissenting).

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It is precisely these factors which give rise to nexus under the expanded nexus statutes. Selected text from several of these statutes is set forth below.

> [P]urposefully or systematically exploiting the market provided by this state by any media-assisted, media-facilitated, or media-solicited means, including but not limited to direct mail advertising, unsolicited distribution of catalogues, computer-assisted shopping, television, radio or other electronic media, or magazine or newspaper advertisements or other media.[28]
>
> [M]eans of advertising which is broadcast from or relayed from a transmitter within this state ... or if the retailer benefits from any banking, financing, debt collection, telecommunications, or marketing activities occurring in this state.[29]
>
> [A]dvertisements in regional or national publications in an edition which is not by its contents geographically targeted to Minnesota but which is sold over the counter in Minnesota or by subscription to Minnesota residents.[30]

Expanding judicial and administrative interpretations

The states have also been aided by judicial and administrative interpretations significantly expanding use tax collection responsibilities. These decisions suggest that the analytical underpinnings of *Bellas Hess* may be eroding and that all but the most minimal of contacts may create a collection duty.

In *Giftmaster, Inc.*[31] the Division required an out-of-state producer of mail-order catalogs placed in airplanes to collect sales tax on all merchandise delivered in New York. The airline was deemed to be an independent contractor creating nexus between the distributor and the state.[32]

The Massachusetts Department of Revenue recently issued a ruling providing that a Massachusetts vendor who simply sends orders and deposits to an out-of-state manufacturer is responsible for collecting Massachusetts sales tax, even if the manufacturer ships directly to the customer.[33]

In *Republic Airlines, Inc.*[34] the state tax commission held that the in-flight sale of liquor and consumption of complimentary beverages on interest commercial flights passing over Wisconsin, but neither taking off nor landing in the state, were subject to Wisconsin sales and use tax. This decision is analytically questionable and contrary to a U.S. Supreme Court decision relating to taxation of the aircraft itself.[35]

In a ruling by the Commissioner, Virginia has determined that where an out-of-state purchaser orders goods by telephone, and the goods are shipped from Virginia to a third state, the sale is taxable in Virginia. The Commissioner's rationale appears to be that the request to deliver the goods outside the Commonwealth constituted a use in Virginia, and that title therefore passes in the state.[36]

Finally, Spiegel recently settled pending litigation with the states of North Dakota and Texas. In each instance, Spiegel agreed to prospectively collect tax in exchange for exoneration from any past liabilities. Not to be deterred in its quest for an anti-*Bellas Hess* test case, however, North Dakota promptly sued another out-of-state mail order firm to enforce collection.[37]

U.S. SUPREME COURT 1988-89 TERM

The U.S. Supreme Court had an active 1988-89 term, and as in recent years, state and local tax cases dominated its calendar.

In *Goldberg v. Director of Illinois Dep't of Revenue*[38] the Court found a transaction tax on interstate communications services constitutional under *Complete Auto Transit, Inc. v. Brady*.[39] Crucial to its decision was the Court's finding that only a state in which a call originated or terminated, and was charged or billed, has sufficient nexus to tax an interstate transmission. This decision is therefore likely to play an important role in future legislative activity in the area of transaction taxation. For example, recall that the repealed Florida "use" tax on services taxed services purchased and paid for outside the state based on the value of the services apportioned to Florida.[40]

Shell Oil Co. v. Iowa Dep't of Revenue[41] held that unitary business income may include income derived from the production of Outer Continental Shelf oil and gas. The Court held that the Outer Continental Shelf Lands Act was not intended to preclude inclusion of such amounts in the income tax base, but rather to prohibit direct (transaction) taxation by adjacent states. Another natural resources case[42], held that a state may constitutionally include in the tax base income from out-of-state oil production but disallow a deduction for the crude oil windfall profits tax.

Davis v. Michigan Dep't of Treasury[43] held that disparate treatment of state and federal employee retirement benefits violates 4 U.S. Code Sec. 111 and the principle of intergovernmental tax immunity. This decision may produce interesting side effects due to the Court's implicit finding that retirement benefits are earned during the period of employment.

Accordingly, *Davis* provides analytical support for the taxation of income of non-residents attributable to their period of employment in the state.

Allegheny Pittsburgh Coal Co. v. County Comm'n of Webster County, West Virginia[44]; *East Kentucky Energy Corp. v. County Comm'n of Webster County, West Virginia*[45] held that the local practice of valuing property based on its most recent sales price violates the equal protection clause. The expected challenge to California's Proposition 13, under which property may not be significantly revalued until it changes hands, has taken an interesting turn. In *Northwest Financial, Inc. v. San Diego County*[46] a trial court sustained

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28. Fla. Stat. Sec. 212.0596(2)(e).
29. Iowa Code Sec. 422.43.
30. Minn. Stat. Sec. 297A.21, subd. 4(6).
31. Slip Op. No. TSB-A-88-50-S (New York Division of Taxation 1988).
32. See *Scripto, Inc. v. Carson,* 362 U.S. 207 (1960).
33. DOR-D-88-14, DOR-D-88-15, Massachusetts Department of Revenue 31 December 1988.
34. No. S-12041, slip op. (Wisc. Tax App. Comm'n 4 May 1989).
35. *United Air Lines, Inc. v. Mahin,* 410 U.S. 623, 631 (1973) (state has no nexus to tax an airplane based solely on its flight over the state); see also *Goldberg v. Sweet,* No. 87-826, slip op. (10 Jan. 1989) (state may not constitutionally tax electronic signals merely passing through).
36. P.D. 89-116 (10 April 1989).
37. *North Dakota Tax Comm'r v. Quill Corp.*, No. 41677 (N.D.D.C. 24 July 1989).
38. No. 87-826 (10 January 1989).
39. 430 U.S. 274 (1977).
40. See generally Burgner, "State Taxation of Interstate Telecommunications Can Be Expensive", 19 *Tax Adviser* 568 (1988).
41. No. 87-984 (8 November 1988).
42. *Amerada Hess Corp. v. New Jersey Dep't of Treasury,* No. 87-453; *Texaco, Inc. v. New Jersey Dep't of Treasury,* No. 87-464 (April 1989).
43. No. 87-1020 (28 March 1989).
44. No. 87-1303.
45. No. 87-1310 (18 January 1989).
46. No. 611092 (Cal Super. Ct. filed 12 April 1989).

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a *demurrer* to the taxpayer's challenge. The taxpayer has 60 days from 27 July to take an appeal.[47]

The Court decided 2 sales and use tax cases, one on First Amendment grounds and the other interpreting the interaction of state sales and use taxes with the federal bankruptcy code. *Texas Monthly, Inc. v. Bullock*[48] invalidated a Texas sales tax exemption for religious periodicals. And in *California State Board of Equalization v. Sierra Summit, Inc.*[49] the Court held that a state may properly impose sales or use tax on bankruptcy liquidation sales.

Questions regarding state and local taxation of Indian reservations have increasingly made their way to the Court's docket in recent years. Such cases have grown from the inherent tensions between the Indian reservations and the surrounding states. The reservations, many of which contain significant natural resources, seek to maximize revenues and fund essential tribal services. The surrounding states, on the other hand, also provide services to the reservations and seek to tax activities conducted on Indian land. Taxpayers caught in the middle seek to avoid the injustice of multiple taxation.[50]

Cotton Petroleum Corp. v. New Mexico[51] held that a state may impose oil and gas severance taxes on oil and gas produced by non-Indian lessees. Additionally, *Oklahoma Tax Comm'n v. Graham*[52] held that a suit to force Indians to collect state excise taxes on cigarette sales and bingo receipts was improperly removed to federal court.

Finally, *McKesson Corp. v. Florida*[53] and *American Trucking Ass'n Inc. v. Arkansas Highway and Transportation Department*[54] have been moved for reargument next term, with additional questions to be briefed. First, when a taxpayer pays under protest a state tax found to violate clearly established law under the Commerce Clause, must the state provide some form of retrospective relief, such as a tax refund or an offsetting tax on past beneficiaries of the tax preference, or may the state elect to provide only prospective relief? And second, may a state, consistently with the Due Process Clause of the Fourteenth Amendment, remedy the effects of a tax found to discriminate against an interstate business in violation of the dormant Commerce Clause by retroactively raising the taxes of those who benefited from the discrimination?

These questions highlight a recurring problem facing the Court: when must a state grant relief other than prospective relief in cases involving state and local taxes found to be unconstitutional.[55] Faced with potential refunds sometimes amounting to hundreds of millions of dollars, state courts have increasingly relied on prospective relief to deny the claims for refund.[56]

The prospectivity doctrine has significant implications for taxpayers faced with arguably unconstitutional state and local taxes. Of course, taxpayers may simply elect not to pay the taxes. They do so, however, only at their own peril.[57] Increasingly, taxpayers are seeking escrow arrangements or injunctions to ensure that identifiable funds are available in the event the taxpayer prevails. This is a strategic litigation issue which cannot be overlooked when deciding to challenge a state or local tax.

CONCLUSION

What state are our taxes in? This is a question being asked more frequently than ever before. A comprehensive multistate, multitax review is designed to answer this question by maximizing opportunities and minimizing exposure areas. Areas considered by multinational taxpayers frequently include propriety of the reported tax base, allocation and apportionment, nexus and ability to tax, state tax reporting options, and economic incentives. These areas are important for all state and local taxes: taxes based on income, net worth and capital stock taxes, sales and use taxes, ad valorem property taxes, unemployment and payroll taxes, and the myriad miscellaneous taxes making up the states' fiscal structures.

This article touched on many of these areas and set forth analytical foundations and trends underlying and underscoring the importance of state and local taxation in a comprehensive plan aimed at minimizing the overall tax burden. As in recent years, however, the one thing which can be predicted with certainty in the areas of state and local taxation, particularly as applied to multinational taxpayers, is that it will be unpredictable.

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47. See also *Van Decker,* No. A-574-88T5 (N.J. Super. Ct. 21 June 1989) which follows *Allegheny Pittsburgh.*
48. No. 87-1245 (21 February 1989). The first amendment provides that "[c]ongress shall make no law ... respecting an establishment of religion". U.S. Const. Amend. I. The Establishment Clause therefore "prohibits government from abandoning secular purposes in order to put an imprimatur on one religion, or on religion as such, or to favor the adherents of any sect or religious organisation". Gillette v. United States, 401 U.S. 437, 450 (1971). Stated simply, the first amendment requires that a statute possess "a secular legislative purpose" and that "its principal or primary effect ... be one that neither advances nor inhibits religion". Lemon v. Kurtzman, 403 U.S. 602, 612 (1971).
49. No. 88-681 (12 June 1989).
50. See Nagel, Gossett, Groebe and Burgner, "Taxation on and by Indian Reservation", 7 *Property Tax Journal* 441 (1988).
51. No. 87-1327 (24 April 1989).
52. No. 88-266 (29 March 1989).
53. No. 88-192.
54. No. 88-325, restored to calendar and set for reargument (3 July 1989).
55. See generally Tatarowicz, "Right to a Refund for Unconstitutionally Discriminatory State Taxes and Other Controversial State Tax Issues Under the Commerce Clause", 41 *Tax Lawyer* 103 (1987).
56. E.g. *American Trucking Association v. Conway,* 146 Vt. 579, 508 A.2d 408 (1986), *cert. denied,* 107 S. Ct. 3262 (1987); *Salorio v. Glaser,* 93 N.J. 447, 460, 461 A.2d 1100, 1111 (1983), *cert. denied,* 464 U.S. 993 (1983).
57. See *Ashland Oil, Inc. v. Rose,* 350 S.E.2d 531 (W.Va.1986), *appeal dismissed,* 107 S.Ct. 149 (1987).

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AUSTRALIA:

Government Restrictions on International Corporate Finance (Thin Capitalisation)

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I. INTRODUCTION

There are essentially 2 ways in which a company may be financed – through equity or through debt. There are numerous differences between the 2 methods of corporate finance.

First there are legal differences. An investor who owns shares will be entitled to an investment return based on profits of the company. The original investment may not normally be returned, except on dissolution of the company; however, the investor is usually able to sell his shares and hence realise the prevailing market value of his investment. A provider of loan capital, on the other hand, is normally entitled to a fixed investment return regardless of the company's profits. The capital sum invested is usually due for repayment on a fixed date. It may be possible for the investor to sell his debt rights but the value would be determined by such factors as market interest rates.

There are also economic differences which motivate both the investor and the issuing company differently in the case of equity and debt financing. Debt finance has a fixed return which must be met regardless of the company's profitability and is usually constant throughout the life of the debt. Equity will have a return determined by the company, and accordingly, can be used where the investor and issuer can wait for the investment return to build up over a period of time.

Finally, there are also differences in the tax treatment of debt and equity. Equity is designed to produce an investment return in the form of a distribution of taxed profits, especially where a full dividend imputation system is in existence. Debt is designed to give a return to the investor which results in an expense to the company before profits are calculated.

Typically, any corporation will be financed by a combination of debt and equity. The proportions in the combinations will be determined by numerous factors based on the legal, economic and tax differences detailed above. Within a single tax jurisdiction, i.e. within the national boundaries, the fact that tax factors affect the decision is of no major concern to the tax authorities, as all payments will fall within the tax net and revenue collection should not be impacted. However, in the international context the differences between debt and equity may be a significant concern to the tax authorities.

The "mischief" to which thin capitalisation rules are directed is the use of debt funding to reduce disproportionately the taxable income of a business entity in one jurisdiction by transferring the income into a different jurisdiction by means of before-tax interest payments. This can be referred to as using debt finance as a form of quasi-equity.

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II. THIN CAPITALISATION OF AUSTRALIAN BUSINESSES

The contents of this article are based on the laws as at August 1989 and include proposed amendments announced by the Federal treasurer in a press release dated 30 March 1989 and in the Federal Budget speech delivered on 15 August 1989.

A. Summary of operation

Thin capitalisation of Australian business entities by non-residents of Australia is dealt with in Division 16F of Part III of the Income Tax Assessment Act (ITAA). The Division is first applicable to taxpayers in respect of the year of income that commenced on 1 July 1987 (subject to certain transitional measures) and was introduced to enact measures first announced by the Treasurer on 30 April 1987.

The aim of the Division, as stated by the treasurer, is ". . . to protect Commonwealth revenues and to prevent losses arising from thinly capitalised foreign investment in Australian companies or businesses. Thin capitalisation arises where an investment by a foreign person or entity is excessively geared up with 'in-house' loans from the investor or his overseas associates".

The Division adopts the approach of fixing an arbitrary level for gearing, above which a business is considered to be thinly capitalised. The arbitrary level adopted applies to the foreign debt provided by certain foreign investors and is a multiple of the foreign investor's equity in the Australian business. For most businesses, the level is 3 times equity, although for banks and financial institutions the level is increased to 6 times equity.

The thin capitalisation measures can be seen as complementary to the measures of Division 13 in trying to prevent revenue escaping from the scope of the Australian tax system. Division 13 may apply (as well as in many other ways) to require interest rates paid by Australian businesses to non-arm's length overseas lenders to be, at most, arm's length commercial rates. The thin capitalisation measures complement this by seeking to limit the principal amount of loans from non-arm's length overseas lenders. However, the approaches of Division 13 and the thin capitalisation rules of Division 16F are to be contrasted. The former seeks to apply tests based on arm's length comparisons while the latter applies to a fixed multiple of the foreign investor's equity, without reference to arm's length principles such as ability to service the debt, norm in the industry or the level of debt that independent third parties might provide.

The operative provisions of the division are found in Subdivision C, Secs. 159GZS-159GW. The different sections deal separately with the situations of resident companies, resident company groups, partnerships, trusts and estates and Australian branches. However, the treatment for each type of business enterprise is essentially the same. Accordingly, only the position of resident companies is dealt with here. In fact, throughout the article, to avoid repeating essentially the same story 5 times for each of the 5 different cases, only the position for resident companies will be considered, and the other cases will be commented upon only where they differ or vary from the analogous or expected situation. The specific position of resident company groups will be dealt with separately, under its own heading.

The operative section (Sec. 159GZS) disallows as a deduction from the assessable income of the Australian company, in each year of income, a proportion of certain interest expenses that would otherwise be deductible to that company. The "certain interest" concerned is foreign debt interest, which is discussed in detail subsequently, but basically is interest on foreign borrowing from related overseas lenders ("foreign controllers") or their associates. The proportion disallowed is the same as the proportion of the foreign debt that exceeds a fixed multiple of those same lenders' equity ("foreign equity product") in the resident company. The fixed multiple is 3, in the case of most businesses, or 6 in the case of banks and financial institutions. Accordingly, the maximum foreign debt that is allowed under the divisions before any disallowance occurs is 3 times the foreign equity (or 6 times the foreign equity for banks and financial institutions).

Under existing legislation, the disallowed portion of interest expenses is calculated by reference to the highest amount of the related party foreign debt at any time during the year of income, without reference to the duration of the debt or average amounts of the debt. The formula used to calculate this disallowed interest expense (IE) is as follows:

$$IE = A \times \frac{B\text{-}C}{B}$$

where
A = Total interest on all foreign debt for relevant year
B = Greatest total foreign debt on any one day
C = Foreign equity product

A simple example demonstrates the concept. Consider the following company's balance sheet extract, in which a non-resident investor holds 20% of the shares:

	A$
Issued and paid-up capital	100
Share premium	100
Capital and revaluation reserves	10
Revenue reserves	40
Shareholders' funds	250
Sundry assets	490
Borrowing	(240)
Net assets	250

The foreign equity of the company is 20% × $ 250 = $ 50. The foreign equity product is then 3 × $ 50 = $ 150. Accordingly, any borrowing in excess of $ 150 from the overseas investor would result in a disallowance of interest deductions. If $ 200, of the total of $ 240, of borrowing were from the overseas investor, the total disallowance of interest in any year would be

$$\frac{\$\ 200 - \$\ 150}{\$\ 200} \times \text{the interest incurred on the } \$\ 200 \text{ debt during the year}$$

i.e. ¼ of the interest due to the overseas investor would be disallowed.

In a press release dated 30 March 1989, the Federal Treasurer announced an alternative method for calculating the disallowed portion of interest expense which is available for years of income beginning on or after 1 July 1988. The alternative method is to be based on a weighted average for those days on which the debt to equity ratio is exceeded. The formula is as follows:

$$IE = A \times \frac{B\text{-}C}{D} \times \frac{E}{365}$$

where
IE = Interest expense to be disallowed
A = Total interest on all foreign debt for relevant year
B = Average daily foreign debt for those days on which excesses occurred
C = Foreign equity product
D = Average daily foreign debt for entire year
E = Number of days on which excess foreign debt existed

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It must be noted that taxpayers who wish to use this alternative method must first elect for the alternative formula to apply and secondly must have kept a daily record of the level of foreign debt.

Using the example above, assume that the average daily foreign debt to exceed the foreign equity product is $ 200 and the number of days on which these excesses occurred was 183. The amount of interest disallowed would be:

$$\frac{\$\,200-\$\,150}{\$\,200} \times \frac{183}{365} \times \text{interest incurred during the year,}$$

i.e. ⅛ of the interest due to the overseas investor would be disallowed.

There are 2 important aspects of the operation of the Division to note:
(1) the disallowance of a deduction is absolute, there is no quarantining[1] or carry-forward; and
(2) the disallowance operates on a year by year basis, taking interest expenses incurred and otherwise deductible in each year of income.

In order to get a detailed understanding of the Division, it is now necessary to examine closely the legislation and, in particular, to become familiar with the definitions that form the building blocks of the legislation.[2]

B. Australian owned non-resident company (Sec. 159GZD)

A non-resident company is, for the purposes of Division 16F, an Australian owned non-resident company where a resident:
(1) controls or is capable of controlling, either directly or through one or more interposed companies, trusts or partnerships, more than 85% of the votes in the non-resident company; and
(2) is beneficially entitled to receive, directly or indirectly, more than 85% of any dividends that are or might be paid, or of any distribution of capital that is or might be made, by the non-resident company.[3]

Such a company is, until 30 June 1990, excluded from the definition of a "foreign controller" and accordingly, falls outside the scope of the division. This is consistent with the treatment of such companies under the old Foreign Takeovers Act ("FTA") and Foreign Investment Review Board ("FIRB") guidelines and means that no restrictions will be placed on Australian businesses in respect of any investment and/or loans by such a company.

Although little explanation was provided, included in the Federal Budget delivered on 15 August 1989 was a short statement to the effect that, from 1 July 1990, Australian owned non-resident companies will no longer be excluded from the definition of "foreign controller", and hence, the thin capitalisation provisions of the Act will apply to such entities from that date.

C. Substantial control of voting power (Sec. 159GZJ)

This is a preliminary definition which itself occurs in later definitions.

A person is deemed to have substantial control of voting power in a company if the person controls or is capable of controlling, directly or indirectly, at least 15% of the votes in the company. The "directly or indirectly" refers to holdings, through interposed companies, partnerships or trusts; the "capable of controlling" references mean that it is not sufficient merely to look at indirect beneficial interest.[4]

The definition of substantial control of voting power is varied for partnerships and trusts. For partnerships, a person is deemed to have substantial control of voting power if directly or indirectly:
(1) the person is able:
  (i) to control or conduct the management of affairs of the partnership; or
  (ii) to admit or expel, or to veto the admission or exclusion of a partner to or from the partnership; or
(2) the person controls or is capable of controlling at least 15% of the votes that might be cast at a meeting:
  (i) for the purpose of controlling or conducting the management or affairs of the partnership; or
  (ii) to admit or expel, or to veto the admission or expulsion of, a partner to or from the partnership.

For trusts, a person is deemed to have substantial control of voting power if, directly or indirectly:
(1) the person is able to appoint or remove, or to veto the appointment or removal of, a trustee of the trust; or

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1. "Quarantining" is a term used in Australian tax law practice to describe the restricting of deductibility of expenditures or losses to deduction from certain types of income. *International Tax Glossary,* IBFD (1988).
2. Two aspects of the thin capitalisation rules not dealt with in this article are the transitional measures that apply to the first years of operation (1987/8) and the detailed rules relating to what constitutes a bank or financial institution. The transitional rules relate to 2 different areas: firstly, to which companies the division first applies in 1987/8 and to which companies it first applies in 1988/9; secondly, the dates for measuring foreign debt and foreign equity during the first year. What constitutes a bank or financial institution is defined exhaustively in Sec. 159GZA by reference to the Banking Act, 1959 and the Financial Corporations Act, 1974. One noteworthy exclusion from the definition is a financial corporation where the sole or principal purpose for which the corporation borrows money is to lend to an associate of the corporation or an associate of a foreign controller of the corporation. For these purposes "associate" is defined (see text). Accordingly, in-house finance companies are excluded from the 6 times foreign equity measure and have only the normal 3 times equity maximum debt ratio.
3. Income Tax Ruling IT 2479 makes it clear that in determining whether a particular non-resident company is Australian owned, the interests in the company held by a number of different Australian residents should be aggregated.
4. In the example given in the Explanatory Memorandum to the legislation, the following structure exists:

A non-resident
↓ 50% voting power
B resident company
↓ 50% interest
C resident partnership
↓ 50% voting power
D resident company

A has only 12.5% indirect beneficial interest in voting power in D. However, through B and C, A is capable of controlling 50% of the voting power in D. A is therefore in substantial control of voting power in D.
Consider an extension of this example, the operation of which has been confirmed with the Australian Taxation Office:

A non-resident company
↓ 15% voting power
B resident company
↓ 15% interest
C resident partnership
↓ 15% voting power
D resident company

In this example, and following the logic of the Explanatory Memorandum, A has *substantial control* of the voting power in D even though the indirect beneficial interest of A is only 0.3%. This is interesting to note as Sec. 159GZJ(1) requires *control* of 15% of the voting power which, when using the more common definition of "control" (e.g. under the group loss provisions), would require A to own more than 50% of the voting power in B and B to own more than 50% of the voting power in C. It appears therefore that the Australian Taxation Office has adopted the meaning "substantial control" for that of "control".

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(2) the person controls or is capable of controlling at least 15% of any votes that might be cast at a meeting to appoint or remove, or to veto the appointment or removal of a trustee of the trust.

D. Foreign controller (Sec. 159GZE)

The definition of foreign controller is the most crucial definition in the division. The division applies only where a foreign controller is deemed to exist, so that if there is no foreign controller, there can be no restriction on interest deductions (or foreign investor in the case of an Australian branch operation). This is because the definitions of foreign debt and foreign equity both refer to a foreign controller. The foreign controller is essentially a de minimis restriction providing a threshold level of investment below which the thin capitalisation rules do not apply. This is necessary, for example, to avoid the situation where only minor or portfolio investments by, say, foreign banks in Australian companies could lead to loss of interest deductions by those Australian companies.

In respect of an Australian resident company, foreign controller is defined as a non-resident person other than an Australian owned non-resident company (see definition above), that satisfies any one of 4 separate tests as follows:

First test: the non-resident, either alone or together with "associates" (as defined in Sec. 189GZC) has substantial control of the voting power in the resident company (see above for substantial control definition).

Second test: the non-resident, either alone or together with associates, is beneficially entitled to receive, directly or indirectly, at least 15% of any dividends or any distributions of capital, that are or might be paid by the resident company.[5]

Third test: the non-resident, either alone or together with associates, is capable under a scheme of gaining the control laid down under the first test or the entitlement laid down under the second test.[6]

Fourth test: the resident company, or its directors, is or are accustomed or under an obligation (whether formal or informal) or might reasonably be expected to act in accordance with the directions, instructions or wishes of the non-resident, either alone or together with associates.[7]

In respect of partnerships and trusts the definition of foreign controller is exactly analogous. In the case of partnerships, the equivalent "fourth test", as above, is imposed on the partners. In the case of trusts, the equivalent "fourth test" is imposed on the trustees of the trust, and there is a separate fifth test which makes any non-resident trustee of the trust a foreign controller.

E. Associates (Sec. 159GZC)

The definition of associate is broadly the same as the very wide definitions contained in Sec. 26AAB and the capital gains tax provisions. However, for the purposes of thin capitalisation these definitions are extended even further in that certain "substantial control" tests require only 15% or more of voting control and not 50%.

F. Foreign debt (Sec. 159GZF)

The definition of foreign debt is relatively straightforward in the legislation, as follows:

> foreign debt in relation to a resident company means the balance outstanding on any amount owing by the company, where:
> (a) interest *is or may become payable* to a foreign controller, or to a non-resident associate of a foreign controller, of the company in respect of the amount owed;
> (b) the interest is or will be, apart from this Division, allowable as a deduction from the assessable income for the company of *any* year of income; and
> (c) except in the case of interest that is taken to be payable to a foreign controller or non-resident associate under Sec. 159GZL, GZN or GZD – the interest is not, or would not be, assessable income of any year of income of the foreign controller or non-resident associate to whom it is or becomes payable.

In Sec. 159GZA, "foreign debt interest" is defined to mean, simply, interest payable on foreign debt. However, interest does not include foreign exchange losses incurred on repayment of a debt, nor does it include debt dividends payable on preference shares. Further, the Commissioner, in a letter to the Executive Director of the Australian Merchant Bankers' Association dated 22 November 1988, has stated that payments made under an interest rate swap transaction (of the type described in IT 2050) will not give rise to an amount of foreign debt for thin capitalisation purposes for the same reasoning as that given in IT 2050 in relation with withholding tax implications.

It should be noted that interest must be payable (or become payable) to a non-resident before debt is caught under the definition. Accordingly, interest payable to resident associates of a foreign controller will not cause debt to be foreign debt (assuming there are no back-to-back loans – see below). It should also be noted that the interest and principal need not be payable to the same party.

Excluded from the definition of foreign debt are all non-interest bearing debt (e.g. many trade creditor accounts), all debt due to non-residents or their associates who are not foreign controllers (e.g. most unrelated party foreign debt), and all debt that bears interest that would be assessable income to the recipient in Australia (e.g. the interest is receivable by a non-resident through an Australian permanent establishment).

In relation to banks, the Treasurer announced, by way of press release on 30 March 1989, that since nostro and vostro accounts are only short-term clearance accounts and any debits or credits to those accounts will eventually be reflected elsewhere in a bank's accounts, the thin capitalisation legislation is to be amended as from 1 July 1987 to exclude nostro and vostro account balances from the debt/equity ratio calculations of foreign banks.

Also in the 30 March 1989 press release was the foreshadowed amendment of the definition of foreign debt to exclude debenture securities qualifying for Sec. 128F withholding tax exemption (see below).

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5. In this case, a direct or indirect entitlement to dividends or capital means that beneficial entitlement held indirectly through trusts, partnerships and other companies are included. However, in this case only proportional beneficial interests are included. In reference to the example given in note 3, assuming that income and capital entitlement followed the voting interests, the indirect interest held by A in D under this second test would be only 12.5%.
6. In relation to this test it should be noted that although a "scheme" is required, "scheme" is (typically) widely defined in Sec. 159GZA to include any agreement, etc., whether or not enforceable, etc., and whether there are 2 or more parties or only one party involved.
7. From the explanatory memorandum it can be inferred that the fourth test may apply where there is some past pattern of conduct indicating that the resident is conforming with wishes of the non-resident or where there are current circumstances, even without any past pattern, such that the non-resident or its directors might reasonably be expected to so act.

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1. Additional deeming of foreign debt and anti-avoidance measures

There are numerous sections which add to the basic definition of foreign debt by deeming what would otherwise not be foreign debt to be such.

2. Back-to-back loans (Sec. 159GZO)

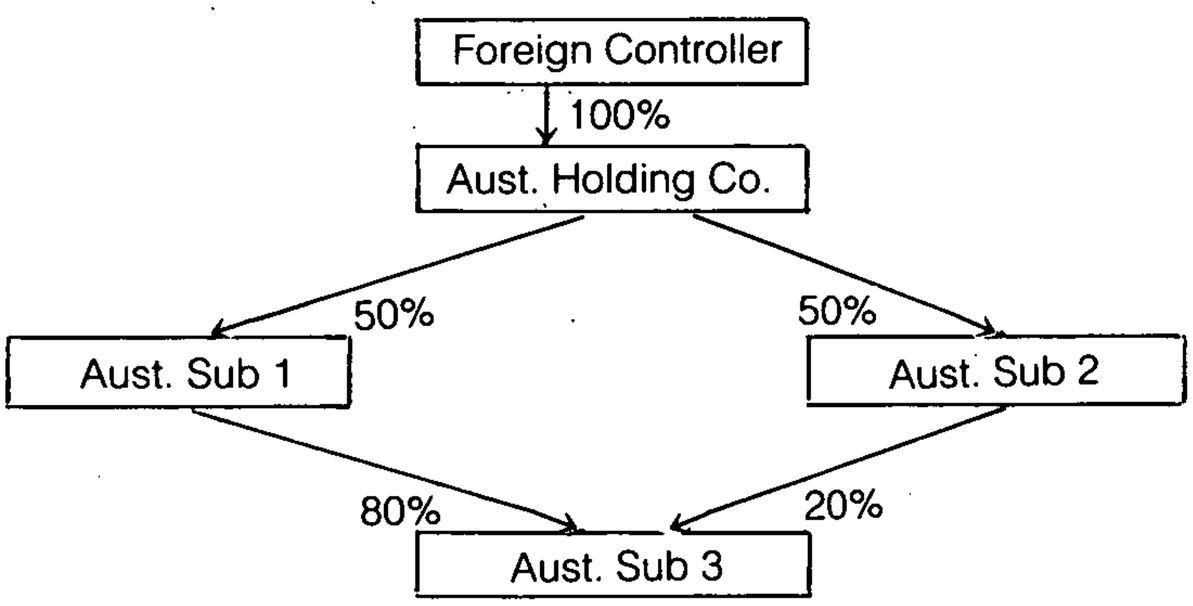
Sec. 159GZO applies where debt is owing to a foreign controller through an intermediary (i.e. "back-to-back" loan arrangements) thus prima facie avoiding the definition of "foreign debt".

Sec. 159GZO(1)(a) and (b) define the back-to-back arrangements that are then subject to the deeming provisions of Sec. 159GZO(c) and (d).

First, under a scheme (regardless of the motive of the scheme) an amount must become owing by an "intermediary" to a foreign controller (or non-resident associate) in relation to a resident company. The definition is extended to include further intermediaries by including amounts owing by a person to someone who is already an intermediary by one or more applications of the first definition. Second, an amount must become owing by the resident company to an intermediary (whether before or after any amount becomes or became owing by the intermediary to the foreign controller). This appears somewhat narrow, as the intermediary would appear to have to be the same entity, or chain of entities to be caught. For example, the following back-to-back type arrangement may not be caught provided there is no debt arising between X Bank Inc. and X Bank (Aust.) Pty. Limited from the arrangement.

A Limited (U.K.) — X Bank Inc. (U.S.A.)
↓ 100% — ↓ 100% subsidiary
A (Aust.) Pty. Limited — X Bank (Aust.) Pty. Limited
A Limited deposits A$ 100 million with X Bank Inc.
A (Aust.) Pty. Limited borrows A$ 100 million from X Bank (Aust.) Pty. Limited.

In IT 2479, the Commissioner stated that he will not apply Sec. 159GZO where the debt funding follows the chain of equity investment. For example, using the company structure below:



Loan monies directed through the Australian Holding Co. and Aust. Sub 1 to Aust. Sub 3 would not be caught. However, loan monies directed through Aust. Holding Co. and Aust. Sub 2 to Aust. Sub 3 will be caught.

The legislation as it stands does not provide for the principle being followed by the Australian Taxation Office (i.e. the capacity to "allow" deductions for certain foreign interest payments where there is a foreign controller). The above example illustrates the Commissioner's interpretation of Sec. 159GZO only and how he will seek to apply the section in practice.[8]

3. Interest-like payments (Sec. 159GZK)

This section deals with the situation where there are deemed interest payments to a foreign controller or non-resident associate under Secs. 128AC and 128AD. Sec. 128AC applies to certain financial agreements such as hire purchase and lease agreements. Sec. 128AD applies to certain payments under bills of exchange and promissory notes.

Sec. 1289AC may operate to deem all or part of a payment by a resident to a foreign controller or non-resident associate to be interest. In this case all or part of the payment is deductible to the resident ("adjusted Sec. 128AC interest") and the deemed interest is not assessable to the non-resident recipient. Where this applies, a deemed foreign debt arises equal to the eligible value of the relevant agreement property less the amount of attributable agreement payments to date that do not constitute adjusted Sec. 128AC interest.

Where Sec. 128AD operates to deem all or part of a payment by a resident to a foreign controller or non-resident associate to be interest, a foreign debt is created. The amount of the deemed foreign debt is the total amount of the payment less the amount deemed by Sec. 128AD to be interest.

4. Sec. 159GZL

This section ensures that amounts in the nature of interest to which Sec. 128F(6) applies are treated in a similar manner for the purposes of the thin capitalisation rules. Sec. 128F(6) allows an Australian resident company to use a wholly owned overseas subsidiary to issue debentures to the public and gives interest withholding tax exemption to payments made by the resident to the non-resident subsidiary (which the subsidiary then uses to service the interest on the debentures). Sec. 15GZL ensures that the amounts paid by the resident company are deemed to be interest paid to the ultimate holders of the debentures, and not to the wholly owned subsidiary.

As the legislation currently stands, if such securities are held by a foreign parent or associate at the end of the year (which may occur where the foreign parent or associate acts as manager, dealer or underwriter), the securities will reduce the equity of the Australian company and thus may have an adverse effect on the debt/equity calculations. However, following the Federal Treasurer's press release on 30 March 1989 it is proposed that all securities qualifying for withholding tax exemption under Sec. 128F(6) will now be excluded from the thin capitalisation controls for short periods where those securities are held by a foreign associate in the capacity of manager or dealer. The exclusion is to operate from the introduction of thin capitalisation being 1 July 1987.

5. Accruals deductibility on discounted securities (Sec. 159GZX)

This section brings the accruals deductibility of certain discounts on securities (that would be excluded from Division 16E by Sec. 159GT(6)) into consideration for the purposes of the thin capitalisation rules.

8. It should be noted that the back-to-back anti-avoidance legislation does not catch other arrangements of financial support from overseas related companies or parent companies. Specifically, parent company guarantees are not caught.

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The issue price of a security issued or transferred to a foreign controller or non-resident associated is treated as foreign debt for each year that it is so held. In each year in which foreign debt exceeds the foreign equity product a notional adjustment of deemed interest on the security must be recorded. In the year when the Australian taxpayer would otherwise be entitled to a deduction for the interest (i.e. on redemption) the total notional adjustments are applied to reduce the amount of the interest deduction.

G. Foreign equity (Sec. 159GZG)

The definition of foreign equity is also a relatively straightforward definition, which exhaustively takes each separate constituent of equity and defines what it is for the purposes of the Division and at what time it should be measured.

In summary terms, foreign equity is made up as follows:

		Constituent	*Time of measurement*
	(a)	Paid-up value of shares held by foreign controllers or their non-resident associates.	End of year of income
plus	(b)	Share premium account that foreign controllers or their non-resident associates would be entitled to if the company were wound up.	End of year of income
plus	(c)	Accumulated profits and revaluation reserves attributable to foreign controllers or their non-resident associates.	Beginning of year of income
less	(d)	Balance of amounts owing to the company by foreign controllers or their non-resident associates.	End of year of income
less	(e)	So much of any profits or revaluation reserves used to pay up shares issued to foreign controllers or their non-resident associates.	Total through the year of income
less	(f)	Accumulated losses	Beginning of year of income

Each of these items requires separate analysis of the detailed definition from Sec. 159GZG.

1. Paid-up shares

The paid-up value of all shares and interests in shares, beneficially held by foreign controllers or their non-resident associates, are included in foreign equity. Accordingly, shares held through nominees are counted due to their beneficial ownership. Similarly, the appropriate interest of shares held jointly or in smaller portions with non-foreign controllers is also included.

All forms of shares including ordinary and preference shares are within the definition. Also, redeemable shares (subject to the anti-avoidance provisions of Sec. 159GZG(6) to 159GZG(9)) are included.

2. Share premium account

Share premium is measured similarly to paid-up share capital and specifically measures that portion of the total share premium that would be due to be paid to the foreign controller or non-resident associates if the company were wound up at the end of the year of income, the company had no accumulated losses at that time and at that time the assets less liabilities of the company at least equalled the amount standing to the credit of the share premium account.

3. Accumulated profits and revaluation reserves

Foreign equity includes the appropriate foreign controller or non-resident associates' share of accumulated profits and revaluation reserves as at the beginning of a year of income measured as the *lesser* of:

(i) accumulated profits and revaluation reserves as if those profits and reserves were distributed as dividends; or

(ii) on the basis that the company was then wound up and the company's assets less liability at least equalled the amount standing to the credit of accumulated profits and asset revaluation reserves and the company had no accumulated losses at that time.

Revaluation reserves only qualify for the purposes of the definition if they are recorded in the company's accounting records. Further, only the arm's length value of an asset may be taken for the purposes of determining the revaluation amounts by reference to independent valuations, rather than merely by in-house directors' valuations.

4. Amounts owing by foreign controllers

Foreign equity is reduced by amounts owing to the company by foreign controllers or their non-resident associates as at the end of the year of income.

The explanatory memorandum specifies this will apply where share capital from a foreign controller is subsequently lent back to the foreign controller. However, from the legislation, the reduction in foreign equity could also apply to other current (i.e. non-capital) loans to the foreign controller, and also to normal inter-group trading accounts. It is far from clear in the legislation whether such "amounts owing" are to be taken on a net amount outstanding basis or whether gross debits and gross credits have to be considered separately.

It has been argued that the treatment of a trading account as a loan-back frustrates normal trading relations between a resident company and its foreign controller. Accordingly, in the Federal Treasurer's press release of 30 March 1989 it was announced that genuine short-term trade credit is to be exempted from the loan-back provisions of the legislation and thus does not have to be added back in the calculation of foreign equity. The press release stated that "genuine short term" was taken to mean less than 30 days.

Whilst the Treasurer's announcement was silent on the issue of whether the new provision would apply only to the sale of goods or whether trade credit arising from the supply of services would also be included, recent discussions with the head office of the Australian Taxation Office have revealed that the exemption is to be extended to cover the supply of services.

5. Profits or revaluation reserves used to pay up shares

Reducing foreign equity for amounts used to create bonus shares during a year is simply a way of eliminating double counting which would otherwise occur due to the measurement of paid-up shares as against profits and revaluation reserves at different times.

Cash dividends paid from profits do not affect the foreign equity.

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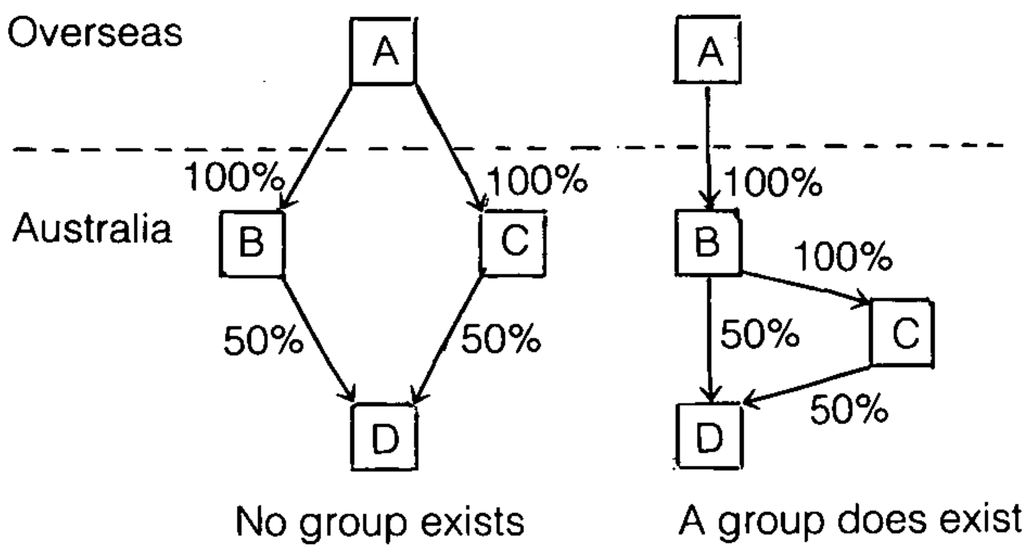
6. Accumulated losses

Accumulated losses are deducted from foreign equity on the basis of the company being wound up at the beginning of the year of income and the reduction in capital distribution that would apply to foreign controllers or their non-resident associates.

H. Resident company groups (Sec. 159GZI)

Where, if in applying Sec. 80G, only resident companies were taken into account, 2 or more companies would be group companies in relation to each other in relation to a year of income, the companies shall, for the purposes of Division 16F, be taken to be members of a resident company group in relation to the year of income.

For example:



The result of the above definition is that companies are considered to be grouped only where they have an Australian resident holding company and 100% common control within the group.

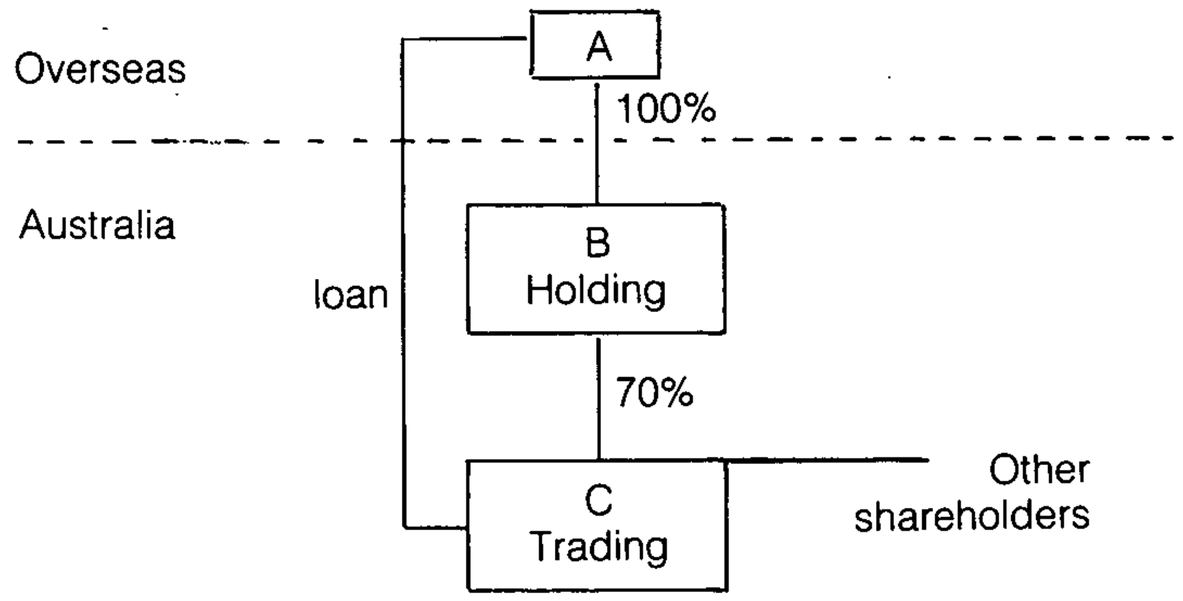
It should be noted that the common control test must be satisfied for the entire year of income for companies to constitute a "resident company group".

Sec. 159GZT contains the operative provisions with respect to resident company groups. For a group, foreign debt is measured as "the greatest total foreign debt at any time in the year of income of all of the members of the resident company group". From this definition, it is clear that it is not the sum of the greatest foreign debt of each subsidiary, possibly measured at different times during the year, but it is the greatest value of the aggregate of foreign debt of each company in the group, all measured at the same time. At this point in time, it is not certain how the alternative method of measuring foreign debt (see above), recently announced by the Federal Treasurer, is going to apply to group companies.

For a group, foreign equity is only the foreign equity of the Australian holding company of the group. This has been confirmed by the Commissioner.[9] There is no "indirect interest" of the holding company in reserves, etc. of its subsidiary companies. Because of the definition of "resident company group", none of the subsidiaries can have any foreign equity.

A group is considered thinly capitalised when the greatest total foreign debt exceeds the foreign equity product. When this occurs, foreign debt interest is disallowed in the same proportion as the excess foreign debt bears to total foreign debt. The disallowance of interest is applied in the same proportion to each member of the group separately.

In the Federal Treasurer's press release of 30 March 1989 it was announced that current legislation is to be amended with respect to the grouping provisions relating to Australian banks. Under existing legislation, foreign banks established in Australia with Australian shareholdings (and encouraged by the Australian government at the time of deregulation in the banking industry) were disadvantaged. This was due to the company structure often adopted by the banks which was as follows:



In the above company structure, C does not have any foreign equity, nor is it a group company as B does not own 100% of the shares. Consequently, any interest incurred in respect of the debt is not deductible pursuant to the thin capitalisation provisions.

Accordingly, it is proposed that the Australian holding company be treated as an offshore company for the purposes of thin capitalisation. Thus, in the example above, if B were treated as an offshore company C will have an amount of foreign equity thus allowing the thin capitalisation provisions to operate more equitably. However, it is proposed that an Australian holding company will only be treated as an offshore company where the Australian holding company does not itself have any interest bearing debt owing to the foreign parent or foreign associates.

The proposed amendments are to operate retroactively from 1 July 1987.

I. Planning points and specific questions

1. Redeemable preference shares and other changes to issued capital

Redeemable preference shares could be seen as a simple remedy to a thin capitalisation problem. The paid-up value of shares component of foreign equity is measured at the end of a year of income. Accordingly, if, as the end of the year of income was approaching, it appeared that a disallowance of foreign debt interest may occur due to the foreign debt exceeding the foreign equity product, a foreign controller could increase the foreign equity product by investing in redeemable preference shares issued by the Australian company.

However, Sec. 159GZG(6)-159GZG(9) is an anti-avoidance measure which prevents taking the above course of action and then redeeming the preference shares shortly after the year end. The need for this course of action is also reduced following the introduction of the alternative weighted average method of calculating foreign debt as announced by the Federal Treasurer on 30 March 1989 (see above).

9. Income Tax Ruling IT 2479.

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The new anti-avoidance measures have a wider impact than merely redeemable shares. A claw-back of foreign equity is required where certain equity in the form of a share or an additional share (defined to be an "eligible share") is counted as foreign equity in a given year of income and the eligible share ceases to be held or certain other events occur during the subsequent 2 years of income.

There are 4 circumstances in which a share in an Australian resident company, owned at a year end by a foreign controller or non-resident associate, is treated as an eligible share for these purposes:

(a) the year end owner became beneficial owner of the share during the year of income otherwise than by acquisition from a foreign controller or non-resident associate, e.g. the Australian resident company issued the share during the year or the share was acquired from a resident during the year;
(b) the share was beneficially owned at any time during the year by someone who was not a foreign controller or non-resident associate;
(c) the share was beneficially owned at any time during the year by a foreign controller or non-resident associate who acquired the share otherwise than by acquisition from a foreign controller or non-resident associate (e.g. the foreign controller owning the share at the year end acquired the share from another foreign controller during the year, which itself acquired the shares directly from issue by the company);
(d) where none of the above apply, where the share had at any time during the year a paid-up value less than its paid-up value at the end of the year of income (e.g. a call was paid on the share during the year).

Clawback[10] will be required, if, generally during the subsequent 2 years of income, any of the following occur:

(a) the foreign controller or non-resident associate ceases to beneficially own the share, otherwise than by death or by disposal to another foreign controller or non-resident associate;
(b) an amount is distributed out of a share premium account in relation to the share (e.g. redemption out of share premium account);
(c) an amount is distributed by way of repayment of paid-up capital in relation to the share (e.g. reduction of capital).

The provisions proceed to define formulae to the extent that foreign equity is reduced and limits the application in certain circumstances. In relation to the claw-back situations above, the amount clawed back is as follows:

(a) the amount of any calls paid up during the year;
(b) the amount of the distribution from the share premium account;
(c) the amount of the distribution being return of paid-up capital.

2. Maximising foreign equity in resident company groups

As noted above, the foreign equity in a resident company group is only the foreign equity held in the holding company. Accordingly, it may be important to maximise this equity by recognising the equity of subsidiary companies. It is of course to be noted that the foreign equity concept applies to the separate entity account of the holding company and not to the consolidated group accounts.

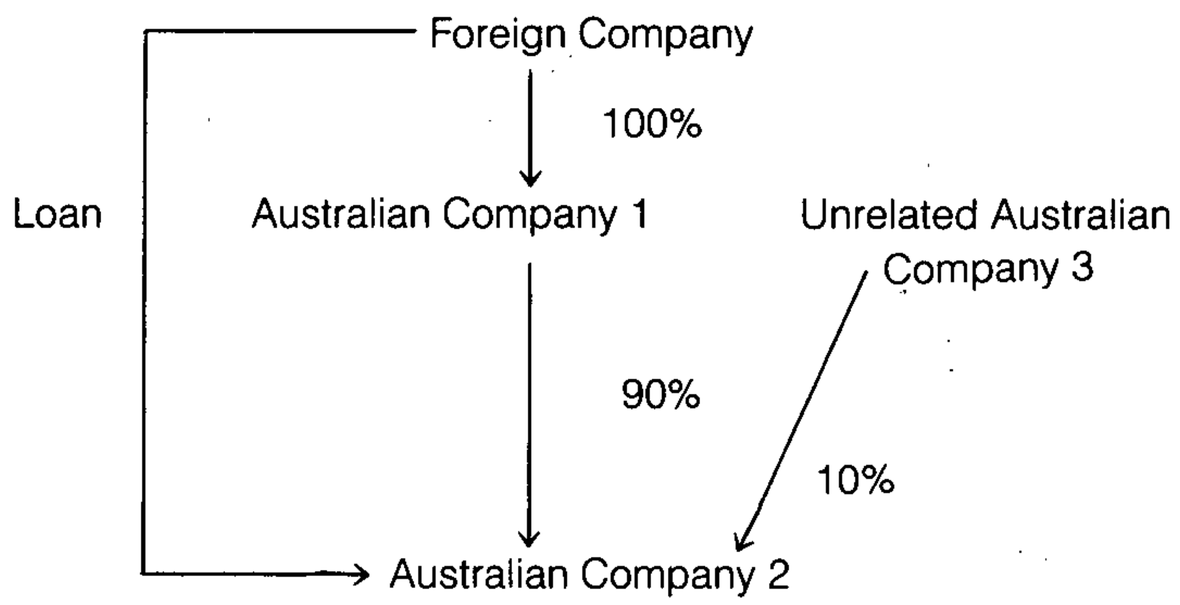
Holding company equity may be maximised in 2 ways. First, subsidiary company profits may be paid to the holding company as dividends. The dividends will increase the accumulated profits of the holding company. Second, the increased value of subsidiary companies created by retained profits, etc. may be reflected in the investment of the holding company by revaluation of that investment, creating revaluation reserves. It must be emphasized, however, that such a revaluation must be done on an arm's length basis and not merely "in the opinion of the directors"; otherwise, the anti-avoidance provisions of Sec. 159GZG will apply. In this regard, it may be advisable to obtain independent valuations.

In both cases the foreign equity component (of accumulated profits or revaluation reserves) is measured as at the beginning of a year of income. Consequently any action taken during a year of income will only increase the foreign equity of the following year.

3. Situations where foreign equity is nil

There are certain shareholding structures which create the unusual position of foreign equity in a company being nil while there are still foreign controllers.

Example 1

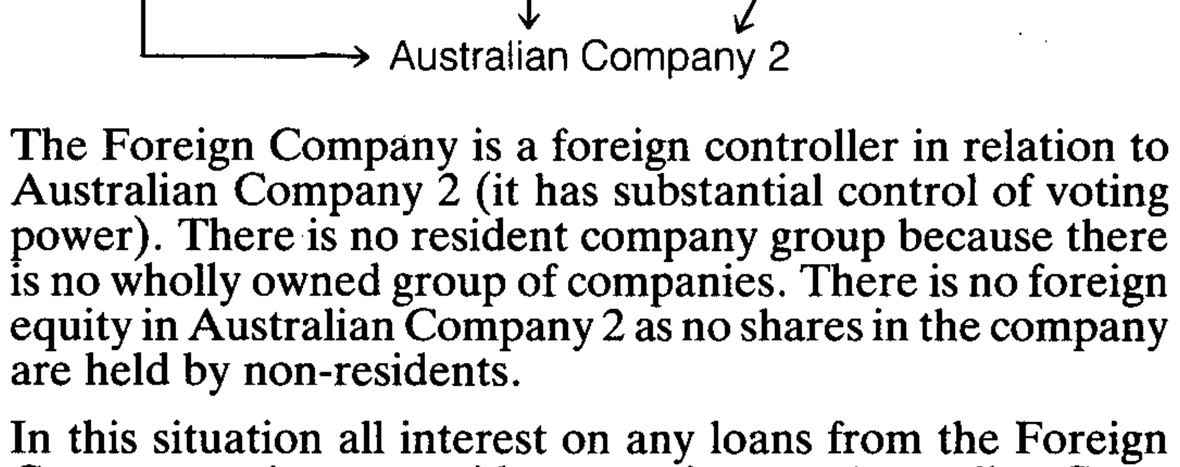


The Foreign Company is a foreign controller in relation to Australian Company 2 (it has substantial control of voting power). There is no resident company group because there is no wholly owned group of companies. There is no foreign equity in Australian Company 2 as no shares in the company are held by non-residents.

In this situation all interest on any loans from the Foreign Company or its non-resident associates to Australian Company 2 would be non-deductible to Australian Company 2, as the foreign equity product would be nil. Accordingly, consideration should be given to using back-to-back loans in these circumstances, also bearing in mind the anti-avoidance provisions of Sec. 159GZO.

This situation, however, will not apply to Australian holding companies in relation to foreign banks which are treated as offshore companies for thin capitalisation purposes.

Example 2



10. "Claw-back" is a term which describes a provision to recover tax which proves in retrospect to have been due. *International Tax Glossary*, IBFD (1988).

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The Foreign Company is a foreign controller in relation to Australian Company 3. There is no resident company group because there is no Australian holding company. There is no foreign equity in Australian Company 3 because no shares in the company are held by non-residents.

Again, all interest on any loans from the Foreign Company or its non-resident associates by Australian Company 3 would be non-deductible by Australian Company 3. Once again, the use of back-to-back loans should be considered.

4. Netting off amounts due to and from foreign controllers

There are problems that may arise from thin capitalisation because of the inclusion in the definition of foreign equity of amounts due from foreign controllers, which are deducted from the sum of the other components of foreign equity (Sec. 159GZG(1)(d)).

For example, compare the following 2 balance sheets of an Australian company, wholly owned by an overseas holding company (and assuming the greatest foreign debt method of calculating foreign debt is used):

	Balance sheet A	Balance sheet B
Shareholders funds	100	100
Sundry net assets	60	60
Amounts due to Holding company	(50)	(45)
Amounts due from Holding company	90	85
	100	100
Foreign debt	50	45
Foreign equity	10 (100 less 90)	15 (100 less 85)
Foreign equity product	30	45
Excess foreign debt	20	nil
Interest disallowed	20/50 × total foreign interest	nil

If interest were due on the amounts due to the holding company at a rate of 10%, while amounts due from the holding company were interest-free trading accounts, the positions under A and B would be as follows:

A total interest expenses: 50 × 10% = 5

excess disallowed under Division 16F: $\frac{20}{50} \times 5 = 2$

net interest deduction: 3

B total interest expenses: 5 (assumed the same)
excess disallowed under Division 16F: nil

net interest deduction: 5

This significant result, being an extra 66% deduction being available for interest expense, resulted from only a very small netting off of balances. The results are even further distorted if larger amounts are netted off.

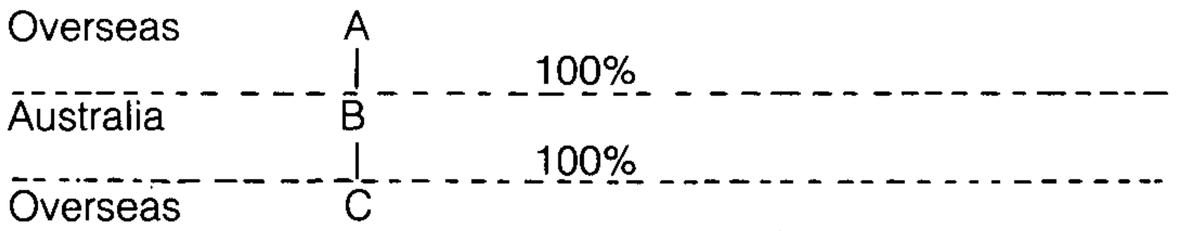
Income Tax Ruling IT 2479 makes it clear that all amounts owing by a foreign controller to an Australian resident company are deducted from the amount of foreign equity in that Australian company. Although the aim of the legislation is to catch only foreign equity which is subsequently lent back, the ruling acknowledges that in practice funds within the company would become mixed. Accordingly, all amounts owing by the foreign controller including trade debts (in excess of 30 days – see above), non-interest bearing debts and amounts invested in debt instruments, etc. are to be deducted from foreign equity.

5. Wide meaning of the term "associate"

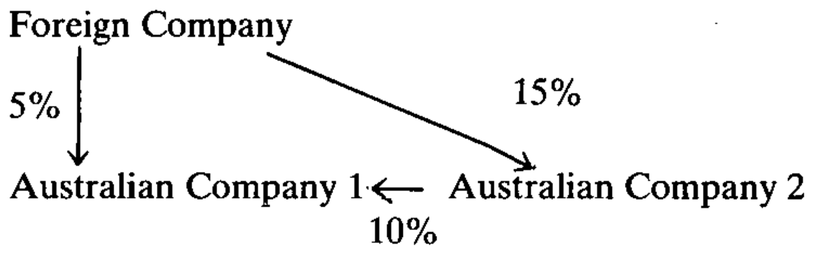
The meaning of "associate" for the purposes of the Division is very broad.

It should be noted that a foreign controller may become such, partly through relationships of the subject company with Australian associates of that foreign controller. It is not necessary that the conditions for the foreign controller to exist are satisfied with respect only to non-resident companies. Accordingly, in each of the following examples, the Foreign Company is a foreign controller with respect to Australian Company 1.[11]

It must be noted that in circumstances such as those characterised below, a foreign subsidiary of an Australian company usually falls within the definition of "associate", and hence amounts owing at the end of the year of income to the Australian company by its overseas subsidiary will have to be subtracted when calculating the amount of "foreign equity" held in the Australian company by its foreign parent.

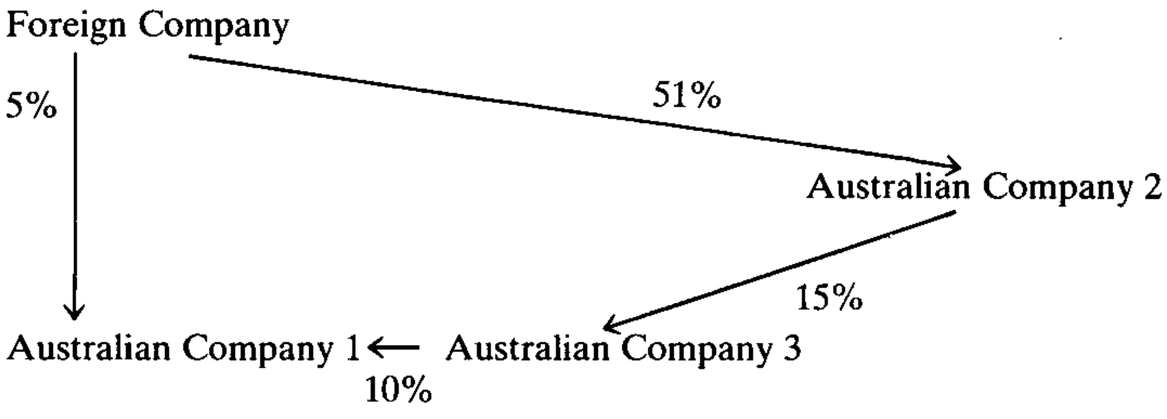


11. *Example 1*



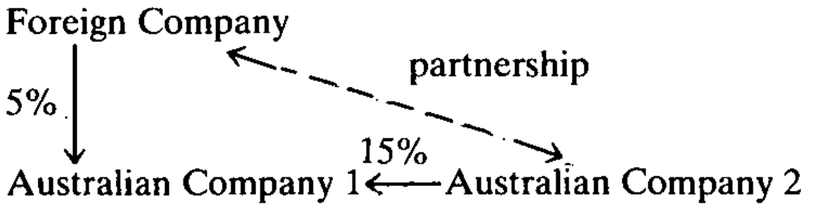
(by Sec. 159GZC(1)(b)(v)(B))

Example 2



(by Sec. 159GZC(1)(b)(v)(B))

Example 3



(by Sec. 159GZC(1)(b)(i))

In this case, the partnership could be an otherwise unconnected or innocent looking arrangement such as a leasing partnership in which Australian Company 2 may be, say, the lease packager with only a 1% partnership interest.

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6. Is accrued interest included in foreign debt?

In general terms, accrued interest is not included in the definition of foreign debt which includes only ". . . the balance outstanding on any amount owing by the company . . .". Accordingly, foreign debt includes only the principal part of any outstanding foreign debt. However, once interest has become due and payable on foreign debt, this amount of interest also becomes a balance outstanding. To determine whether "capitalised interest" in this case becomes foreign debt, the other aspects of the definition must be examined.

First, interest must be or may become payable to a foreign controller or non-resident associate in respect of the debt represented by the overdue interest. Second, such interest must be allowable as a deduction from the assessable income of the Australian company. This will be satisfied provided the original interest now capitalised was itself deductible. Third, the interest must not be assessable income to the foreign controller or non-resident associate to whom it is payable. This would also be satisfied provided it was satisfied in respect of the original capitalised interest.

Accordingly, the capitalised interest would appear to represent foreign debt in the case that it itself was or could become interest bearing.

7. Non-interest bearing debt

In Income Tax Ruling IT 2479, the Commissioner interpreted the term "interest is or may become payable". Debts will not be interest-free if, having regard to the amounts outstanding at a particular time, it can be said that interest is or may become payable. The example of trade debts is taken. Debts within a period for which interest can never be charged are interest-free. When any interest-free period ceases, the debt will, from that date, be considered interest bearing.

This is contrasted with the position of debt that is interest-free provided repayment occurs prior to a certain date, but, if payment is not made by then interest accrues from the date the debt was incurred. In this case, it is taken that interest may become taxable during the entire life of the debt, and so the debt is never regarded as interest-free.

8. Debt and equity denominated in foreign currency

Foreign debt denominated in a currency other than the Australian dollar is to be measured using the historical exchange rate at the date the loan was drawn down.

Foreign equity is generally measured in terms of amounts appearing in the balance sheet which are recorded at current exchange rates as at balance date. Accordingly, to the extent that foreign exchange movements are accounted for they will be reflected in the measurement of foreign equity.

9. Accounting standards

Foreign equity is measured by reference to a company's balance sheet. Balance sheet amounts may vary depending on the accounting methods adopted by the company.

For the purposes of the thin capitalisation rules, the Commissioner stated that accounts must be prepared, for the purpose of measuring foreign equity, in accordance with approved accounting standards.[12] In this case, approved accounting standards mean standards adopted by the Accounting Standards Review Board (ASRB), which are compulsory under the Companies Code. Even where an entity may not be governed by the standards (e.g. a partnership), compliance with the standards is required.

Obviously, where accounts are qualified or in some other way inconsistent with ASRB standards, some modification for tax purposes and thin capitalisation may be required. The question remains though, where an accounting standard allows a range of methods to be adopted and one method is adopted for accounts purposes, whether a different but still acceptable method under the standard can be adopted for tax purposes. The law seems unclear although it is assumed that the Commissioner would not look favourably on such arrangements.

10. More than one foreign controller

Where an Australian resident company has 2 or more foreign controllers, the foreign debt and foreign equity of all foreign controllers is to be combined for the purpose of calculating any excess foreign debt interest that may be disallowed.

Accordingly, although in respect of individual foreign controllers the 3:1 ratio may be exceeded, it is still possible that no disallowance will occur if the ratio is not exceeded when all foreign controllers are taken together.

Under Sec. 159GZS, in calculating any disallowance of excess interest using the current greatest debt method, the measurement of foreign debt is as follows: "the greatest total foreign debt of the taxpayer at any time in the year of income . . .".

From this, it follows that where there are 2 or more foreign controllers the greatest total foreign debt is the greatest aggregate foreign debt at any one time during the year and not the aggregate of the greatest foreign debts of each controller at different times.

III. THIN CAPITALISATION IN FOREIGN JURISDICTIONS

A. United Kingdom

There are no specific controls by the U.K. government on inward investment into the United Kingdom. However, the government has publicly stated that it is aware of a problem of the method of financing of international company groups. In respect of the 1987 report by the OECD on thin capitalisation, the government accepted the report and is actively considering alternative solutions to the problem. The government stated as follows:

> We welcome this study by the OECD of the international tax consequences which can arise from thin capitalisation – that is the use of loans as a substitute for equity capital in the financing of companies for the purpose of obtaining a tax advantage. The problem for the U.K. manifests itself primarily in relation to subsidiaries of foreign companies, and it gives rise to growing concern. In considering the case for any possible counteraction the wider economic and commercial implications must, however, be assessed and we are therefore inviting comments on the OECD report from interested parties . . .

It is widely expected that the request for comments is a prelude to future changes in the legislation, although no indication of its form has been given.

There are present rules (Sec. 233 of the Income and Corporation Taxes Act, 1970) which impact on the making of

12. Income Tax Ruling IT 2479.

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inter-group loans from parent or fellow subsidiary companies. A 75% ownership level is given as the test for a group relationship in this case. Interest, or similar payments, are recharacterised as distributions (dividends) where they relate to a loan provided by a non-resident group company. In this case, no deduction is available for the U.K. borrowing company against profits for the interest expense.

Many of the U.K.'s double taxation treaties give protection against this rule, although as treaties have been renegotiated the United Kingdom has sought to amend the treaties so that the U.K. Inland Revenue may consider arm's length tests in relation to both rates of interest and principal sums where inter-group loans are concerned. In this regard it is useful to note that the Inland Revenue's internal guidelines indicate debt/equity ratios in excess of 1:1 may be considered non-arm's length.

In the case of investment from Australia into the United Kingdom, protection arises under Art. 9(4) of the Australia/U.K. Double Taxation Treaty. Accordingly, loans may be made from Australian companies to their U.K. subsidiaries or other group companies without restrictions arising under Sec. 233 on the interest payments by the U.K. companies.

It is noted, however, that thin capitalisation by Australian groups of their U.K. operations is unlikely in the present circumstances of the comparative corporate income tax rates in the 2 countries, i.e. 35% in the United Kingdom and 49% in Australia.

B. United States

The United States has controls on the inward capitalisation of domestic subsidiaries by non-resident group companies. The rules apply where a U.S. company is considered thinly capitalised taking into account both purported debt obligations to group companies as well as debt obligations to independent third parties which are guaranteed by group companies.

In determining whether a company is thinly capitalised, the U.S. Internal Revenue Service (IRS) must attempt to determine whether loans can be considered to have the economic characteristics of equity capital. The relevant section (Sec. 385) of the Internal Revenue Code (IRC) specifies certain factors which must be taken into account in such determination. These include:

(a) adequacy of consideration for the debt;
(b) debt/equity ratio;
(c) whether the debt is convertible into equity;
(d) subordination of debt to other borrowings;
(e) relationship between borrower and lender;
(f) presence of traditional debt characteristics (e.g. repayment terms, written instrument and fixed instrument payment dates).

In addition to the statutory factors, the IRS also applies certain other tests designed to consider substance over form. These would include ability of the borrower to service the debt and meet repayment of the principal from anticipated cash flows. In such circumstances, formal cash flow projections can be provided to the IRS to substantiate debt levels.

The effect of a business taken to be thinly capitalised is that loans may be considered as equity capital for tax purposes. In this case, interest payments are recharacterised as distributions (dividends), to the extent of the business's accumulated earnings and profits. Payments of principal would be similarly treated. Payments in excess of earnings and profits are recharacterised as a return of capital to the extent of the foreign investor's investment in the U.S. business. Any distributions in excess of this amount are considered as a non-taxable disposition of the shares in the business (provided the business does not constitute a U.S. Real Property Holding Company). For Australian investors into the United States, recharacterisation of payments as distributions would result in U.S. withholding tax of 15%.

It is interesting to note that proposed guidelines to be issued under IRC Sec. 385 suggested a debt/equity ratio of 3:1 as a safe level for related party investment. These guidelines were withdrawn, but it is understood that the IRS still uses this ratio as a major indicator in deciding thin capitalisation questions.

A related question to that of thin capitalisation is the rate of interest that may be applied on related party loans. Under IRC Sec. 482, unless a more appropriate rate can be established, the interest rate on related party loans should be the greater of:

(a) the interest rate incurred by the non-U.S. related companies plus related costs incurred in relending the funds to the U.S. business; or
(b) 130% of the "applicable federal rate" (AFR) which is given for loans of various maturities.

Where the rate is in excess of an arm's length rate, the IRS may adjust the borrower's taxable income to reflect the arm's length rate. The disallowed portion may be treated as a distribution for U.S. tax purposes.

C. New Zealand

New Zealand has no thin capitalisation rules as part of its tax regime. However, debt/equity ratios of 3:1 are usually specified as a maximum for foreign investment as part of Overseas Investment Commission (OIC) approvals. The OIC operates in a similar manner to the Australian Foreign Investment Review Board, in that approval is required for many forms of business investment into New Zealand. The OIC is a New Zealand governmental body.

D. Other European countries

The following is a brief review of the thin capitalisation rules for inward investment applied by various European countries.

1. Belgium

Belgium has no direct controls on thin capitalisation, other than restraints which exist for the protection of creditors provided by company law. A financial plan must be filed on the formation of a company which demonstrates that it will be able to meet its obligations, including the financing of its debts. No group consolidation of results is permitted for taxation purposes.

2. Denmark

Until May 1983, the excessive use of debt was constrained by exchange control regulations (debt/equity ratio of not more than 4 : 1). When exchange control ceased, the Danish revenue took an interest in thin capitalisation. Specific rules have been introduced denying an offset of a parent company loss against operating profits of the subsidiaries included in joint filing. The loss which may be offset is limited by reference to the proportion of the loss of the parent company which corresponds to a "normal" return on the purchase price paid for the subsidiaries.

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3. Finland

Finland uses a number of approaches to restrict the use of debt. Exchange controls limit the use of parent debt in foreign controlled marketing companies during the first accounting period to the amount of ordinary equity (i.e. a 1:1 debt/equity ratio). The debt should remain outstanding for 5 years but may be repaid by installments during that time. The approach to manufacturing companies is less strict and these are looked at on a case by case basis. There are no specific thin capitalisation rules put forward by the tax authorities. However, the latter may use a doctrine which can be considered to be based either on an "abuse of law" or "substance over form" to deny interest on loans considered as equity. Their ability to do so is, however, inhibited by treaty non-discrimination clauses since domestic companies usually have significant gearing.

4. France

The exchange control authorities are unlikely to grant permission for investment from overseas if the debt/equity ratio is too high. However, this will not affect EEC investors. There are rules that limit the rate of interest that is deductible on loans from a shareholder to 100% of the annual yield of French corporate bonds. Interest deductions on loans from foreign parents are limited to interest of not more than one and a half times the share capital.

5. Germany (Federal Republic)

In the past the authorities attempted to use the general doctrines of "abuse of law" coupled with arm's length pricing principles but without success as a number of Supreme Court decisions have been decided against them. The government has become increasingly concerned about thin capitalisation, and there are proposals put forward in the form of a series of discussion documents which seek to regulate the position. The latest proposal involves a re-characterisation of debt provided by shareholders (or affiliates) to the extent that the level of debt exceeds the "norm" for the industry. Clearly, such a loose definition will cause uncertainty, and it remains to be seen whether this proposal is accepted.

6. Ireland

Ireland adopts a rule equivalent to that in the United Kingdom, whereby any interest payment to a non-resident parent company (or affiliate) is re-characterised as a distribution. This rule will not be of much significance where the Irish subsidiary is exempt from tax (because of export sales relief) or subject to the 10% tax applied to manufacturing. The provision is overridden by a concession where existing treaties provide for a zero Irish rate of tax on interest, and have not been re-written since the change in Irish rules.

7. Italy

Italy has historically relied on exchange controls to restrain the use of debt, though, as a member of the EEC, these are not in practice an important barrier to the use of debt by EEC investors. Only SpAs[13] can issue debentures, and these must not exceed the company's paid-up capital.

8. Netherlands

While there are no specific tax or exchange control restrictions on the use of debt, the tax authorities may mount a "substance over form" argument if the gearing used is excessive. If the company cannot be expected to service the debt, it will be argued that part at least can only be regarded as equity. In the case of intermediate holding companies for overseas investments, it is normal for an advance ruling to be obtained from the tax authorities. Typically, such rulings will limit the debt/equity to 6 : 1. However, interest on borrowings to finance acquisitions of foreign companies will not be deductible for Dutch tax purposes.

9. Norway

There are no specific thin capitalisation regulations either for tax purposes or for exchange control (though there are restrictions on the amount of gearing in the oil industry). However, the tax authorities have argued that excessive debt should be treated as equity. The corporate law also provides some inhibition in that a legal reserve fund must be established: it must be built up to an amount that is equal to at least 20% of the share capital and such an amount as is sufficient, together with the share capital and revaluation fund, to cover the debts of the company.

10. Portugal

Portugal has historically relied principally on exchange controls to regulate the position. Normally, any finance from the parent company had to receive prior authorisation from the Bank of Portugal which can therefore control the amount of debt and interest rate. Generally, companies are not allowed to obtain external financing.

11. Spain

Because of the entry of Spain into the EEC its exchange controls have been liberalised though it is necessary to obtain authorisation for large loans and to notify smaller loans (loans not exceeding 750 million pesetas). The authorities will restrict approval of loans unless the terms for interest and repayment are at market rates. There are, however, no specific thin capitalisation rules.

12. Sweden

There are no specific restraints on the use of debt. Although exchange controls are in force, they are liberally applied but could be used to prevent the use of an extreme debt/equity ratio.

13. Switzerland

While the exchange control authorities do not impose any restrictions, the tax laws of most cantons and, in practice, the federal tax authorities do impose limits on the amount of interest bearing debt. Generally speaking, interest bearing loans may not exceed 6 times equity; amounts in excess of this limit will be treated as equity for capital and profit tax purposes. The determination of arm's length rates of interest is linked to Swiss rates of interest. While higher rates may be appropriate in respect of other currencies, the tax authorities will be likely to challenge rates of interest which cannot be clearly defended based on market conditions.

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13. SpA (Società per Azioni) is a share company which is required to have at least 200 million lire of capital.

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AUSTRALIA:

Government Restrictions on Debt Funding

Debt Creation Involving Non-Residents

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NEIL WILSON

The debt creation rules (now embodied in Division 16G of the Australian Income Tax Assessment Act) were foreshadowed at the time that the thin capitalisation measures were first announced by the Treasurer on 30 April 1987. Just as the thin capitalisation rules were designed to replace the existing administrative provisions administered by the Foreign Investment Review Board in relation to debt/equity ratios, the debt creation rules were intended to replace similar guidelines imposed by the Foreign Investment Review Board for investments under the foreign investment policy. Whilst the debt creation rules apply from 1 July 1987, the same date that the thin capitalisation provisions apply from, there are transitional arrangements covering the period between 1 July 1987 and 19 June 1988 (being the date draft legislation was released by the Government).

The basic thrust of the legislation is to deny interest deductions incurred by Australian companies, that are controlled by non-residents by 50% or more equity ownership, on borrowings made in connection with the acquisition of assets from related parties. In addition, the provisions are also intended to control the remittance of monies abroad in the form of capital proceeds from the acquisition of assets where the funds generated are from borrowings in respect of asset sales on which otherwise tax-deductible interest would be payable.

One of the important distinctions that can be made between the provisions of Division 16G (debt creation) and Division 16F (thin capitalisation) is that Division 16F applies only in respect of interest paid, or deemed to be paid, to non-residents. The provisions of Division 16G are much broader and apply to both domestic and non-resident interest bearing debt even where that debt is with completely unrelated parties.

In their submission to the government on the draft legislation, referred to above, the Taxation Institute of Australia undertook an international comparison in order to consider the approach of other governments to transactions of a similar nature to those that will be impacted by the legislation. The rationale for such a comparison was stated to be as follows:

(a) if there is an accepted "fiscal evil" associated with such transactions it would be expected that at least some other countries would have enacted similar provisions;
(b) the proposed legislation is directed at debt creation arrangements involving non-residents, and, as such, foreign controlled companies operating in Australia will primarily be affected;
(c) if Australia's tax provisions are seen to discriminate against foreign owned entities and hence are perceived as being out of step with tax provisions in other industrialised countries, then foreign investment into Australia must be adversely affected.

The comparison covered 12 countries and included countries which could be said to be capital importing as well as capital exporting. None of the 12 countries had currently any legislation similar to that now enacted in Australia. In addition, as at August 1988 (the date of the submission), none of the countries had any proposals for similar legislation.

Whilst the debt creation legislation is draconian and must be considered whenever any form of reorganization is being considered in an Australian group of companies which are ultimately foreign owned, the provisions, as enacted, contain a number of concessions which were not present in the draft legislation as released and these are discussed in more detail below.

Whilst thin capitalisation applies not only to companies, but also to trusts, partnerships and Australian branches of overseas companies, the debt creation rules currently only apply to companies seeking tax deductions for interest incurred.

However, in the Second Reading Speech which accompanied the legislation's introduction into Parliament, it was noted that "...the Government will quickly respond if evidence emerges of entities other than companies being used to circumvent the provisions...".

KEY DEFINITIONS

Asset

This is defined to mean any form of property and includes an option, a debt, a chose in action, any other right, goodwill and any other form of incorporeal property and any form of property created or constructed.

Capital entitlement factor

This term is defined to be the percentage that a person (and any non-resident associates taken together) will be beneficially entitled to receive indirectly or directly of any "notional capital distribution" by the company.

As with all similar provisions, there are extensive tracing provisions designed to prevent the intention of the legisla-

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tion from being frustrated. Obviously, in most cases, the capital entitlement factor would be the percentage of shareholding in the Australian company by a non-resident.

Foreign controller

A foreign controller, in relation to Division 16G, is defined to be a person who is a non-resident and whose "capital entitlement factor" in respect of the company under consideration is at least 50%.

The transitional provisions referred to above impact upon the definition of foreign controller. Where an acquisition of an asset occurred on or after 1 July 1987 but before 20 June 1988, the reference to 50% in the definition will be read as 100%.

It is also interesting to note that in the draft legislation, as released, the capital entitlement factor in determining whether a non-resident was a foreign controller was to be 15%. This figure was increased to 50% after extensive lobbying of the government by business interests.

Interest

This term is defined to include an amount in the nature of interest. The question arises whether discounts on bills and other securities are included in this definition. Despite technical arguments to the contrary, the practical answer is that the Australian Tax Office takes the view that they are so included.

APPLICATION

The debt creation rules apply only to interest incurred in respect of an amount owing in connection with the acquisition of an asset if the interest was incurred on or after 1 July 1987 and the acquisition occurred on or after 1 July 1987, otherwise under a contract entered into before that date.

OPERATIVE PROVISION

The operative provision of the debt creation rules requires the following 3 conditions to be satisfied:

(1) an amount of interest expense is incurred which, but for Division 16G (debt creation) and Division 16F (thin capitalisation), would otherwise have been an allowable deduction to the company;
(2) the interest has been incurred in connection with the acquisition of an asset by the company; and
(3) any of the following 3 conditions are satisfied:
  (i) the seller (the "eligible seller") of the asset was a foreign controller of the company after the acquisition;
  (ii) the company was a foreign controller of the seller before the acquisition; or
  (iii) in cases where there is a common foreign controller, the common foreign controller was the foreign controller of the seller before the acquisition and the buying company immediately after the acquisition.

If these tests are satisfied, the amount of non-deductible interest is calculated as follows:

amount of non-deductible interest =
deduction × asset ownership factor × capital entitlement factor

The "asset ownership factor" is defined to be the seller's interest in the asset immediately before the acquisition by the buyer, and this would normally be 100%. If, however, for example, an asset is acquired from 2 sellers who previously jointly owned the asset and only one of the sellers was an eligible seller in relation to the foreign controller, the eligible seller's interest in the asset prior to the sale will be 50%. As a result, the asset ownership factor would be 50%.

It is clear that where interest is only partly incurred in respect of the amount owing in connection with the acquisition of an asset, then the provisions apply to the deduction only to a corresponding extent.

It can be seen that the rationale for the formula is to examine whether the ownership of all assets is altered. If the ultimate underlying ownership has altered, then the interest will be deductible. If the ultimate underlying ownership of an asset is unchanged (albeit transferred between related companies), then any interest paid on that acquisition is not deductible.

RELIEVING PROVISIONS

In the absence of any relieving provisions, it can be seen that the debt creation rules would apply to a whole range of transactions which would ordinarily be considered as quite commercial. As a result, there are a number of provisions which prevent the application of debt creation rules in certain circumstances. These are as follows:

(a) the acquisition of cash, unless the cash was used to acquire a business or part of a business;
(b) the acquisition of trading stock, provided that immediately prior to the acquisition, the asset was trading stock of the seller and, again, the acquisition was not part of the acquisition of a business or of part of a business;
(c) the acquisition of shares, provided the shares had not previously been issued;
(d) the acquisition of an asset, provided the seller was a non-resident immediately before the acquisition and the asset had not previously been used for the purposes of gaining assessable income in Australia or in carrying on a business for the purposes of gaining assessable income in Australia. Were it not for this provision, shares held by non-residents in resident companies would come within this exclusion since the dividend income on the shares would not be assessable income in Australia to the holder;
(e) the Commissioner is given general discretion not to apply the debt creation rules where he is satisfied that the acquisition of an asset does not result in an increase in the debt owed by the group constituted by the taxpayer claiming the interest deduction and the seller of the asset; or an increase in the ability of the seller or its associates to make payments which are not dividends that are assessable income or liable to dividend withholding tax to a foreign controller of the seller.

A corporate group restructure which results in an increase in the overall debt of the group or an increase in the ability of an Australian company to make untaxed payments to a foreign controller is precisely what the Division is aimed at preventing.

In relation to the first test, the Treasurer gave 2 examples in the explanatory memorandum as to how the test would be applied.

Example 1

A foreign controller owns all the shares in 2 Australian companies, A and B. A then acquires all the shares in B with borrowed funds. There has been an increase in the overall indebtedness of the

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group constituted by the effective taxpayer, A, and the eligible seller, being the foreign controller. The Commissioner would not be satisfied that the acquisition of the asset does not result in an increase in the overall indebtedness of the group, and the debt creation rules would be applied.

Example 2

A foreign controller owns all the shares in 2 Australian companies, A and B. The assets of A are mortgaged to the extent of $ 1 million. A sells all the assets of its business to B for their book value of $ 4 million. B finances only $ 1 million of the business acquisition by loan. On transfer of the assets from A to B, the mortgage of A's assets is extinguished. In effect, the $ 1 million mortgage debt of A has been replaced by the $ 1 million loan of B. The overall indebtedness of the group constituted by the affected taxpayer, B, and the eligible seller, A, is unchanged. The Commissioner would be satisfied that the acquisition has not resulted in an increase of the overall indebtedness of the group constituted by the affected taxpayer, B, and the eligible seller, A.

In relation to the second test, if an eligible seller uses the proceeds of the sale of an asset to repay loans (other than from a foreign controller or an associate of a foreign controller), the ability of the eligible seller to pay amounts to a foreign controller which are not subject to tax will not be increased. However, where the proceeds of the sale of an asset are not used by an eligible seller to repay loans from persons other than a foreign controller or their associates, the ability of the eligible seller to make untaxed payments to a foreign controller will generally be increased.

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The U.S. Foreign Tax Credit

An Overview of the 1986 Tax Reform Act Provisions and Subsequent Amendments

Leonard W. Rothschild, Jr., Steven L. Mack and David M. Cordova

The Tax Reform Act of 1986 (TRA) added many new provisions to the Internal Revenue Code (IRC) which limit the benefits available from the foreign tax credit. This article will briefly review those changes and subsequent amendments contained in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

BACKGROUND – FOREIGN TAX CREDIT

The United States taxes U.S. residents and domestic corporations on worldwide income. U.S. taxpayers often must pay foreign taxes as well as U.S. taxes on foreign-source income. In order to avoid double taxation of the income, U.S. tax law provides a foreign tax credit. The purpose of the credit is to reduce U.S. tax on foreign-source income that is subject to foreign tax; therefore, the credit is limited to U.S. tax on foreign-source income or the amount of foreign tax paid, whichever is less. This limitation is computed mathematically as the product of the U.S. tax (before credit) multiplied by the ratio of foreign-source taxable income to total taxable income. Accordingly, the amount of credit that may be claimed is proportionate to foreign-source income. This rule gives U.S. taxpayers an incentive to earn foreign-source income.

U.S. parent companies may also receive a credit for taxes paid by a foreign subsidiary which is at least 10% owned when the subsidiary pays a dividend to the parent. The U.S. parent is deemed to have paid a proportionate share of the foreign taxes paid by the subsidiary on those earnings remitted as dividends.

Before the TRA, taxpayers were able to group virtually all types of income into one general limitation category and separately compute the above limitation. This generally allowed taxpayers the ability to offset highly taxed income with lower taxed income, such as dividends, certain interest and royalty income. Although certain types of income were subject to separate limitations (such as non-business interest income), it was often not difficult to circumvent the adverse effect of making a separate limitation computation. If a separate limitation applied, the credit was limited to the product of the U.S. tax multiplied by the ratio of foreign-source taxable income of that type of income to the total taxable income, or the amount of foreign tax paid on that type of income, whichever was less. The separate limitation was created primarily to prevent a taxpayer from generating lightly taxed non-business interest income and using this foreign-source income to help utilize excess credits generated from other types of income.

The TRA made the following changes to the computation of the foreign tax credit.

(1) The number of separate limitation categories was increased, requiring the computation of more separate limitations which in many cases will reduce the availability of the foreign tax credit.
(2) The rules for determining the source of income were modified in some instances, including those relating to the source of income from the sale of personal property.
(3) The rules for allocating expenses (which must be deducted from income in arriving at the foreign-source taxable income which is used in the limitation formula) were changed, particularly the rules concerning the source of interest expense and expenses of affiliated groups. Generally, these changes reduce the number of alternative methods taxpayers may use in determining source and eliminate the planning tool of incurring expenses in a particular member of an affiliated group for the purposes of source, so taxpayers are more limited in choosing ways to manipulate foreign-source taxable income.
(4) The rules for translating foreign currency into U.S. dollars have been modified, requiring, for example, that taxes paid or accrued be translated using the exchange rate on the date paid. This change mirrors the actual economics of the transaction.
(5) In the case of computing the deemed paid credit, such as that available with dividends or Subpart F income, post-1986 earnings and profits must be pooled in determining the proportionate amount of deemed paid taxes. This is a change from the previous rule which looked to earnings and profits year-to-year, which allowed the taxpayer to pay dividends from years with high proportionate foreign taxes to maximize the deemed paid credit.

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FOREIGN-SOURCE INCOME – ADDITIONAL LIMITATION CATEGORIES

The TRA increased the number of separate limitation categories or baskets to 10. Taxpayers must compute a separate foreign tax credit limitation with respect to each basket, thus limiting utilization of foreign tax credits.

The new baskets are as follows:

1. Passive income

Passive income[1] is defined by reference to the Subpart F definition of foreign personal holding company income[2]. Included in this definition are dividends, interest, royalties, rents (subject to several exceptions), the net gain from the sale of property that generates passive income or property which does not give rise to any income, net gain from certain commodities and currency transactions and "income equivalent to interest".[3]

Rents and royalties derived in the active conduct of a trade or business from unrelated persons are excluded from the passive income basket.[4]

There are a number of provisions which remove passive income from the passive basket which are discussed below. These exceptions include high withholding tax interest, export financing interest, high taxed income, financial services income and shipping income. In addition, application of the look through rules to income from controlled foreign corporations may remove income from the passive basket.

2. High withholding tax interest

Any interest subject to a withholding tax of at least 5% is high withholding tax interest.[5] An exception may apply to such interest received from a controlled foreign corporation when it is recharacterized under the look through rules which are described below.

3. Financial services income

Income of persons predominantly engaged in the active conduct of a banking, insurance, financing or similar business is generally considered financial services income.[6] This definition contained in TAMRA represents a change from the TRA provision that applied the category to any taxpayer actively engaged in the banking, financing or insurance business.

4. Shipping income

The definition of shipping income is cross referenced to foreign base company shipping income in Subpart F (Secs. 954(f) and 904(d)(2)(D)).

5. Non-controlled Sec. 902 corporation dividends

Dividends from each foreign corporation (except controlled foreign corporations) owned from 10 to 50% by the taxpayer fall in the uncontrolled Sec. 902 corporation dividend basket. A taxpayer will have a separate basket for each Sec. 902 non-controlled corporation it owns. This provision should adversely affect many corporate joint ventures.

If a foreign corporation is owned exactly 50% by a U.S. person and 50% by a non-U.S. shareholder, it may be possible to remove the foreign corporation from the non-controlled basket if the U.S. person can increase its ownership in the foreign corporation to more than 50%. One way that this can be accomplished is to have the U.S. person purchase stock in the 50% non-U.S. shareholder of this foreign corporation. If this is done, and the Internal Revenue Service (IRS) respects the applicable attribution rules in Sec. 958, then the foreign corporation will become a controlled foreign corporation.

6. Other baskets

Three categories, pertaining to Foreign Sales Corporations (FSCs) and Domestic International Sales Corporations (DISCs), are retained from prior law.[7] There is also a separate category for foreign oil and gas extraction income.[8]

7. Overall income

Any income which does not fall into one of the above categories is overall limitation income. Included in the overall basket is export financing interest, which is defined as interest derived from financing the sale for use or consumption outside the United States of property which is produced in the United States by the taxpayer or a related person. This provision was intended to provide an incentive to exporters of goods manufactured in the United States.[9]

"High taxed" income is also assigned to the overall basket.[10] Income that is passive income and taxed at a rate greater than the maximum applicable U.S. rate (28% for individuals and 34% for corporations after 1987) is "kicked out" of the passive basket into the overall basket. The foreign tax rate should be computed after an allocation of expenses at the U.S. recipient level. This provision will make it difficult to average the rates on high and low taxed income in the passive basket. Regulations provide for grouping of items of income for purposes of determining the high tax kickout.

CONTROLLED FOREIGN CORPORATIONS

U.S. shareholders of controlled foreign corporations (CFCs) are subject to special look through rules[11].

Subpart F income is treated as separate limitation income to the extent that the CFC has earned separate limitation income. Rents and royalties paid by a CFC are treated as separate limitation income to the extent the CFC has earned income in the various categories. Interest from a CFC is categorized first as passive income to the extent the CFC has passive income, and the excess is prorated in proportion to the CFC's income from the other categories. Finally, dividends are treated as separate limitation category income based on the CFC's proportional earnings and profits.

A CFC's income that would be Subpart F income except that it meets the de minimis exception (lesser of 5% of gross income or $ 1,000,000) and is attributable to foreign base company income and gross insurance income is treated as overall limitation income, unless it is financial services income.

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1. Sec. 904(d)(2)(A), Internal Revenue Code 1986. Hereinafter all reference will be to the 1986 Code.
2. Sec. 904(c).
3. Sec. 954(c)(1)(E).
4. Sec. 954(e)(2)(A).
5. Sec. 904(d)(2)(B).
6. Sec. 904(d)(2)(C).
7. Secs. 904(d)(1)(F), (G) and (H).
8. Sec. 907.
9. Sec. 904(d)(2)(G).
10. Sec. 904(d)(2)(F).
11. Sec. 904(d)(3).

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THE OVERALL LOSS RULES

In order to prevent the separate limitations from working to the taxpayer's advantage by allocating losses to one or more baskets, thereby increasing the limitations in other baskets, the IRC provides loss allocation rules which spread a loss in a given basket to other baskets with income.[12] The loss of any basket is allocated to the other baskets in proportion to their income. Income earned in later years in the loss basket is recharacterized as income earned in the other baskets to the extent the income of the other baskets was reduced in accordance with this rule.

Additionally, if a taxpayer earns foreign-source income and U.S.-source losses, the U.S.-source loss is allocated to the separate limitation baskets in proportion to their income[13].

If a taxpayer earns an overall foreign-source loss for a given year, foreign-source income earned in subsequent years must be recharacterized as U.S.-source income to the extent of the prior overall foreign loss (but not more than 50% of the current foreign-source income)[14]. This is known as the recapture of overall foreign loss rule.

CHANGES TO COMPUTING FOREIGN-SOURCE INCOME

1. Personal property sales

The TRA changed the rules for determining the source of income from the sale of personal property. The source of inventory sales will continue to be to the place where title passes. However, the source of other sales will generally be the residence of the taxpayer.[15] The sales of personal property by U.S. citizens and permanent residents may be foreign source only if a tax of at least 10% of the gain is actually paid to a foreign country. If a sale is made through an office or other fixed place of business, the source of the sale is generally the location of the office. The source of sales of depreciable property is treated the same as inventory property, except that gain, to the extent of prior depreciation deductions, must be allocated between U.S. and foreign sources in proportion to the source of the depreciation deductions taken in prior years. A special rule provides that gain from the sale of stock in an affiliated corporation by a U.S. resident is foreign source if the stock is sold in a foreign country and more than 50% of the gross income of the affiliate for the last 3 years was derived in the active conduct of a trade or business in the country.

The IRC also specifies that if the payments for the sale of an intangible are contingent on the productivity of the intangible, the gain is to be sourced as royalties.

2. 80/20 corporations

Interest paid by an 80/20 corporation (a domestic corporation which earned at least 80% of its gross income from foreign sources over the past 3 years) is generally foreign-source income.[16] If the interest is received by a related person, however, the source is apportioned between U.S. and foreign sources in proportion to the source of the corporation's gross income for the past 3 years.[17] Dividends paid by an 80/20 corporation are considered all U.S. source. However, for purposes of the withholding tax on dividends to foreign shareholders, the source of the dividend is apportioned between U.S. and foreign source in proportion to the gross income of the corporation.[18] There is a look through rule through a chain of subsidiaries to determine the original source.

3. Dividends from certain foreign corporations

Dividends from a foreign corporation are apportioned between U.S. and foreign sources if at least 25% of its gross income in the last 3 years was effectively connected with a U.S. trade or business.[19] The prior law required a 50% threshold.

4. Transportation and miscellaneous income

Income from providing transportation by ship or aircraft between the United States and a foreign country or possession is apportioned 50% to U.S. sources and 50% to foreign sources.[20] Income from activities in space or international waters is U.S. source if performed by a U.S. person (citizen or resident alien or domestic corporation), or else is foreign source.[21] Income from international communications earned by a U.S. person is 50% U.S. source and 50% foreign source. If earned by a non-U.S. person, income is foreign source unless attributable to an office or fixed place of business in the United States, in which case it is U.S. source.[22] Interest on bank deposits in the United States is U.S.-source income, but it is not subject to U.S. withholding tax.[23]

ALLOCATION OF EXPENSES

1. Research and development (R & D)

Congress continued to change the rules relating to the source of R & D expenses in the TRA. A Treasury Regulation issued in 1977 set out rules for allocating R & D expenses as follows:

(a) First, to the extent the expenditure was required solely to comply with a local law, allocate the expenditure to that location (not necessarily the location where the R & D was performed).
(b) Next, up to 30% of the expenditures may be automatically allocated to the location of the R & D.
(c) The remaining R & D expenses must be allocated between U.S. and foreign sources in proportion to the sales of the type of product for which the research was done.

Alternatively, instead of steps 2 and 3, the taxpayer may apportion the remainder under a gross income method, as long as the amounts apportioned to U.S. and foreign-source income could be no less than 50% of what they would have been if steps 1, 2, and 3 had been followed.

Congress did not allow these Regulations to become effective, passing a 2-year moratorium in 1981 followed by another 2-year moratorium in 1984.

In the TRA, Congress increased the U.S.-source R & D deduction, thus favoring the taxpayer. Congress modified the Regulations by (1) increasing the automatic allocation in step 2 from 30% to 50%; (2) allowing the taxpayer to use an alternative gross income apportionment after applying step 2 (thus permitting an automatic 50% allocation with the gross income method), and (3) eliminating the rule that

12. Sec. 904(f)(5).
13. Sec. 904(f)(5)(D).
14. Sec. 904(f)(1).
15. Sec. 865.
16. Sec. 861(a)(1)(A).
17. Sec. 861(c)(2).
18. Sec. 871(i)(2)(B).
19. Sec. 861(a)(2)(B).
20. Sec. 863(c).
21. Sec. 863(d).
22. Sec. 863(e).
23. Secs. 871(i)(2)(A); 881(d).

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the gross income method could be used only if it did not reduce the expense allocated to either U.S. or foreign source to less than 50% of what it would have been under the sales method. This modification was to last 1 year, expiring in 1987.

The TAMRA further modified the rules and extended the moratorium. The modified rule is effective only for the first 4 months of the first tax year beginning after 1 August 1987. It modified the rules by (1) increasing the automatic allocation in step 2 from 30% (50% under the TRA) to 64%, (2) allowing use of an alternative gross income method after applying step 2 (as allowed under the TRA), and (3) limiting the effect of the gross income method so that the amount allocated under that method to foreign sources can be no less than 30% of what it would have been under the sales method. Additionally, the Act provided rules for implementing the rules for affiliated groups.

All the moratoriums and modifications will expire after the first 4 months of a taxpayer's first taxable year beginning after 1 August 1987, so the original regulation will be effective at that time. However, it appears that the Treasury is working on new Regulations concerning the source of R & D expenses, so the rules could change again.

2. Interest

The TRA required interest expense to be allocated on an affiliated group basis rather than a separate company basis.[24] Expenses other than interest must also be allocated on an affiliated group basis. The Act also eliminated the gross income method of allocating interest expense. Assets which produce tax-exempt income are ignored in apportioning interest expense. The basis of the stock of a 10% or more owned foreign or non-consolidated U.S. subsidiary is to be adjusted by the accumulated earnings of the subsidiary in the apportionment formula. The TAMRA clarified that undistributed Subpart F income which resulted in an increase in the basis of the CFC's stock is not to be double counted in adjusting the basis for accumulated earnings and profits. Transitional rules apply with 3, 4, and 5-year phase-ins. Treasury issued Temporary Regulations implementing these new rules and specifying the method of apportioning interest expense among the various separate limitation baskets.[25] These Regulations specify that in cases where a U.S. shareholder of CFCs has a higher proportional debt than the CFCs, and has loaned money to the CFCs, a portion of the U.S. shareholder's interest expense is apportioned in proportion to the assets of the CFCs.[26]

EARNINGS AND PROFITS

The TRA adopts a multi-year pooling approach towards allocating earnings and profits (E&P) and a proportionate share of deemed-paid foreign taxes.[27] E&P is allocated broadly into a post-1986 pool. Dividends paid after 1986 are first presumed to be paid out of the post-1986 pool until it is exhausted, and then out of the pre-1987 pool as under prior law. This is to prevent a U.S. shareholder from timing a dividend to increase the percentage of E&P apportioned to foreign taxes. The dividend is presumed to be paid out of the pool of post-1986 E&P ending on the last day of the taxable year in which the dividend is paid, eliminating the rule characterizing dividends paid in the first 60 days of a taxable year as being paid from the prior year's E&P.

For purposes of Sec. 902, if a corporation first acquires at least 10% of a subsidiary after 1986, the post-1986 pool is computed by taking into account the E&P and foreign taxes paid in only those years during which the 10% stock ownership requirement of Sec. 902 was met[28]. No credit will be available for post-1986, pre-acquisition taxes paid by the subsidiary.

TAX TRANSLATION RULES

The TRA made some changes to the mechanics of translating foreign taxes into U.S. currency. As under prior law, Sec. 902 E&P is translated at the exchange rate effective on the date of the distribution. However, unlike prior law, the U.S. dollar amount of foreign taxes deemed paid is now calculated at the exchange rate effective on the date the taxes were paid. For purposes of Secs. 960 and 964, E&P is calculated at the weighted average exchange rate for the taxable year; however, the foreign taxes are translated at the rate effective on the date the taxes were paid.

EFFECTIVE DATES AND TRANSITION RULES

The changes made by the TRA are generally effective for the first taxable year beginning after 31 December 1986. However, 3, 4 and 5-year phase-ins apply to the changes for determining the source of interest expense. The changes relating to the source of R & D expenses have various effective dates, as discussed. Special rules apply to the carryforward and carry-back of foreign tax credits. Carry-forwards from pre-1987 years to post-1986 years usually stay in the same category as in the pre-1987 year. Carry-backs from post-1986 to pre-1987 years generally fall into the overall basket for pre-1987 years. The Act also bars a carry-back to a pre-1987 year to the extent that the excess credit was due to the rate reduction caused by the Act.

CONCLUSION

The net effect of these complicated rules is to make it more difficult for U.S. taxpayers to maximize use of foreign tax credits. Taxpayers that now find it difficult to currently utilize foreign tax credits must take steps to change that situation. These companies must carefully review their foreign tax situation and be certain that foreign taxes paid are kept to a minimum. These companies should also examine their worldwide operations and ascertain that all intercompany charges are properly allocated. For example, a U.S. based company that incurs administrative charges that benefit the foreign subsidiaries should charge the applicable foreign subsidiaries and obtain a foreign tax deduction.

Although the TRA changes have generally made it more difficult for multinational companies to plan for maximizing the foreign tax credit, some new planning opportunities are available due to the change in structure for computing the foreign tax credit. For example, a U.S. parent of a controlled foreign corporation can sometimes use the look through rule to its benefit. The changes have increased the complexity of computing the credit, but also have created certain new planning opportunities for multinational taxpayers.

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24. Sec. 864(e). An affiliated group is a group of corporations at least 80% owned by a common parent. Before the change, a group of companies could choose to use a given corporation to borrow for the group, and the source of the interest expense would be calculated by reference to that corporation alone. This allowed taxpayers to control the source of interest expense to some degree. TRA change effectively eliminates the ability to incur interest expense in a corporation that has no foreign assets in order to avoid an allocation of interest expense to foreign-source income.
25. Temp. Treas. Reg. Secs. 1.861-8T-1.861-14T.
26. Temp. Treas. Reg. Sec. 1.861-10T(e).
27. Secs. 902 and 960.
28. Sec. 902(c)(3).

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INTERNATIONAL:

Tax Reform in Developing Countries

The Administrative Dimension

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Tax reform in developing countries has recently come to center on 2 objectives: restructuring tax systems toward more efficient taxes that do not distort market forces and choosing taxes that work, i.e. taxes that are administratively feasible. The latter concern is perhaps a reaction to stereotyped recommendations of ideal taxes that are unsuited to the country setting or that do not take account of the quality and quantity of scarce administrative resources. The new emphasis on taxes that work puts the focus on tax administration. It also means that tax administrators must widen their own horizons – they must ally with tax policy experts to change tax structure in a desirable way, while still carrying out their practical duties of assessment and collection of revenue within the existing tax system. The new role of tax administration therefore requires a brief look at tax administration from the point of view of an economist.

How would an economist view tax administration?[1] A useful definition would begin with the set of statutory laws making up the tax system. Such a body of legislation represents the tax system from the point of view of those who design tax policy. In contrast to the legal statutes stands the "real" tax system, or the system as it is applied in practice. Tax administration can be seen as the link between the legal and actual systems. Whenever actual practice differs from legislative intent tax administrators are making an impact in determining the overall deficit, the allocation of the tax burden on different sectors of the economy, the question of how the rich and poor share the tax burden and the efficiency of the economy. If legislation were perfectly enforced, then tax administration would make no difference for the above questions. But in fact, any tax administration collects some taxes better than others; taxes on wages, for example, are more effectively collected in the United States than taxes on interest or capital gains. In most industrial countries, however, the tax legislation by and large approximates the "real" tax system. By contrast, in developing countries the gap between the two can be very great. Part of the task of tax reform is to reduce the gap between legislation and reality. Tax reform involves a trade off between designing taxes that are simple enough to be administered, but still relatively efficient in the sense of minimizing distortions in the allocation of resources.

TAX ADMINISTRATION AND TAX STRUCTURE

Following the idea that some taxes are easier to collect than others, a number of writers have explored the connection between tax administration and tax structure.[2] They have asked: why does a country develop a particular tax structure (a set of taxes making up total revenue) and why does this tax structure differ among countries and change during the process of economic growth?[3] This literature argues that certain bases of taxation – "tax handles" – offer easy ways to collect revenue. The "tax handle" theory in fact offers a sweeping historical view of tax structure change. The theory argues that low income economies are forced to collect revenue from easy to administer taxes which can be collected in an economy where businesses do not use sophisticated accounting, where the tax administration is weak and where the population may not be literate. As the economy becomes more modern, it is then able to use more sophisticated taxes, such as sales and income taxes, that depend on the use of bookkeeping and accounting. In sum, advanced economies have a certain freedom of maneuver in choosing tax systems, while low income developing countries are locked into certain easy to collect taxes.

1. This question is addressed in Goode, Richard, "Some Economic Aspects of Tax Administration", *IMF Staff Papers* (June 1981). See also Mansfield, Charles Y., "Tax Administration in Developing Countries, An Economic Perspective", *IMF Staff Papers* (March 1988).
2. This literature includes Hinrichs, Harley H., *A General Theory of Tax Structure Change During Economic Development,* the Law School of Harvard University, Cambridge (1966); Lotz, Jorgen R. and Morss, Elliot R., "Measuring Tax Effort in Developing Countries", *IMF Staff Papers,* Vol. 14 (November 1967); Bahl, Roy W., "A Regression Approach to Tax Effort and Tax Ratio Analysis", *IMF Staff Papers,* Vol. 18 (November 1971); Tait, Alan A., Graetz, Wilfred and Eichengreen, Barry, "International Comparisons of Taxation for Selected Developing Countries", *IMF Staff Papers,* Vol. 26 (March 1979); and Tanzi, Vito, "Tax Policy in Middle Income Countries: Some Lessons of Experience", *International Monetary Fund,* DM/81/62 (1981).
3. It should be noted here that "tax structure" refers to the revenue importance of different taxes rather than the legislative content of tax laws.

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The insight that administrative constraints in part determine the actual tax structure of developing countries appears accurate if we examine the actual tax structure of developing countries among themselves and in comparison to industrial countries.[4] Looking at Table I, the group of countries with the lowest per capita income represents the countries in which the tax structure is most determined by administrative considerations, i.e. the availability of accessible tax handles. For these countries import duties, based on a very convenient tax handle, account for 32% of total tax revenue. The personal income tax, a much more difficult tax to collect, accounts for 9% of tax revenue. In contrast, for the most wealthy developing countries the share of import duties drops to only 18% of tax revenue, even though the share of imports in GDP has not changed. For the same group of higher income countries, the share of the personal income tax rises to 13%, indicating a greater use of this difficult to collect tax (Table I).

The tax structure of the average developing country is shown in the bottom line of Table I. Total tax revenue is divided as follows:

Individual income tax: 11%
Corporate sales tax: 17%
General income tax: 10%
Excises: 12%
Import duties: 26%
Export duties: 7%
Social security taxes: 9%
Wealth and property taxes: 3%

Even the above breakdown gives the impression that the tax structure of developing countries is closer to that of industrial countries than is actually the case. Although precise data to prove the point are not available, one could say with a high degree of certainty that most of the revenue from import duties stems from a small group of highly taxed consumer goods, perhaps amounting to no more than 25% of total imports. The personal income tax is mainly collected from withholding taxes on civil servants and employees of large firms, and so is often more accurately characterized as a payroll tax on wages than a general income tax. Most of the yield of the corporate income tax stems from a handful of modern (often foreign) enterprises, and most excise revenue from duties on beer, liquor, tobacco and fuel. The bulk of the yield from the "general" sales tax again stems from a selected group of consumer imports in low income developing countries, although in higher income countries the domestic base becomes more significant.

In accordance with the "tax handle" theory, then, the effective tax structure of developing countries (as opposed to the legislative tax system) is characterized by reliance on a half dozen narrow tax bases reflecting administrative convenience. "Administrative convenience" takes on a number of meanings in this context. For import duties the centralization of taxable goods in a port leads to ease of administration. Export duties also apply to goods concentrated in a port and may be applied to a central marketing board or a few large exporters in lieu of collecting personal income tax from a multitude of small farmers. The problem of valuation is simplified by this concentration, or can be circumvented entirely by using specific duties or administered reference prices. For the personal income tax, withholding of taxes on wages paid by large enterprises and government is the meaning of "administrative convenience". Other taxes such as the corporate income tax may be inherently more difficult to administer because its base of net profits requires more sophisticated accounting measures such as depreciation. In such cases, administrative convenience may take the form of simply accepting, with only perfunctory audit that presents no serious challenge, a reasonable amount of taxation as defined by the firm. If firms are unwilling to contribute a "reasonable" sum, governments may then adopt simple rules of thumb, such as using a percentage of gross sales to replace the concept of net profit.

When developing countries as a whole are compared with industrial countries, the importance of administrative constraints in determining the tax structure is again demonstrated. Table II shows a comparison of tax structure in the average developing country (as defined by the sample) with tax structures in such industrial countries as the United States, France, the Federal Republic of Germany and Japan. In this table, tax revenues are shown as a percentage of Gross Domestic Product. From Table I we can see that foreign trade taxes are the most important source of revenue in low income developing countries and remain important for middle and upper income developing countries. In contrast, such taxes are scarcely used for revenue purposes in the industrial countries shown in Table II. Another important difference in tax structure between developing and industrial countries is that the latter rely to a much greater

4. See Tanzi, Vito, "Quantitative Characteristics of the Tax Systems of Developing Countries", in *Modern Tax Theory for Developing Countries,* edited by D. Newbury and N. Stern, Oxford, Oxford University Press (1987).

Table I

Tax revenue by type of tax and by group of countries[1]

(In percent of total taxes)

Per capita income		Total	Income taxes				Domestic taxes on goods and services				Foreign trade				Social security	Wealth and property	Other
Range (1)	Average (2)	taxes (3)	Total (4)	Individual (5)	Corporate (6)	Other (7)	Total (8)	General sales, turnover, VAT (9)	Excises (10)	Other (11)	Total (12)	Import duties (13)	Export duties (14)	Other (15)	(16)	(17)	(18)
< 300	206	100.00	20.83	9.09	11.03	1.71	29.45	13.38	12.64	3.43	42.55	32.01	11.01	0.14	3.53	2.33	2.39
300 < Y < 650	510	100.00	25.95	10.20	15.03	1.58	26.18	8.60	12.61	4.97	39.05	30.62	7.25	0.17	8.58	2.24	2.81
650 < Y < 1550	1,086	100.00	33.06	11.85	20.78	7.03	24.09	8.89	10.43	4.77	30.07	24.07	8.40	0.07	9.15	2.94	3.72
1550 <	2,554	100.00	39.19	12.97	24.79	2.25	24.13	7.65	11.38	5.09	20.39	18.24	2.57	0.06	14.48	2.75	2.62
All countries	1,043.9	100.00	29.75	10.90	17.54	3.28	26.09	9.67	11.86	4.56	33.37	26.51	7.06	0.12	9.29	2.55	2.90

Source: Tanzi, Vito "Quantitative Characteristics of the Tax System of Developing Countries", in *Modern Tax Theory for Developing Countries*, edited by D. Newbery and N. Stern (Oxford: Oxford University Press, 1987). Data from IMF, *Government Finance Statistics Yearbook*, Vol. VI (1982); World Bank Atlas (1981).

1. Average of sample of 82 countries. Refers to three-year period generally centered around 1979.

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Table II

Tax structure in developing and selected industrial countries

(Each tax category as percent of GDP)

	Income taxes				Foreign trade taxes			Domestic taxes on goods and services			
	Total	Personal income	Corporate profits	Other	Total	Exports	Imports	Total	Vat, sales	Excises	Other
Developing countries[1]	5.5	1.9	3.1	0.6	5.6	1.1	4.5	4.4	1.6	2.0	0.8
United States[2]	12.3	10.2	2.1	—	0.3	—	0.3	4.6	2.1	2.5	—
United Kingdom[2]	14.7	10.3	4.4	—	0.4	—	0.4	11.1	5.6	5.4	—
France[2]	7.9	6.0	1.9	—	0.2	—	0.2	12.7	9.0	3.7	—
Germany[2]	12.6	10.5	2.0	—	0.4	—	0.4	9.8	6.3	3.5	—
Japan[2]	12.5	6.7	5.8	—	0.3	—	0.3	3.6	—	3.6	—

Sources: For developing countries, see Tanzi, Vito, "Quantitative Characteristics of the Tax Systems of Developing Countries," in *Modern Tax Theory for Developing Countries*, edited by D. Newbery and N. Stern (Oxford: Oxford University Press, 1987). For industrial countries, see *Revenue Statistics of OECD Member Countries, 1965-84*, OECD, Paris, 1985.

1. Average of sample of 82 countries. Refers to three-year period generally centered around 1979.
2. 1984 data.

extent on a single broad-based income or consumption tax. Revenue from taxes on general consumption such as VAT amounted in 1984 to 9% of GDP in France, 5.6% in the United Kingdom and 6.3% in the Federal Republic of Germany, while VAT and other general sales taxes averaged only 1.6% of GDP in developing countries. For the same year, personal income tax amounted to over 10% of GDP in the United States, the United Kingdom and the Federal Republic of Germany compared with 1.9% of GDP in the average developing country.

THE PROBLEM: ADMINISTRATIVE CONSTRAINTS LEAD TO FAULTY TAX STRUCTURE

Why should developing countries be concerned that their tax structures have been shaped by administrative constraints rather than economic principles? Reliance on easy to administer taxes is costly for developing countries for several reasons. From the stabilization point of view, a tax system should be composed of one or at most several predominant taxes with a rate schedule that can be adjusted quickly and with a high degree of certainty to alter the amount of purchasing power available to the private sector. From an efficiency point of view, a good tax system is one that leads to the least distortion of relative prices, both the prices facing the consumer and those facing the producer. In some developing countries, many different import and excise tax rates on narrow bases are combined with a variety of exemptions to produce almost random effects on consumer choice and producer incentives; in a number of others, especially the East Asian group, more rational tariff systems have been implemented. Heavy reliance on foreign trade taxes can be singled out as the most undesirable aspect of developing country tax systems with regard to both stabilization and resource allocation. From a stabilization point of view, foreign trade taxes tend to tie government revenue to unpredictable fluctuations of export commodity prices and so aggravate fiscal stabilization problems. From a resource allocation point of view as well, trade taxes have no place in a "first-best" tax structure. The discriminatory nature of trade taxes insures that their use imposes both a production distortion cost and a consumption distortion cost. Import duties, often relied upon for revenue, may lead to excessive effective protection and encourage inefficient domestic industry. Equity goals are also heavily compromised by the tax structure of developing countries. To an outsider, this tax structure may appear to be highly progressive because the rate structure of the personal income tax is often highly progressive. On closer examination, however, the vertical equity of the system is compromised by the fact that the personal income tax collects a relatively small share of total revenue and applies mainly to wage earners whose incomes may be lower than the self-employed. Thus, an apparent vertical equity in rate structure of personal income tax and import duties is negated by a combination of selective administrative and legal exemptions.

With regard to horizontal equity – the principle that those with equal incomes pay equal taxes – the tax structure of the typical developing country is more clearly inadequate. On a broader basis, one can say that selective administration of the statutory tax system discriminates against the modern sector of the economy. The modern sector tends to fall into the income tax net because it keeps better accounts, is more centralized, and thus more revenue productive from the point of view of the tax collector. Although a heavier burden of taxation on the modern sector may be appealing on equity grounds, one should bear in mind that such a strategy tends to impede the growth of the dynamic sector that may be the key to more rapid long-term growth of the economy.

HOW CAN TAX ADMINISTRATION IMPROVE TAX STRUCTURE?

Given the fact that tax structure is flawed in developing countries, one may ask what can tax administrators do about it. One should recognize at the outset that tax administration is "endogenous" to LDC economies. Tax administration cannot be changed in the same manner that one can change the exchange rate – tax administration reflects basic social and economic conditions such as literacy, income distribution and attitudes toward government authority, and therefore cannot be altered overnight. Some of the difficulties facing the tax administrator follow from objective characteristics of LDC economies: large agricultural sectors, often with many small holders; and in urban areas many small enterprises and a low standard of formal accounting. These characteristics, which make taxation difficult, must be taken as given by the tax administrator since they cannot be changed in the short or even medium term.

A second set of problems refers to the "supply side" of tax administration. Typically, tax administration offices are understaffed and ill equipped to deal with sophisticated oppo-

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nents such as foreign multinationals, not to speak of domestic professional and self-employed taxpayers. These difficulties need not be taken as given, since the supply of tax administrators could be upgraded in the foreseeable future by training, higher salaries and more budget allocations to tax collection. A third set of difficulties deals with attitudes of taxpayers and tax authorities. In many developing as well as advanced economies, informal contacts replace the rule of law – the political will to enforce collections does not exist. This subjective barrier to effective tax administration may be the most important and most difficult to change. However, it would be a counsel of despair to assume that attitudes cannot be changed by a combination of forceful leadership and new technology. In fact, tax administrators in developing countries are making progress in 2 fundamental directions – first, in changing their tax structures in a desirable direction, and, second, in learning to collect more revenue from taxes that already exist.

CHANGING TAX STRUCTURE: REFORM OF THE PERSONAL INCOME TAX

Of all taxes the personal income tax is one of the most difficult to administer. The final amount paid should take into account the unique circumstances of each taxpayer. This amount includes a determination of different sources of gross income – including wages, interest and dividends as well as such difficult-to-calculate items as capital gains and imputed rental of owner-occupied residences. Typically, subtracted from gross income are personal exemptions, followed by a variety of deductions from income to arrive at a net taxable income. In addition, tax credits may be subtracted from the tax liability itself. Deductions from gross income and/or tax credits may be designed to encourage diverse social, political and charitable goals. The amounts set for personal exemptions and other deductions in effect determine the threshold of income at which taxpayers begin to pay. Beyond this threshold the rate structure of the tax must be set. In principle, the personal income tax is the "fairest" tax because it can be fine-tuned to an individual's ability to pay. The personal income taxes of developing countries were often modeled after European or North American legislation – they assumed an effective tax administration with audit and enforcement capabilities, literacy among taxpayers and a degree of voluntary compliance. In addition, personal income tax legislation transplanted to developing countries reflected the emphasis on equity in designing the personal income tax. The effort to fine-tune the tax to the ability to pay resulted in complicated provisions of the tax base and numerous allowances and tax credits; the threshold at which the tax began to bite was often at a low level and rates were steeply progressive.

As might be supposed from the above, the "real" personal income tax in developing countries was very different from that existing in the legislation. Withholding taxes assured revenue from wage-earners in the formal sector, but most other types of income went virtually untaxed. In recent years a worldwide trend toward lowering personal income tax rates and broadening the tax base has received a great deal of attention in industrial countries. The argument for lower rates is often cast in the form of efficiency arguments – raising incentives to work by lowering marginal tax rates. In developing countries a similar movement has been taking place, but arguments for reform are equally based on considerations of administration and equity. From the administrative point of view the low threshold of the income tax leaves revenue departments burdened with large numbers of low income taxpayers, contributing little in revenue but demanding a high work load from the administration. A fundamental reform is to give up the idea of the personal income tax as a mass tax, and instead reserve it for relatively well-off taxpayers, thus exempting most of the taxpaying population from paying the tax. This can be accomplished by setting a relatively high threshold for the tax. A second reform is to broaden the base of taxation by eliminating the many complicated allowances and deductions. Combined with lower rates of taxation and efforts to collect from income other than wages, the tax should then have the attribute of horizontal equity – the principle that taxpayers earning equal income should pay equal taxes.

Jamaica is an example of personal income tax reform.[5] The country had inherited a complicated tax that excluded several elements of gross income so that the base of the tax was narrow. Instead of a simple standard deduction, the legislation included a maze of 16 tax credits that could be deducted from the tax liability – the purpose of the credits ranged from personal allowances to stimulation of savings, home ownership and even employment of helpers in the home. The threshold of the tax was low and the rate structure steeply progressive – the highest marginal rate of 60% was reached at the income level of 3 times per capita GDP. In practice, the tax was only collected effectively from wage earnings in the formal sector of the economy – the self-employed largely evaded the tax. Thus, horizontal equity was non-existent, and the apparent progressivity of the tax was negated by the fact that upper income Jamaicans could avoid or evade the tax much more easily than those with lower incomes. The tax reform aimed at simplifying the tax, minimizing adverse incentives to work and to save and introducing a greater horizontal equity. The 16 tax credits were replaced with a standard deduction equal to 2 times per capita GDP; the base of the tax was broadened by including interest income and reducing non-taxable allowances, and the steeply progressive structure was replaced by a flat rate of 33⅓%. Only 10 to 20% of the population would pay income tax because of the relatively high standard deduction. In essence, the Jamaica reform involved giving up any attempt to use the personal income tax as a mass revenue tax and changing it instead to an equitable tax on those earning relatively high incomes with a rate low enough not to impair work incentives.

THE CORPORATE INCOME TAX: CAN IT BE REFORMED?

Like the personal income tax, the corporate income tax in developing countries was modelled after its counterpart in industrial countries. Again, the complicated provisions of the tax have not been administered in practice. The corporate income tax depends on defining net profit, an elusive concept because it involves sophisticated measurements of depreciation and valuation of inventories. In addition, most developing countries include such measures as accelerated depreciation and investment credits, adding to the confusion. Finally, investment codes are designed to attract foreign investment; they grant tax holidays, loss carry-overs and exemption from import duties. Many developing countries are at a loss to administer the complicated legislation applying to domestic and foreign enterprises. For foreign multinationals, the concept of net profit is further complicated by issues of transfer pricing and decisions about how much profit could be said to originate in the developing

5. For an examination of the Jamaican tax reform, see Bahl, R., *Bulletin for International Fiscal Documentation* 1 (1990) at 37.

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country. In fact, as noted above, the corporate income tax for many developing countries simply involves payment of a "reasonable" sum as agreed upon by the government and the tax authorities.

As for reform, little progress has been made in comparison with reform of the personal income tax. A cash flow tax has been suggested as a means of getting rid of the complicated problems of valuing inventories and deciding on a concept of depreciation, especially in an inflationary climate. However, such a tax has not gained acceptance in either industrial or developing countries. As a straightforward administrative expedient, some Francophone African countries have set a minimum tax on corporate gross sales, thus getting around defining the concept of net profit. However, this alternative introduces a degree of arbitrariness and non-efficiency into the tax system. The treatment of foreign multinationals remains unsolved, and little progress has been made in reforming or even monitoring investment codes. Thus, while corporate income taxes yield a good bit of revenue for developing countries, reformers have not had much success in making them economically or administratively rational.

CONSUMPTION TAXES: AN ANSWER FOR DEVELOPING COUNTRIES?

We have noted above that direct taxes – especially the personal income tax – are difficult and expensive to administer. Rather than attempt to enforce a comprehensive income tax, many developing countries have instead turned to taxes based on consumption for their revenue needs. Unlike personal income taxes, indirect taxes on consumption do not attempt to fine-tune the tax liability to fit the unique status of each individual. However, they have served well as a mass revenue tax and can be combined with the kind of personal income tax described above to produce a tax system that is roughly equitable while providing needed revenue. Of taxes based on sales or consumption, the value added tax (VAT) is considered economically desirable because it can be broad-based and neutral with respect to the allocation of resources while at the same time encouraging savings. During the last 2 decades, the most important innovation in the tax systems of developing countries has been the introduction of VAT. In 1970, only Brazil and Uruguay among developing countries had a VAT through the retail level. Now, 22 developing countries have such a tax, and others have a simplified VAT extending through the manufacturing stage. Chile can be cited as an example of the revenue potential of the VAT. The Chilean VAT has a broad base, with almost no exemptions, and a standard rate of 20%, recently reduced to 16%. For the year 1987, VAT collections accounted for approximately 8% of GDP after refunds. This ratio of VAT to GDP collections is much higher than the ratio observed in other Latin American countries and in fact is among the highest in the world. Between 1979 and 1987, VAT collections in Chile increased by 30%, showing that it can be an elastic tax which exceeds the growth of GDP.

Administrative considerations have exerted considerable influence on the structure of VAT in developing countries, despite the seeming "self-enforcing" nature of the tax. This "self-enforcing" aspect of the VAT is based on the fact that under the commonly used invoice system of administering the VAT, a taxpayer at any stage in the production process credits his tax paid on the prior stage against his own collection of VAT. The difference is paid to the government. In theory, each taxpayer should have a strong interest in proving that VAT has been paid at the prior stage – hence the self-checking nature of the tax. Although economists have been intrigued with this self-checking mechanism, the tax in practice is far from self-enforcing. Evasion occurs because at the retail stage the consumer has no incentive to be sure that the tax has been paid at previous stages and, in addition, taxpayers have a common interest in avoiding the tax altogether. Evasion of VAT in Chile has been estimated at about 11%, but it is certainly much higher in other Latin American countries and elsewhere.

How can a VAT be successfully administered in developing countries?[6] An important requirement for successful VAT administration is to structure the tax to minimize problems of implementation. From the administrative point of view, a single rate is highly desirable; if necessary, the VAT can be supplemented with selective consumption taxes to reduce regressivity. Exemptions complicate VAT administration because the distinction between what is exempt and what is taxed is often tenuous or arbitrary. Nevertheless, distributional objectives have led many countries to exempt basic commodities. The level of the standard VAT rate is a contentious topic – some tax officials claim that standard rates of 18 to 20% are unenforceable in developing countries. They argue that high VAT rates provide such strong incentives for evasion that the scant administrative resources available in developing countries cannot cope with enforcement. Such arguments were apparently accepted by Peru, which reduced the standard VAT rate from 18% to 11% in 1984 and then to 6% in 1986. However, developing countries such as Brazil and Chile have had considerable success in applying relatively high rates. In discussing the level of the rate, it should be borne in mind that in developing countries a substantial proportion of VAT revenue is collected from relatively few enterprises. Thus, a cut in the VAT rate may do little to improve compliance and instead result in a revenue loss.

A significant proportion of evasion of VAT stems from small businesses. They are much more numerous in developing than in industrial countries, the owners are less literate and use less sophisticated business methods. Since small taxpayers in developing countries could not comply with the normal requirements for the VAT, a number of different expedients have been devised to deal with them. In Costa Rica, all taxpayers are subject to a turnover tax in lieu of the VAT. Other countries, such as Mexico, apply a lump-sum tax which may be graduated according to turnover for taxpayers with yearly sales under a certain limit. In Chile and Korea, taxpayers may deduct taxes paid on their inputs from the lump-sum or the special turnover tax. Another method for dealing with small taxpayers is to require their suppliers to add a notional tax to the price they charge, in lieu of the VAT, that the small enterprises would otherwise be required to pay (e.g. Argentina).

In sum, the experience of developing countries shows that a variety of methods of dealing with small taxpayers is in use and all methods present technical and practical problems. Most developing countries have abandoned the search for truly equitable solutions for small taxpayers and instead turned their attention to ways of pulling into the regular system those taxpayers masquerading as "small" who actually are not. In some countries, any special method for small taxpayers has, in practice, been virtually abandoned, whether because it is too complicated to administer (Peru),

6. See Casanegra de Jantscher, M., "Problems of Administering a Value-Added Tax in Developing Countries", *International Monetary Fund*, WP/86/15.

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or because taxpayers are not complying with it (Argentina). From the point of view of tax administration, the best method of dealing with small taxpayers may be to exempt the truly small ones and require all others to comply with the regular VAT system. Less sophisticated taxpayers should be allowed to keep simplified records and perhaps pay the tax bimonthly or quarterly, but otherwise be subject to the normal system.

USE OF COMPUTER TECHNOLOGY

So far, we have discussed how changes in tax structure (i.e. reform of the personal income tax and introduction of a VAT) can make a tax system easier to administer as well as serving economically desirable goals. Other methods to improve tax administration have also been found, including the use of new technology. Over the past decade computer technology has become an integral part of tax adminstration operations in many developing countries.[7] This technology has an obvious capacity to perform more rapidly such routine tasks as processing forms, compiling statistics and using available data more effectively to improve forecasting of fiscal revenues. However, a careful distinction should be made between the ability of computer technology to perform routine tasks more rapidly and its ability to actually increase revenue collections. After an initial period of overoptimism in the 1960s and 1970s, it has become clear that computer technology is not a panacea for revenue administrations. Computer technology must be combined with the political will to enforce tax collection if it is to yield potential for greater revenue. Technology without accompanying enforcement procedures will not help in increasing revenue.

Given these caveats, how can computer technology help improve tax administration? A central idea is the development of a master file system. The system assigns a unique number to each taxpayer, often the social security number. This unique number directly aids in identifying, assessing and collecting direct taxes, such as the personal income tax, the corporate tax and the property tax. In addition, information relating to the taxpayer such as value of imports or gross sales, can be stored together with his unique number. In this way, the master file can become an important instrument for audit. If the taxpayer identification number is tied to other means of identification, such as a driver's license or passport, it also can be a potentially powerful means of tax enforcement.

In Fiji, major processing problems and backlogs relating to the individual and corporate income taxes were discovered. They were resolved when a computer master system was established for individuals and corporations. Computer assistance was used for income tax returns, processing and refunding tasks. The computer system also enabled assessors, clerical staff and audit personnel to devote more time to audit and enforcement activities, including personal contacts with delinquent taxpayers who were identified by computer processes. In sum, a reliable taxpayer master file system had been established, and was effective in contacting delinquent filers, performing mathematical verification of tax return data, identifying errors and issuing assessment notices and refund checks. In addition, refunds were being computer-control led and applied to outstanding prior year arrears.

PRESUMPTIVE TAXATION

Presumptive taxation may be defined as the use of approximate indicators of income, property or other tax bases, as opposed to actual records.[8] Presumptive methods are especially appropriate in developing countries where conventional records may not exist and "hard-to-tax" groups, such as small retail establishments, self-employed professionals and farmers, make up a large part of potential taxpayers. Use of presumptive taxes for such groups helps to establish horizontal equity, i.e. the principle noted above that equal incomes should be equally taxed. Presumptive taxation may also contribute to efficiency, since the use of average indicators rewards above average effort.

Among industrial countries, the forfait system of France and the *tachshiv* in Israel are long-standing examples of presumptive methods. Several developing countries use net wealth as a base or indicator for estimating net income when auditing taxpayer returns. Argentina's tax laws, for example, provide that the amount of capital invested in an enterprise is one of the factors that can be used to estimate its income. In Chile, when conventional records are not available to assess the income of an enterprise, its income is presumed to be equal to 10% of total tangible assets. In taxing the agricultural sector, authorities have used the value of agricultural land as a basis for presuming income. Again in Chile, when conventional records are not available, farmers are presumed to have an income equal to 10% of the assessed value of their farm. Colombia uses a very comprehensive presumption method, also based on net wealth. As mentioned above, a presumptive tax that is used as a minimum payment for the corporate tax on net profits is a tax on gross receipts. It is relatively easy to administer and effective in yielding revenue.

OTHER TAX STRATEGIES

What other tax strategies have been used to improve revenue collection in developing countries? A number of ideas have been offered, some of them falling under the "gimmick" category. Before discussing strategies that work, it may be well to dispose of the gimmicks. These include:

1. Draconian punishments that cannot be enforced

Under this heading might come such proposals as sending tax evaders to prison. Such a solution goes against a sense of justice that says in some sense the punishment should fit the crime. Draconian punishments for crimes that are committed by many people and for criminals that are caught by random methods will not work.

2. Interlocking tax schemes

Economists since Kaldor have been intrigued by the idea of interlocking tax schemes through which underpayment or non-payment of taxes would be revealed. Kaldor suggested that 5 taxes (on income, capital gains, wealth, personal expenditure and gifts) would be filed by all taxpayers in a single comprehensive return and assessed simultaneously. The taxes are self-checking, i.e. concealment or understatement of items in order to reduce liability in a particular tax would increase liability in other taxes; and information furnished by a taxpayer in order to prevent over-assessment of his own liabilities automatically reveals the receipts and gains made by other taxpayers. Even if put into operation, the proposed system would not prevent evasion in cases in which both parties to a transaction omit it from their records or understate its amount. A more fundamental criticism is

7. See Corfmat, François, "Computing Revenue Administrations in LDC's", *Finance and Development* (September 1985).
8. See Casanegra de Jantscher, M. and Tanzi, V., "The Use of Presumptive Income in Modern Tax Systems", publication forthcoming.

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that the scheme in effect solves the problem of tax administration by assuming it away. Such schemes rely on the voluntary and accurate filing of tax information – they assume that gathering information is the equivalent of collecting taxes.

3. Declaring an amnesty period to encourage payment of taxes owed

Tax amnesties are opposed by most tax administrators. Amnesties appear to be a sign of weakness as opposed to strong enforcement measures. Although amnesties may yield temporary revenue windfalls, experience shows that after a tax amnesty compliance is generally low, as potential taxpayers await another amnesty.

STRATEGIES THAT WORK

In contrast to the above, tax administrators have found successful solutions including the following.

1. Withholding

This procedure is most commonly applied to wage income, although some countries also use it for taxes on interest and dividend income. For a withholding scheme to be successful, there must be a relatively small number of easily identifiable payers of income. Thus, withholding will work for wages, dividends and interest income, but is not appropriate for rental income, income of self-employed professionals and income from small businesses.

2. Frequent reporting and payment

Where inflation is high, significant lags between taxable assessments and actual payment of taxes can reduce tax payments in real terms; in these circumstances it can be an advantage to taxpayers to become debtors of the government. Uruguay, where monthly inflation rates in 1987 were about 4%, has taken steps to counteract this: VAT, excise taxes and advance payments of the income and net wealth taxes are collected in a manner that reduces payment lags.

3. Simplifying payment procedures

Payment procedures can be simplified, for example, by letting taxpayers pay at banks, rather than at a single overburdened tax office. In many Latin American countries, internal taxes are collected through the banking system; banks also receive returns.

4. Strengthening auditing

Auditing is a vital but neglected function. Tax administrators often employ resources for checking refunds from withholding schemes rather than going after the more difficult but higher revenue yields that would come from aggressive auditing of self-employed, professional and business firms. If significant numbers of taxpayers have stopped filing returns, and if large numbers of firms show suspiciously small profits, there is a need for more audit. Measures to strengthen auditing capacity include hiring and training new auditors, cross-checking information from large taxpayers on income tax and VAT returns, and for those who voluntarily accept auditors' assessments, reducing penalties that would otherwise be paid for non-compliance. In Colombia, a new system is being established whereby fines and penalties are reduced if taxpayers immediately accept auditors' preliminary assessments; penalties are progressively increased for those taxpayers who appeal and fail.

SUMMARY AND CONCLUSION

This article has examined the strategy and tools of tax administration in developing countries. The traditional aim of tax administration is to assess, collect and enforce a given set of legislation. The task of tax administrators in developing countries, however, is not so clear-cut. Burdened with legislation that may not be enforceable, they must decide how statutory laws will actually be applied. We also noted that emphasis on easy to administer taxes results in a flawed tax structure, based in large part on foreign trade taxes. Although tax administrators cannot change legislation that would improve the effective tax structure, they can help implement and/or make possible changes in legislation that would improve the effective tax structure. These efforts would be aimed at implementing more broadly based income and consumption taxes in order to reduce dependence on foreign trade taxes.

Given this overall strategy, what are some of the specific solutions that can be used to improve tax administration in developing countries? Three solutions that overlap are the use of withholding, an emphasis on indirect taxes such as the VAT and the application of computer technology. Withholding is applied most successfully to wages, interest and dividends, for which the number of payers of income is small relative to the number of receivers. Computer technology makes it possible to gather related information on a given taxpayer and to use cross checking methods to ensure accuracy. Finally, presumptive methods of assessment have been used to gain added revenue while simplifying administration. All these solutions serve the underlying goals of simplicity, equity and neutrality.

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INTERNATIONAL:

Tax Changes and Economic Development

A Critical Review

Mahmoud Yousefi and Sohrab Abizadeh

I. INTRODUCTION

Among the many common characteristics of Less Developed Countries (LDCs) one may include low standards of living, low levels of productivity, high rates of population growth, high and rising levels of unemployment, interdependence in international relations, etc. Low standards of living are evident by low levels of per capita income. Not only are living standards low in underdeveloped countries, but there is also a manifest growing gap between the rich and the poor. Low living standards are directly linked to low levels of labor productivity. This in turn is attributed to many causes, including the absence or severe lack of "complementary" factors such as physical capital. Basically, investment and capital resources may be mobilized through domestic channels such as saving. Other alternatives include measures such as accepting foreign assistance (perpetrating inflation) and raising taxes. A thorough analysis of tax structure change in LDCs helps us understand their development efforts.

In the last 3 decades, interest has increased, theoretically and empirically, in the construction of tax systems and tax structure changes. Certain observers, for example Hinrichs (1966) and Musgrave (1969), have noted that the more developed countries (DCs) are characterized by a higher ratio of tax revenues to national income than LDCs. Others have questioned the association of tax revenue and national income for LDCs at various stages of development.

Why are we so concerned with tax structure change in the course of economic development? Hinrichs (1966) observes that during development LDCs face an expenditure-revenue gap. The main causes of the gap are as follows. First, according to Deutsch, a political scientist, the rate of social mobilization exceeds the rate of adjustment capabilities. The outcome "is a strain on social organization" and a corresponding increase in demand "for government services that cannot yet satisfactorily be met by government" (Hinrichs p. 48). Second, conventional economic growth theory requires "a shift in saving, say from 5 to 12% of GNP that cannot be met by private or public saving without either inflation or external borrowing" (Hinrichs p. 48). Third, there is a changing role of government consonant with "Wagner's general theory of rising government expenditure with the socio-political lag in increasing ... tax rates and in shifting tax base ..." (Hinrichs p. 49).

The implication of an expenditure-revenue gap is that it "may be filled by internal and external borrowing or grants. If not, the gap may result in some degree of inflation ..." (Hinrichs p. 49). In order to hasten closure of the gap, tax rates may be increased and/or the tax base may be broadened. Further, society's saving ratio may be altered through government's tax and expenditure policies. For instance, the government can affect the propensity to save by altering income and consumption-related (indirect) taxes. In the same vein, it can affect the level of investment by altering (or introducing) a system of profit taxes.

Because capital accumulation is a major concern of many LDCs, an important consideration in public finance is a system of fiscal policy design which promotes that objective. Development economists who address the issue of tax structure change, implicitly assume that LDCs aspire to development (erroneously treated the same as economic growth). These economists argue that in order to ensure a desired rate of growth, LDCs must enhance their productive capacity. Therefore, capital accumulation is a necessary ingredient of the growth objective. However, there are many obstacles to raising the level of private saving. They include such things as low levels of income, demonstration effect, political misgivings, and so on. Yet, national saving may be mobilized and its growth secured if it is increased compulsorily by raising taxes, thereby reducing consumption. In other words, "taxation becomes a form of saving and involves postponement of consumption.

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port competing sector replaces imports in response to a deliberate policy of import substitution. Since taxes on imports are replaced by internal indirect taxes, foreign trade taxes are either stable or falling. In this phase, modern taxes are brought to the forefront so that by the end of this phase these taxes constitute 20-40% of total revenue.

Upon emergence of modern society, the government revenue share of GNP is about 20-35%. In this stage, modern taxes replace traditional taxes and modern direct and internal indirect taxes become predominant. In this stage, tax styles are not so much shaped by economic considerations as they are by the socio-political considerations. In essence, the socio-political ideologies and traditions will tend to become more important than economic structure in shaping the nature of the tax system" (Hinrichs (1966) p. 93).

Can we generalize from these theoretical considerations? Generalizations about tax structure change seem to be difficult in view of many countries, many time periods and a myriad of exceptions. Hinrichs ((1966) p. 97) contends that "even though tax structure change during development may seem to resemble a multi-colored tapestry, ... a general theoretical pattern does emerge". This pattern may be considered an "ideal type" which is not "a system that must follow for all cases under all circumstances". Instead, "it is a heuristic device that establishes ... a framework in which to fit disparate pieces".

III. EMPIRICAL EVIDENCE

The objective of empirical analyses of tax ratio changes is the qualification of determinants of tax effort. This is a useful pursuit since it enables the policymaker to estimate the effect of changes in variables that affect taxes. However, according to Andic ((1973) p. 155) these analyses are "very seldom carried out in a macro-economic sense, in checking the correspondence of a tax system, ..., to the development objectives ..." Instead, these analyses are "carried out in a global sense, ... in that inter-country global tax ratios and performances are compared and related to global proxy variables such as per capita income, the degree of openness..." As another observer (Tanzi (1973)) points out, most of the statistical studies are contradictory. They try to

The problem then becomes one of ability to postpone current consumption" (Musgrave (1969) p. 161). Raising the level of domestic saving through budgetary policy avoids the complications alluded to earlier. Revenues raised this way accommodate development objectives so long as they are not used for government expenditure on defense, social services, etc. Please ((1967) p. 25) points out that this preoccupation with raising revenue through taxes was so significant "in the eyes of many people and institutions interested in economic development that the ratio of tax revenue to gross national product (GNP)" became exceedingly "important criteria for measuring and judging a country's economic performance."

Consequently, if the objective of tax policy is to maximize tax yield, the logical question is what system of tax design would satisfy that objective. One way to ensure an automatic increase in the ratio of government revenue to GNP (or GDP) is to design a tax structure in which the marginal ratio exceeds average ratio, i.e. a progressive tax system. At the same time, the disincentive effects of such a tax structure should not be ignored. On practical grounds, there are limitations to the scope of progressive taxes in LDCs. The preceding statements explain the dilemma of developing countries in designing a tax system which will provide adequate resources for growth purposes, while not inhibiting (or distorting) incentives in the private sector.

II. THEORETICAL FRAMEWORK

Many economists have addressed the problem of tax structure change and economic development. Musgrave (1969) and Hinrichs (1966) have provided much of the theoretical framework, while others have presented the bulk of empirical evidence. In this section, a brief summary of discussions put forth by Musgrave and Hinrichs will be presented.

Musgrave suggests that there are 2 ways in which economic factors affect tax structures. First, as economic development takes place, "the nature of tax base changes ..." and concomitantly "the 'handles' to which the revenue system may be attached." Second, "the economic objectives of tax policy vary with the stages of economic development, as do the economic criteria by which a good tax structure is to be judged" (p. 125).

In the early stages of development, the economic conditions impose severe limitations on the structure of the tax system. Since agriculture is the predominant form of economic activity and it is extremely difficult to reach this sector through income taxation, Musgrave stresses the importance of land taxes. In the manufacturing sector, the effective tax base is limited to a few selected products of large establishments. It is possible to increase the revenue base through the pricing policies of public enterprises. In the early stages, the effectiveness of personal income is "limited to the wage income of civil servants and employees of large firms" (p. 127). Since the determination of business income is exceedingly difficult, business income tax becomes, in effect, "a sales tax, with ad valorem rates varying with the average margin of the industry" (p. 127).

In later periods, it becomes possible to impose income taxes on a broader base, thereby allowing the effective taxation of personal as well as business income. The implication is that the prospects for an increase in the share of direct taxes improve with economic development. Drawing from the experience of the United States and other industrialized countries, Musgrave suggests that the development of tax structure change in modern times has been characterized by the rise of direct taxes, especially income taxes. Further, the U.S. experience suggests that over time a larger fraction of population has fallen within the purview of income tax coverage. Concomitant with the rise in importance of income taxes, there has been a decline in the importance of property taxes in the United States and the United Kingdom. Similarly, sales and excise taxes have declined in relative importance.

Hinrichs (1966) is more ambitious than Musgrave. He proposes a "general theory" of tax structure change and purports "that his empirical analysis reveals an 'ideal type' of tax structure for each level of economic development" (Tanzi (1975) p. 200). His analysis is carried out in 2 broad parts. The quantitative part "attempts to prove ... that the tax burden defined as the ratio yield to gross national output, is on the whole lower in the less developed countries than in the developed countries, and that it is lower in the less developed countries than what it ought to be" (Andic (1973) p. 157).

In his empirical generalizations, Hinrichs stresses the importance of "openness" as the major determinant of government revenue share of GNP. "'Openness' is one of the key determinants of both the size of the government revenue share and its composition" (Hinrichs (1966) p. 98). There are several reasons for the importance of "openness". First, foreign trade is the chief source of revenue for over two-thirds of LDC governments. These revenues are derived from import duties, taxes on exports, government market-

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ing board arrangements, and so on. Second, foreign trade is the sector through which the ability to collect taxes permeates the economy. In Hinrichs' words, "there is a spill over effect of the foreign trade sector size on ability to collect taxes elsewhere in the economy. The greater the size of foreign trade sector, ... the greater the degree of monetization of the economy, the predominance of 'cash' crops ..., and the extent of urbanization and industrialization" (Hinrichs (1966) p. 20).

Hinrichs' empirical analysis leads him to the following generalizations. First, for the LDCs with a per capita income of less than $ 300, "openness" rather than per capita income is the major determinant of government revenue share of GNP. Second, for per capita income in the $ 300-$ 750 range, there is a strong positive relationship between government revenue share and per capita income. Finally, a government revenue share of 18% is necessary, though not sufficient, for a high level of development (i.e. per capita income in excess of $ 750).

Recognizing that the government revenue share of GNP increases with economic development, Hinrichs, in the theoretical part of his analysis, identifies the arrival of different types of taxes at different stages of development. For instance, in traditional societies where "... trade, commercialism, and urbanization have not developed to any great extent," government revenues are derived from such traditional sources as taxes on land, livestock, water rights, poll taxes, tithes, and so on.

The next stage is the transitional stage which consists of 2 phases. In the first phase, old values begin to crumble; government becomes consolidated and centralized, and money, trade and transport develop. In this phase, revenue is obtained by taxing trade and the rising mercantile group. Gradually, traditional sources of revenue lose significance "and are in part replaced by indirect taxes in general and foreign trade taxes in particular" (Tanzi (1975) p. 200). In the second phase, the country has achieved political consolidation and the government has gained dominance "over the regional landed interests, and the spirit of nationalism predominates" (Hinrichs (1966) p. 93). In this phase, the im-

explain "statistically how a particular tax (or often a group of taxes) changes in a cross-section sample when one varies per capita income or ... other variables such as monetization ..." change (Tanzi (1973) p. 199).

To date there have been several empirical studies designed to illuminate the process of tax structure change and economic development. It is generally argued that as development proceeds, the government revenue share of national income rises (for details, see Hinrichs (1965)). This increased share is accommodated by increases in taxes which rise faster than income and by changes in the overall composition of taxes. In other words, as development takes place, the concomitant changes in the commercialization of the economy, urbanization, modernization, etc., imply that more taxes are levied and collected. Also, the type of taxes imposed changes. For instance, sales and excise taxes gain at the expense of foreign trade taxes. In addition, personal and corporate income taxes come into more prominence (for evidence, see Chelliah (1971), Chelliah (1975) and Thorn (1967)).

Usually, in the literature of tax structure change and economic development, it is argued "that high per capita income levels lead to high tax ratios because of both the correspondingly high capacity to pay taxes and high income elasticity of demand for public goods" (Chelliah (1971) p. 280). Using per capita income as an explanatory variable of revenue/tax ratio changes, however, poses a problem recognized by Bird. In such an analysis an identification problem is involved because "income is surely as much a 'demand' as it is a 'supply' factor ..." (Bird (1978) p. 43). The identification problem is particularly serious if an extended time-series is used.

Attempts to formulate policy prescriptions through studies of tax ratio differences and changes in tax components have taken different forms. Many scholars have tried to determine the relationship between tax structure changes and the process of development. We will try to critically discuss some selected studies below. Martin and Lewis (1956), for instance, compared the revenues and expenditures of 16 countries at different levels of economic development. Their objective was twofold: first, to delineate patterns of expenditure and sources of revenue with respect to stages of development, and second, to portray patterns of taxes and expenditures most appropriate to various levels of development.

It is very simplistic to infer from such statistical relationships that a growing trend in tax ratios reflects economic development. One would need to pay close attention to the structure of tax systems as well as the underlying conditions of development. For instance, it is important to know how the fruits of economic progress are divided among the population of a country.

Based on evidence obtained for selected developed countries and less developed countries, Oshima (1957) found a direct link between the percentage share of government expenditure in gross domestic product and the degree of economic development. He argued that an explanation for the link may be found in the relative productivity of different countries. The relationship implies that the greater the productivity, the larger will be the relative margin of incomes above strictly physical subsistence levels and the larger this margin, the greater, generally speaking, the potential taxable capacity of the economy.

Oshima's position, though intuitively appealing, suffers from several difficulties. First, there is no reason to believe that there is a one-to-one relationship between taxable capacity and government's share of GDP. The latter may be relatively high, even in the absence of a concomitant change in taxes collected. Government expenditures may be financed in ways other than by changing tax rates. In industrially advanced societies, for instance, it is not unusual for governments to finance certain projects via deficit spending. In LDCs, occasionally, programs are carried out through inflationary finance.

Second, tax capacity and actual taxes collected are not the same thing. Witness, for instance, the share of taxes in GDP for many oil rich countries. In the past decade the share of all taxes, direct and indirect, in GDP not only did not increase for many OPEC countries, but it declined.

Third, the cause and effect relationship in the tax-GDP link is not clear. For instance, is the high share of government in GDP due to high tax rates or vice versa? Musgrave (1969), among others, has amply demonstrated the adverse influence of high tax rates on investment, production and work effort.

Finally, taxable capacity may be constrained by inadequate and inefficient fiscal machinery such as unskilled tax agents, rudimentary methods of recordkeeping, and wholesale tax evasion because of tax "loopholes". Also, in many LDCs, tax efforts are subverted in response to political power of the property owners. Clearly, in the absence of some changes in social, economic and political institutions within LDCs, adoption of corporate income taxes and capital and

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wealth taxes, without wholesale evasion, would seem impractical and unlikely.

Hinrichs (1965) questioned the findings of previous studies and tried to present a "better" explanation for tax changes using a multiple regression analysis of 60 different countries. The time period for which data were collected was 1957-60. Hinrichs' implicit assumption was that per capita income is reflective of economic well-being. However, if indices other than per capita income explain tax ratio changes more satisfactorily, the validity of the conclusion that tax ratios (taxes/GDP) are related to states of development (as reflected in per capita income) would become less meaningful. Hinrichs himself states that: "... 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 best or worst just plain wrong" (Hinrichs (1965) p. 564).

Hinrichs (1966), in a more thorough study of taxes, attempted to deal with both tax ratio and tax component changes within the course of economic development. The objective was to identify the sources of government revenue and find its relationship to GDP (or GNP). Based on his study, Hinrichs accepted the hypothesis that there exists a direct relationship between total tax ratio and the degree of economic development. Hinrichs further suggested that, in developing countries, tax level differences are correlated to some extent to the "degree of openness" measured by imports as a percentage of GNP. However, while Hinrichs listed a few possible reasons for his findings, he did not offer much empirical support for his reasoning. Abizadeh (1979), however, provided support for the general theory of a direct relationship between total tax ratio and the degree of economic development.

Musgrave (1969) presented a series of bivariate regression equations (a cross-sectional view) to substantiate his arguments regarding tax structure change and economic development. Concerning the share of indirect taxes, he proposed 2 hypotheses. First, the ratio of indirect taxes (T_{id}) to total taxes (T) is inversely related to per capita income. This is expected since the economic structure of low income countries is not suited to the imposition of direct taxes. Further, indirect taxes (including customs duties) can be imposed more readily. Second, the ratio T_{id}/T is positively related to "the T/GNP ratio, or to the overall level of tax rates. The proposition is that direct taxes are ... resorted to increasingly after direct tax rates have reached higher levels" (p. 149). The empirical evidence vindicated the first hypothesis. However, the second hypothesis was not borne out by evidence.

Lotz and Morss (1970) tried to overcome this difficulty in their study. They claimed to have given detailed consideration to some of the factors likely to affect tax levels in developing countries. The authors arbitrarily chose $ 800 of per capita income as the dividing line between developed and developing countries. The cross-section study by Lotz and Morss contained data on 52 developing countries. The authors chose the export ratio (X/GNP) as a measure of "openness". Lotz and Morss hypothesized that the degree of monetization is measured by per capita money holding. Three measures of money supply used were coins and currency in circulation (C^p), M_1 defined as the sum of C^p and demand deposits (DD), and M_2 defined as M_1 plus time deposits (TD). The authors, in their study, paid some attention to different types of taxes and the degree of centralization of the government. Lotz and Morss concluded that tax levels in developing countries are: (1) importantly affected by the availability of taxable bases; (2) kept down by the limited availability of taxable bases.

Frankly, the foregoing conclusions are self-evident. One need not conduct a large statistical analysis to end up with intuitively obvious conclusions. The study fails to recognize that some countries are more favorably placed (in terms of income) to levy taxes. In other words, some countries simply have a greater taxable capacity than others.

In regard to "openness" we are not just simply interested in secular trends of exports and imports. When dealing with LDCs in particular, one has a keen interest in learning about dynamic changes in export and import composition and changes in the foreign trade sector. Exports could possibly rise and imports fall while a country pursues a restrictive trade policy.

In regard to the monetization process, it is not sufficient to look at some measures of monetary aggregates. We need to pay attention to the development of financial markets. In many LDCs where a barter system prevails in rural areas, simple per capita money holding fails to reflect monetization. Per capita money holdings may rise over time without a concomitant change in the monetization process. One way to overcome this shortcoming is to pay attention to the distribution and composition of money and deposit holding in various sectors of the economy. Abizadeh and Yousefi (1985) undertook a multivariate analysis of tax structure change. Although they recognized the importance of international trade taxes, their analysis incorporated variables other than openness measures. The focus of their study was 2 groups of countries designated as "least developed" (consisting of countries such as Somalia, Malawi, Ghana, ...) and "developing" (consisting of countries such as South Africa, Brazil, Portugal, etc.) countries. Abizadeh and Yousefi concluded that during the course of economic development, the relative importance of international trade taxes diminishes. Further, such taxes play a more important role in the revenue structure of the least developed countries than that of the developing countries. Essentially, the study corroborated the findings of earlier research. Two important features of this study were the grouping of countries as alluded to earlier and the use of PQLI as evidence of well-being of a country.

Chelliah (1971) recognized that the general practice of using the T/GNP ratio, where T is inclusive of all taxes and tax-like changes (e.g. royalties on minerals), has certain problems. For one thing, it "does not indicate anything about the proportion of national output generated in the public sector..." nor does it portray "a reliable index of the relative importance of public sector as a final purchaser of goods and services" (p. 257). According to Chelliah, what the T/GNP ratio measures is the relative share of national income which "is 'compulsorily' transferred from private hands into the government sector for public purposes" (p. 258).

Observing trends for countries included in his study, Chelliah found that there had been a shift from property and poll taxes to taxes on income (in the sphere of direct taxes). From these trends, one may conclude that they "conform to the general theoretical argument ..." (p. 268). However, direct taxes constitute a minor part of total revenues in LDCs. The experience of LDCs suggests that the share of direct taxes does not rise with per capita income until a certain minimum level of income has been reached. Once this threshold has been attained there seems to be a positive relationship between the share of direct taxes and per capita income.

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Conceptually, the tax ratio is affected by 4 groups of factors. There are 2 groups of factors on the demand side for government services. They are: "a) the need for services arising out of 'objective' conditions and b) the preferences of people between public and private services..." Two groups of factors postulated on the supply side are: "a) the ability of people to pay taxes and b) the ability of government to collect taxes" (Chelliah (1971) p. 292).

Usually, each country decides for itself what level of taxes to impose in accordance with its own myriad of considerations. Nevertheless, "policy-makers inevitably make comparisons with the level of taxation and the experiences in other countries in a similar stage of development" (Chelliah (1971) p. 299). The usual approach to the determination of tax effort and tax capacity has been to regress variables affecting tax capacity on the tax ratio. The predicted ratio "is what the country concerned would have had if it had made the average tax effort". Tax effort may be defined as "the quotient of the actual tax ratio divided by the tax ratio estimated according to" the following equation:

$$T/y = 10.05 + 0.0031\,(Yp - Xp) + 0.3973Ny + 0.00881X'y$$
$$\quad\quad (7.48) \quad (0.77) \quad\quad\quad\quad (5.55) \quad\quad (1.89)$$

$R^2 = 0.393$, where T/y = tax ratio (excluding social security contributions), Yp = per capita income in U.S. dollars, Yp – Xp = per capita non-export income in U.S. dollars, Ny = the share of mining in GDP, and X'y = the export ratio excluding mineral exports.

Chelliah ((1971) p. 300) derived the indices of relative tax effort on the basis of the above equation "as well as the actual ratios for 49 countries in the sample ..." Considering the actual tax ratios, only "21 of the 49 countries have tax ratios above average ...." On the other hand, tax effort indices indicate that "roughly about the same proportion of countries ...making above average tax effort...," that is 25 out of 49.

There are some problems with these studies. For instance, as Bird (1978) points out: "the successful measurement of taxable capacity used in these studies depends critically on the a priori justification of the explanatory variables as affecting only taxable capacity and not at all either demands for higher public expenditures or willingness to tax" (p. 43).

Mann (1980), being skeptical of cross-section studies, undertook a time-series analysis of Mexico. He rationalized his own statistical analysis of Mexico's tax structure changes by raising questions about the relevance and validity of cross-section studies. His main objection to this type of study was that it relies on the results generated for a specific point in time and that these results are frequently used to infer past and future trends in the tax structure-economic development relationship.

Mann's time-series analysis of Mexico covers the period of 1895-1975. The rationale is that by concentrating on Mexico for the entire period, the same country is observed over time at different levels of development, thereby obviating one of the principal defects of cross-section studies of this nature.

In his paper, Mann reports the results of 32 bivariate regression equations. In most cases R_f/Y (the share of federal government revenues in GDP), R/Y (the share of government revenues of all levels in GDP), and T/Y (total taxes as a fraction of GDP) separately serves as the dependent variable. Per capita income, sectoral share of manufacturing in GDP, sectoral share of the primary sector in GDP and an index of "openness" separately serve as independent variables. Two measures of "openness" are: imports' share in GDP and the sum of exports' and imports' share in GDP.

The regression equations satisfied all the usual conditions of statistical significance. On the basis of these results, Mann concluded that openness and per capita income have statistically significant associations with revenue/tax ratios. He suggested that his results are consistent with those of cross-section studies. However, he cautioned the reader against generalizations based on time-series analysis. These studies are subject to exceptions which may often be merely a function of time period and/or subperiod selected.

Two important criticisms may be raised against Mann's approach dealt with: (1) the relevance of bivariate regression analyses in view of an extended time period; and (2) the naiveness (or lack of a theoretical basis) of his regression equations. In regard to (1), it should be noted that tax rates do not remain unchanged over time. Also, as time proceeds some new taxes are introduced and certain other taxes are deemphasized. With the passage of time many other changes take place. For instance, the composition of income and population changes. In view of all these changes, the secular time trend of tax ratio overlooks some of the underlying changes in the economy.

In regard to (2), it should be remembered that many factors other than per capita income or imports' share of GDP affect tax ratio changes. Simple relationships linking tax ratios and imports' share, for instance, that fail to take account of crucial and missing variables which may be missing are not very revealing. Further, per capita income growth rates really do not tell us much about economic development or stages of development.

One might ask why there has been so much concern with tax ratios and the determinants of tax effort. Bird (1978) offers 7 distinct reasons (Bird, pp. 34-4). Prest ((1978) p. 15) observes that the inferences drawn from these different studies: "... are that the ratio of taxation to GNP is some sort of national virility symbol, and that they should try to emulate the ratios of developed countries, or, at any rate, that those developing countries occupying low positions in their own league table should try to mend their ways and increase their ratios, so that they are closer to those of the leaders".

By and large, the empirical studies do not tell us whether tax ratio increases are attributed to a) efficiency in tax collection, b) changes in tax rates, c) the advent of new taxes, d) inflation, or e) increased tax bases.

IV. CRITICISMS

The empirical studies to tax structure change do not reveal much about the means of accommodating development objectives. As Carl Shoup ((1972) p. 140) has observed, "too often the information is hardly more useful, directly, than data on the proportion of taxation imposed on inhabitants over six feet in height". Bird (1978) points out "that a great deal .... of the variations in national tax ratios are statistically associated with the shares of agriculture, mining ...." and, though interesting, add little to our knowledge in evaluating fiscal performance.

By and large, a basic problem of studies of this nature is a lack of consensus among economists as to what constitutes economic development. The studies of tax structure change may be susceptible to the same criticisms raised against Rastow's "The Stages of Economic Growth". In the past, it has been customary to look at certain indicators such as the fall in the share of the primary (agriculture) sector, the rise in the share of manufacturing, and growth in per capita income to suggest that LDCs in question have passed

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through certain "stages" of development. It is possible that these changes, however, say something about "economic growth" rather than "economic development". These 2 concepts are "two different, but related, processes which are both counterparts and competitors, depending on the time span involved, and the distinction is important from both theoretical and policy-making standpoints" (Flammang (1979) p. 47). One needs to probe beyond the traditional, and potentially misleading, indicators such as per capita income to see what is happening to unemployment (and underemployment), income distribution, diminution of property, improved health, life expectancy, literacy, etc. Although there is not a complete consensus among development economists as to what constitutes development, Todaro (1985) suggests that "economic development" should be redefined "in terms of the reduction or elimination of poverty, inequality, and unemployment within the context of a growing economy" (Todaro (1985) p. 84). It should be recognized that although a high rate of growth of per capita GNP (or GDP) is necessary for development, it is not sufficient. Recently, a better measure, the Physical Quality of Life Index (PQLI), has been introduced by Morris (1979). The PQLI is comprised of infant mortality, life expectancy at age one, and basic literacy. As Morris points out, PQLI "does not try to measure all 'development'; nor does it measure freedom, justice, security, or other intangible goods. It does ... attempt to measure how well societies satisfy certain specific life-serving social characteristics" (Morris (1979) p. 4). More recently, Abizadeh and Basilevsky have developed a multinational scaling of countries in accordance with the degree of economic development (see also Ram (1982)).

A related problem of empirical studies of tax structure change is the assumption of many economists that a higher tax ratio implies more development. Please (1967) points out that the record of many LDCs in channeling more of "domestic resources into economic development" is depressing. Please cites the examples of India, Sri Lanka and Peru where increases in tax efforts were matched, more or less, by persistent declines in public saving. The tax effort phenomenon is only useful if governments in general, and LDC governments in particular, learn to live by their means. That is, tax effort prescription is relevant if "the government can prevent its expenditure from rising as fast as its income" (Please (1967) p. 27).

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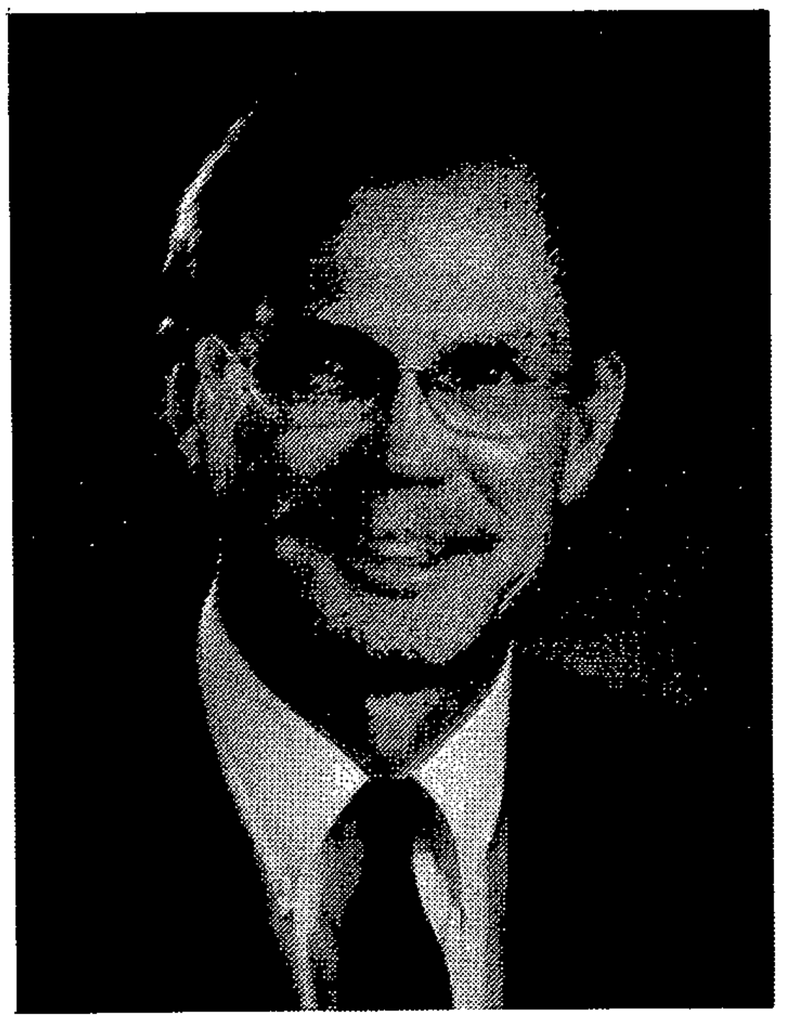
INTERNATIONAL:

United States Anti-bribery and Anti-boycott Legislation of 1977

Looking Back a Dozen Years Later

Michael W. Gordon



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Lord Macaulay wrote that "We know no spectacle so ridiculous as the British public in one of its periodic fits of morality".[1]

It was such a fit of morality that many assumed the United States Congress was having when it enacted in the same year, 1977, the Foreign Corrupt Practices Act,[2] and the Export Administration Act anti-boycott amendments.[3] The former was intended to curtail U.S. corporations from making payments to foreign officials to influence their actions. The latter were intended to stop U.S. persons from assisting the Arab economic boycott of Israel. The moral tone of the laws was generally applauded throughout the world. But a sufficient number of observers echoed Macaulay's thoughts to merit a revisit to these laws to consider how vigorously they have been enforced and their impact on trade, why the Foreign Corrupt Practices Act was amended in 1988, and whether the laws have generated the adoption of similar laws by other nations as domestic law, or by multi-nation organizations as international rules. An initial inquiry shows that there is almost no appellate case law in the United States interpreting substantive elements of these laws, and there has been almost no attention to these 2 subjects in other nations, and relatively little in multi-nation organizations. Most of the commentary on the laws occurred within the first few years after their passage.[4] Little has been written about them since, although the 1988 amendments to the Foreign Corrupt Practices Act will certainly generate some comment this year.

Both the anti-bribery and anti-boycott laws were enacted to address specific international issues involving United States foreign policy. The Foreign Corrupt Practices Act followed the Watergate investigations. Much more than domestic political payments was disclosed. Also disclosed were numerous payments to foreign officials in many countries. They amounted to an estimated $ 300 million, and some payments caused serious disruptions in the governments of several nations, including Honduras and Japan; some unpleasant tension with a friendly, symbolic monarchy in the Netherlands; and alterations in the political balance in Italy. The second enactment, the Export Administration Act *anti-boycott* amendments, nowhere contains either the word Israel or Arab. But the background clearly illustrates that the motivating factor for the provisions was the extensive Arab primary, secondary and tertiary boycott against Israel. The U.S. Congress was determined to prevent U.S. companies both from making payments to foreign officials which threatened to damage foreign relations with the United States, and from supporting the Arab boycott which threatened the very existence of Israel. Both laws were assisted in their passage by a moral sense of necessity, a need to address practices which deviated from the U.S. perception of fundamental principles of international relations. That view was not shared in many other parts of the world.

1. Writing on Moore's Life of Lord Byron.
2. 15 U.S.C.A. Secs. 78q(b)78dd, 78ff(a) (1976, as amended 1988).
3. 50 U.S.C.A. App. Secs. 2401-2420 (1977).
4. Perkins, *Bibliography on the Foreign Corrupt Practices Act of 1977*, 14 West St. U.L.R. 49 (1987).

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These laws should be distinguished from laws which affect trade, but which are not enacted to resolve specific *foreign policy* issues. One such former group of laws affecting trade are those enacted to resolve *domestic issues,* but which have an extraterritorial impact. Two examples are the U.S. antitrust laws and securities laws. The antitrust laws were first enacted in 1898 to break up various business combinations which had an anti-competitive effect in the United States. Because of comparatively recent hostility generated by the extraterritorial reach abroad of the antitrust laws, amendments were adopted in 1982 which mandate a more certain impact of foreign conduct *within* the United States than was earlier required. Marketing distortion practices within the securities industry in the United States brought about the U.S. securities laws in the 1930s. They also have an impact abroad. Tension during the last few years between the United States and Switzerland, caused by persons using secret Swiss accounts to trade as insiders in U.S. corporations' securities, led to numerous discussions and the adoption of some new Swiss law.

Another group affecting trade are laws directed to specific *trade* issues. They may be laws which implement international agreements, such as new GATT round codes; laws which restrict trade, such as "Buy America" laws; or laws which open the borders to more trade, such as the generalized system of preferences or Caribbean Basin Initiative, both favouring developing nations.

No laws have been so dressed in moral garments as those which have involved foreign policy issues. Perhaps a nation prefers to discuss such issues in moral terms rather than its own political interests. They are interesting laws for their political, economic and moral aspects, as well as for the 2 current questions specifically directed to the anti-bribery and anti-boycott laws, the lack of interpretive case law, and the lack of foreign domestic or international attention to enacting similar laws.

The anti-boycott laws were slow to evolve. The Arab nations began to boycott Jewish goods by 1945, before Israel was founded. The boycott was formalized and extended beyond a primary level in 1951, with the establishment of an Arab League boycott office in Damascus. Several members of the U.S. Congress began to express concern when the boycott assumed dimensions requiring foreign corporations to report considerable information before doing business in Arab nations, including data about activities with Israel business and employment of Jewish persons. There was no sense of repulsion to boycotts qua boycotts (as existed with bribery), but there was concern that nations were using boycotts to attempt to cause serious harm to a nation which the United States had long supported. The United States has in the past itself initiated boycotts, including ones currently in force, such as those against Cuba, Nicaragua and Libya. The anti-boycott laws state that it is U.S. policy "to oppose .... boycotts fostered or imposed by foreign countries against other countries friendly to the United States". None of the U.S. boycotts has ever assumed the tertiary level dimensions and organization of the Arab boycott against Israel.[5] The moral repulsion lies not so much in the idea of a primary boycott. What creates more concern is the secondary and tertiary levels, which carry the boycott closer to the point at which a question of human rights violations becomes legitimate. Over the objections of much of the business community, a Congress not satisfied that voluntary reporting was adequate enacted the anti-boycott provisions in 1977 as amendments to the Export Administration Act. The provisions, much like those of the Foreign Corrupt Practices Act also passed that year, were broad in nature. But they were supplemented a year later by extensive regulations, which included extremely lengthy and detailed hypothetical situations and suggested solutions applying the law. The regulations often are contradictory and confusing.

While the anti-boycott provisions were the result of several years of *overt* boycotting by the Arab nations and years of discussion in the Congress, the anti-bribery laws were the result of many years of *covert* bribery by corporations, but a very short period of debate in Congress. The Watergate investigations beginning in 1974, to inquire about domestic political payments, also uncovered numerous payments made by the U.S. corporations to foreign officials abroad. The Securities and Exchange Commission adopted a voluntary disclosure program, the results revealing that approximately 450 American companies had paid more than $ 300 million to foreign officials.[6] Many officials were not named for fear of local reprisals. Some names which were disclosed caused serious consequences. Prime Minister Tanaka of Japan resigned, and Prince Bernard of the Netherlands was implicated, both the result of Lockheed Aircraft Corp.'s payments. The President of Honduras resigned after disclosure of a payment from United Brands. The reaction in Europe to the U.S. announcements was that disclosure of names of recipients was self-destructive. A French official thought the process was "crazy" since bribes were a matter of doing business.[7] But the media in the United States pursued the issue with vigor. Congress quickly and nearly unanimously (in contrast with the division over regulating boycotts) enacted the Foreign Corrupt Practices Act. But curiously, unlike the less popular anti-boycott law, which generated little adverse comment after it was enacted, the Foreign Corrupt Practices Act was immediately attacked. The opponents of the FCPA, mainly businessmen who viewed the Act as hurting U.S. business abroad, pursued its amendment until, with increasing sympathy in Congress and an increasing U.S. trade deficit, the Act was amended in 1988 to diminish its restrictiveness.[8] The original FCPA proponents argued that its heart was removed.[9] The 1977 version imposed liability on a person for having "reason to know" that payments to an agent might be passed on to an official. The amendment changed the requirement to "knowing". The original Act did allow for an exception for payments made to officials carrying out functions that were "essentially ministerial or clerical", which are often called "grease payments". The new amendments delete this language and substitute an exception for "routine governmental actions", which are then quite extensively defined. Several members of Congress who had supported the original bill in 1977 thought the amendments would render the Act

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5. A primary boycott exists when nation A refuses to trade with nation B. It becomes a secondary boycott when nation A refuses to trade with any nation which trades with nation B, and is tertiary when nation A does not allow any imports from any other nation if those imports contain components made by a business in any nation which has been blacklisted by nation A.
6. Prior to enactment of the FCPA, bribery was subject to challenge by the SEC for failure to make proper and full disclosure of some corporation activities, and by the Internal Revenue Service for deducting from income received any foreign bribes paid and listed as ordinary and necessary business expenses. The FCPA added provisions to the securities laws which specifically made the payment of bribes unlawful.
7. See *Payoffs: The Growing Scandal,* Newsweek, 23 February 1976, at 26.
8. The amendments were part of the Omnibus Trade and Competitiveness Act of 1988, Pub.L. No. 100-418, 102 Stat. 1415 (1988).
9. The New York Times had much earlier suggested that demanded amendments created a loophole large enough to fly a Lockheed through. 23 July 1981, at D1, D13.

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ineffective. Senator Proxmire called the amendments the "bring back bribery bill". It is not at all certain that the FCPA hurt U.S. business. The truth probably is somewhere in between allegations of considerable harm and no harm. The U.S. trade deficit has many causative elements. The FCPA may have contributed to the deficit in a very marginal degree, because of both the FCPA's mere existence and its effectiveness in discouraging companies to make bribes where they are most commonly required to obtain contracts. Documentation of losses attributable to the FCPA are nearly impossible to prove, thus causing the Act's proponents to argue that there have been no losses. Many factors affect exports, including changing values of currency; new initiatives by companies to expand sales abroad for diverse reasons; foreign nation's either impending imports for balance of payments or protectionist reasons, or opening imports under GATT or IMF pressure; and the effect of trade on the nation's domestic deficit. The international trade deficit certainly *contributed* to the willingness to amend the Act in 1988, as did the unwillingness of other nations, or the international community, to adopt similar legislation.[10]

With the enactment of the Export Administration Act antiboycott amendments and the Foreign Corrupt Practices Act, the U.S. government possessed the laws necessary to reduce both participation in the Arab boycott, and making payments to officials abroad. Many viewers awaited an outpouring of appellate decisions which would illustrate how the laws were to be applied, as witnessed with the Foreign Sovereign Immunities Act of 1976.[11] But that was not to be the case. Almost no decisions have been made at the appellate level involving either law, and most of those which exist involve issues of constitutionality, creation of private rights of action, or statute of limitations.[12] It is unfair to suggest that the absence of appellate decisions indicates that the United States has not attempted to enforce these laws. There was some expectation that the anti-boycott provisions would be enforced less enthusiastically by the Department of Commerce, then would the anti-bribery provisions by the Department of Justice.[13] Commerce is considered to be more favourable towards business. When the proponents of amendments to the FCPA began to draft new provisions, they also proposed transferring the location of the law to the Export Administration Act from the securities laws, hoping for more lenient treatment by the Department of Commerce. That idea was abandoned by the time of the amendments in 1988, which appeared as amendments to the securities laws.

The records of the Department of Commerce's Office of Anti-boycott Compliance disclose that 275 persons were charged with violations through fiscal 1986.[14] Fines had surpassed $ 5 million, and several persons had export licenses suspended. The Department had also issued thousands of warnings and notices about possible violations. These were largely cases which were the result of companies reporting their receipt of boycott requests from Arab nations. Where companies had in some way complied with the request, the Department normally negotiated a fine as part of a consent decree, usually also involving the company agreeing to establish an internal compliance program. These procedures were handled administratively by the Department, and the results are thus not found in appellate cases. Some are published privately.[15] Even where the charges were more serious, such as agreements to refuse to do business, consent agreements have normally been the result. That is partly because the maximum fine of $ 10,000 per violation is considerably less than the costs of litigating the issue in court. The 3M company even agreed to a $ 137,500 fine, the highest at the time, 1981.[16] The Department began to use export denials as a sanction in 1982. Because of their potential impact on business, one might expect that companies would refuse a consent decree containing an export suspension. But the first 2 cases involved Xerox, which was already on their Arab blacklist and thus did not do business in the area, and Columbia Pictures, which did only a very small amount of business in one Arab nation.

In 1985 and 1986, the number of cases initiated by the Department of Commerce began to decline. This was defended by the Department because they were using limited resources to attach the most serious breaches, involving the blacklist, religious discrimination and refusal to deal issues. The previous focus had been almost exclusively on reporting violations. There have been expressions of concern that the Department was addressing only the areas most easily enforced, but not most important in curtailing assisting in the boycott. It is difficult to measure whether the method chosen by the Department is effective in achievement by *any* challenge to the Arab boycott. The enactment of the law did cause some Arab states to not enforce the boycott where their interests were thus benefited. Whether the law has increased trade between the U.S. and Israel, decreased trade between the U.S. and Arab nations, or had little impact, is impossible to measure. There is some consensus that U.S. firms have lost business, but not in any significant aggregate amount. But because the Arab nations are also nations which have long been participants in questionable payments to government officials, the 2 laws, anti-boycott and anti-bribery, have likely *together* not caused inconsiderable lost business. Additionally, and perhaps more important, together they create a tension of extraterritorial regulation creating barriers between the nations which is further likely to be trade inhibiting.

Considering the Foreign Corrupt Practices Act, there are similarities in the enforcement pattern. The FCPA has also generated mostly consent decrees, corporations preferring to accept a negotiated fine rather than litigate in the federal courts. Corporations have a strong preference to avoid having their practices made public. They particularly do not

10. No European nation responded with effective and clear legislation prohibiting payments abroad by corporations. See Goldstein, *European Views of United States Anti-Bribery and Anti-Boycott Legislation,* 1 Northwestern J. Int'l L. & Bus. 363 (1979) (hereinafter Goldstein). Some critics of the FCPA argued that the U.S. was trying to export its sense of morality to the world. But few foreign public officials condemned the FCPA for that reason, and some welcomed it as a positive influence on corrupt regimes, particularly in developing nations.

11. That Act has generated several hundred mostly federal court opinions, including several important interpretations by the U.S. Supreme Court.

12. *United States v. Core Laboratories,* Inc., No. 3-54-09 51-C (N.D. Tex. 24 July 1984), aff'd 759 F.2d 480 (5th Cir. 1985) (EAA and the statute of limitations); *Abrams v. Baylor College of Medicine,* 581 F. Suppl. 1570 (S.D. Tex 1984), aff'd 805 F.2d 528 (5th Cir. 1986) (EAA and affirming private right of action); *Bulk Oil (ZUG) A.G. v. Sun Co.,* Inc., 583 F Supp. 1034 (S.D.N.Y. 1983, aff'd 742 F.2d 1431 (2d Cir. 1984), cert. denied 469 U.S. 129, 105 S.Ct. 129 (1984) (EAA and rejecting private right).

13. Commerce has authority to administer the Export Administration Ace, while the Department of Justice enforces the securities laws, which include the antibribery provisions.

14. Fenton, *United States Antiboycott Laws: An Assessment of Their Impact Ten Years After Adoption,* 10 Hastings Int'l and Comp. L.R. 211, 275 (1987) (hereafter Fenton).

15. See Int'l Boycotts (Bus. Law Inc.); Boycott L. Bull.

16. Two of the 3M subsidiaries involved were United Kingdom and Italian companies. Both the U.K. and Italian Governments objected to what they considered to be an inappropriate extraterritorial application of U.S. law. The U.K. Government labelled it an "economic coercion" over another nation which, paradoxically, the EAA was intended to prevent. See Fenton at 266.

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like being labeled "corrupt", with its moral implications. Nor do they like charges of aiding the Arab boycott of Israel, although that carries less moral condemnation than *being* corrupt. Thus, the inclination to deal with the issue administratively is understandable.

From its enactment, the FCPA had a critical following which believed that vigorous enforcement would cause a serious loss of United States business, and would catch many unknowing persons in its net. That has proven unfounded. As in the case of anti-boycott enforcement, there have been few reported decisions. But also as in the case of the anti-boycott law, the lack of reported appellate decisions should not suggest that the law has not been enforced at the administrative level.

Many actions have been brought charging violations of the FCPA accounting requirements, to some degree paralleling the Department of Commerce's choice of the easier path with the anti-boycott laws, addressing reporting violations.[17] Few actions have been brought to enforce the anti-bribery actions. One of the problems is that the bribe usually occurs in the foreign nation, and thus the proof of the bribe, particularly discovery, requires the cooperation of the foreign nation. Such proof acquisition may adversely affect foreign relations. By 1987, only 10 actions to enjoin bribery had been reported, and only one in the reported case law.[18] As in the case of the anti-boycott law, other decisions were reported in private reports.[19] Some persons agreed to fines which were considerable, International Harvester paid $ 510,000, and Crawford Enterprises, Inc. (both involved in bribes to Pemex, the Mexican national petroleum company) paid $ 3.45 million. The court denied a Department of Justice request for prison terms. Bribery was thus clearly a cost of doing business, not a threat to management freedom. The government had brought few cases, but had selected them carefully. All but one resulted in a guilty plea.[20]

It should be apparent from the above comments that both the anti-boycott and anti-bribery laws have been enforced at a level which has encouraged companies to agree to consent decrees, but has not involved challenges which the companies have believed to be sufficiently costly or damaging to refuse consent agreements and allow the questioned conduct to be heard in public in the courts. The 1988 amendments to the FCPA are unlikely to change that practice.

The foreign response to the 2 laws has not been encouraging to the U.S. enforcement process. The anti-boycott law received little response from foreign nations. Germany and the Netherlands seemed satisfied that their governments could by negotiation defuse any Arab actions such as blacklisting companies. The United Kingdom briefly considered anti-boycott legislation, but none was enacted. The U.K. Foreign Office is more inclined to favour Arab interests than the U.S. State Department, and British firms are allowed to make commercial decisions involving the boycott exclusively on commercial grounds. France did enact laws which might have been used to challenge any assistance given to the Arab boycott, but the government interpreted the legislation so as to render it useless. The motivation for such emasculation was the paramount interests of French trade and employment.[21] The anti-boycott laws generated a minimum of response based on moral foundations. The Arab boycott was not viewed as sufficiently threatening to Israel to raise a question of human rights. Israel was successful economically, more so than many Arab nations.

The United States enactment of the *anti-bribery* law brought more response, and also illustrated that many other nations had very contradictory policies applicable to how their businesses acted abroad, in contrast to how they acted at home. Nearly all nations have laws prohibiting making payments to *domestic* government officials. Those laws are enforced in many nations, but an operational code exists in others which tends to allow some internal bribery, particularly smaller amounts to minor officials to speed up lawful processes. But while *domestic* bribes may be condemned, similar payments to *foreign* officials are in almost no other country prohibited.[22]

Most developed nations outside the United States have laws allowing the tax deduction of bribes as business expenses. Some are more accommodating. French law mirrors business thinking that bribes overseas are a cost of doing business. The French export insurance program, COFACE,[23] usually covers "commissions" as part of export risk. Newspaper reporting of bribes by officials of the British government to gain very substantial contracts in Iran (under the Shah) brought no adverse response.[24] The European attitude tends to be that bribery regulation ought to be at least initiated by the host country. Since much bribery occurs when doing business in developing nations, it is assumed that such practice is the norm, and that business is only accomplished by following that norm. Undoubtedly, however, were particular developing nations to ask assistance of a developed nation to stop such payments, such assistance would be forthcoming. Not because of any moral compulsion, but rather because the rules of the game were changing. The United States probably would have no FCPA were it not for Watergate. The moral repulsion at the disclosure of political payments *within* the United States may have affected the response to the disclosure of payments made abroad. But there was more. Many of the payments had been made to officials in *developed* nations. Bribery was usually viewed as linked with *developing* nations. Indeed, had the only disclosures been of payments such as those made by United Brands in Honduras, it is doubtful that there would have been any response beyond what is European thinking, that such payments are required to do business in the third world. Furthermore, the payments were large and caused severe dislocations with United States relations with friendly developed nation governments. Some response was necessary. That which followed was thus to some degree the product of a unique situation, not a routine enactment of legislation based on moral concepts of how business ought to function. It is consequently not surprising that other nations were not inclined to follow with similar legislation.

Paralleling the lack of enthusiasm for anti-bribery and anti-boycott legislation by other nations, has been the very modest response on the multilateral level. But at that level attempts at least have been made, even if results have not been forthcoming. One of the first efforts was within the

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17. See Longobardi, *Reviewing the Situation: What is to be Done with the Foreign Corrupt Practices Act?* 20 Vand. J. of Transnat'l L. 431, n. 323 (1987) (hereafter Longobardi).
18. *United States v. McLean,* 738 F.2d 655 (5th Cir. 1984), cert. denied, 470 U.S. 1050 (1985).
19. See FCPA Rep. For a discussion of these cases, see Longobardi at 478.
20. The one which did not is the one reported decision, United States v. McLean.
21. See Goldstein at 366-369.
22. Sweden has criminal sanctions similar to the U.S. See Bogdan, *International Trade and the New Swedish Provision on Corruption,* 27 Am. J. Comp.L. 665 (1979).
23. Compagnie Française d'Assurance pour le Commerce Exterieur.
24. See Goldstein 364, n. 8.

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framework of the International Chamber of Commerce in 1975. The effort failed, according to one writer when the participants "began to take a serious look at the standards" which they would have to follow.[25] The Organisation for Economic Co-operation and Development (OECD), basically comprising the industrialized nations, issued a guideline in 1976 that stated that corporations should neither offer nor receive questionable payments abroad.[26] All the OECD nations signed their approval. Some nations have circulated information to corporations about the guidelines of the OECD, and have urged the corporations to adopt policies consistent with the guidelines. Most members have not gone that far, but the OECD results are the closest to an international agreement on anti-bribery policy anywhere adopted. The results elsewhere are disappointing to those urging the adoption of such a policy. Suggestions at a GATT meeting by the U.S. delegate that bribes be considered were quietly put aside.

The United Nations would seem to be the most likely organization to deal with the issue of payments to officials. If so many nations prohibit bribes within their nations, it would follow that such concept could be implemented internationally through this largest multinational body. The Economic and Social Council did establish a Special Committee on Illicit Payments, but some years of meetings have generated no conclusions. The Commission on Transnational Corporations has also considered the issue, but when it was first raised in 1976 at a Commission meeting, it was not enthusiastically received.[27] As Professor Rubin has explained, it did become a subject in the drafting of a Code of Conduct for Transnational Corporations.[28] But there were 2 problems. First, the developing nations initially viewed such a code as a manner of controlling perceived excesses by developed nation corporations, not as a code of conduct for both sides, the host nation as well as the foreign corporation. The developing nations were willing to discuss the issue of payments, but more as a trade for what they wanted, than on its own merits. Secondly, the one provisions as presented in the version of the code in 1988 states that "Transnational corporations shall refrain ... from offering, promising or giving any payments, gift or other advantage" to officials.[29] The language is vague and, as are so many provisions which are the product of multi-nation negotiation, diluted from trying to reach a consensus to the point where the agreed upon language means different things to different people. Consequently, even if the code were to be adopted, it is predictable that the payments provision will have little effect.

The lessons which we may draw from the experience of the United States in first enacting its own anti-boycott and anti-bribery legislation, and second, in urging much of the rest of the world to follow suit, are several. There is no American *business* ethic which mandated either law. Indeed, it was business conduct which brought the laws about, and business has generally argued for moderating or ending the laws. Undoubtedly, many businessmen would prefer to see the laws remain, *if* similar laws were in place and enforced in other nations. It is not that United States businessmen wish to be able to operate by using bribes and supporting the Arab boycott, rather they wish to be able to compete on even terms with business from other nations. The laws exist because of a Congressional response to, first, the Arab attempt to bring United States business into active assistance in the Arab boycott, which was part of a broader Arab design to terminate the existence of Israel as a nation, and, second, the discovery that United States businesses were bribing foreign officials to a degree that threatened the very existence of those governments. Neither law was the result of a general plan to regulate the conduct of U.S. business abroad. Both laws caused the United States to promote similar legislative responses in other nations and in international forums. It was an unsuccessful attempt. But as time has softened the impact of the events which led to the laws, they may be enforced less vigorously, or, as with the FCPA, amended to reduce their severity. Amendments are not easily accomplished to any law which has a real or purported moral foundation. The amendments to the FCPA, consequently, were buried deeply in the 1,000 page Omnibus Trade and Competitiveness Act of 1988. If anything is predictable, it is that these 2 laws will neither be amended to strengthen them, nor enforced more vigorously, in the absence of new foreign policy implications. It is also predictable that in the absence of parallel instances in other industrialized nations to those which generated the United States laws, those nations will not enact similar legislation. Finally, *nothing* of import is likely to be produced by any multinational organization, whether it be the ICC, OECD, GATT or the United Nations.

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25. See Rubin, *International Aspects of the Control of Illicit Payments*, 9 Syracuse J. Int'l L. & Com. 315 at 317 (1982) (hereafter Rubin). See also J. Kline, *International Codes and Multinational Business* 90, 228-229 (1985).
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27. See Rubin at 319.
28. See Rubin at 321.
29. Proposed Text of the Draft Code of Conduct on Transnational Corporations, Para. 21. E/1988/39 Add. 1, E/1983/17/Rev.1-E/C.10/1983/S/5/Rev/1. annex II.

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BELGIUM:

Reflections on the 1988 Tax Reform

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I. INTRODUCTION

Belgium's overall tax rate has become one of the highest in the world. Including social security payments, it tends to exceed 46% of Gross Domestic Product (GDP).

The following schedule shows the budgetary relevance over 1987 of the different types of taxes in percentage of GDP, and allows a comparison between Belgium and the average for all of the EC countries.[1]

1987	Direct taxes	Indirect taxes	Social security payments	Other receipts	Total
Belgium	18.2	11.4	14.7	1.8	46.1
EUR 12	12.4	13.2	14.6	3.5	43.7

It is clear that the level of Belgian direct taxes of 1987 substantially exceeds the EC average while the indirect taxes remain under the average level of the 12 EC countries.

The substantial tax reductions that were planned or realized in other countries with an often much lower overall tax level inevitably led to a political debate on tax reform in Belgium.[2] From the beginning, it was generally recognized that there was a need for a substantial reduction of the overall tax rate, and specifically of the individual income tax. However, a budget deficit of more than 9% in 1986 was a serious obstacle to realizing the aspirations in the tax field.

In 1986 a previous Government (a coalition between the Catholic and Liberal Parties) appointed a Royal Commission to prepare the harmonization and simplification of the Belgian tax system. Its first report was presented to the Minister of Finance on 11 February 1987.

It has eventually partly inspired the Tax Reform that has been enacted on 7 December 1988. This law essentially meant to reform the individual income tax (personenbelasting/impôt des personnes physiques). Some measures, however, do effect both corporations and individuals. A reform of the corporate tax has been announced but not enacted at the time this article was written.[3]

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II. MAIN FEATURES OF THE BELGIAN INDIVIDUAL INCOME TAX AS LAID DOWN IN THE TAX REFORM ACT OF 1962

A. Basic principles

In 1962 the previous system of schedular income taxes was replaced by a system of comprehensive taxes on the taxpayer's aggregated income. The individual income tax applies to the total world-wide income of residents. It is basically meant as a progressive tax on the individual's aggregated income, regardless of its source and/or nature. Particular income types such as certain capital gains may however be taxed at fixed rates. Furthermore, certain types of foreign income qualify for unilateral relief from international double taxation. Husband and wife are assessed on their aggregate income.

1. *Source:* Report of the Commission of Finance of the Senate, Doc. 440/2, (B.Z./S.E. 1988), Schedule 9 referring to a Communication of the E.C. Commission of 8 July 1988.
2. See Spruyt, A.J.J., "The Belgian Tax Reform 1988 – Highlights: What does it mean for the business and corporate taxpayer?", 1 *Intertax* 21 (1989) at 21.
3. *Editor's Note:* The tax reform law was enacted on 22 December 1989 and published in the Belgian Official Gazette of 29 December 1989. For a summary of these changes, see 24 *Tax New Service* 3 (1990) at 36.

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B. Problems concerning the assessment of income

The basic idea of equal taxation of the different types of income has never been fully realized since some types of income and some deductions are not always taken into account for their real amount. In the following, we will give some examples of such lump-sum assessment of income or of some of its components.

Although income from smaller undertakings must in principle also be determined according to its effective amount, a subsidiary lump-sum basis of assessment may be calculated. This lump-sum income is often inferior to the effective income. In practice, income from smaller agricultural, commercial and artisan enterprises is generally determined according to such a lump-sum method.

Real estate income is to a large extent also calculated on a lump-sum basis, the so-called "cadastral income" representing the estimated net rental value of immovable property. It derives its lump-sum character from the fact that it is determined according to market standards at a fixed date and remains unchanged for a long period. Presently, "cadastral income" is for instance still determined according to market standards of 1 January 1975 although it is clear that the actual rental value of real property has considerably increased. Private dwellings inhabited by their owners qualify for a tax allowance that mostly reduces their taxable income to zero. Owners who rent a dwelling are only taxed on its "cadastral income" and not on the rent effectively collected.

In some cases, "cadastral income" is used as a minimum basis of assessment of income from real estate rented to companies and business enterprises. Only when the net amount of the actual income exceeds the "cadastral income", the first is withheld as a basis for assessment. The real amount of income is, however, reduced by a lump-sum deduction for expenses of not less than 40% (in case of constructed property). This lump-sum deduction is granted even if the effective expenses do not reach this amount. It may result in a significant exemption of real estate income. Real estate income is therefore always largely subject to lump-sum taxation, even if its real amount is to be withheld.

C. Particularities related to the effectiveness of taxation

Difficulties may arise in order to realize the effective taxation of some types of income. Although personal property income was part of taxable income, dividends, interest, etc. were often not declared by the beneficiary. Tax authorities had only limited means to obtain relevant information with respect to income from personal property. This was due to the fact that such property is to a large extent represented by bearer documents and to the absence of any obligation to inform the tax authorities about the identity of the beneficiaries of these types of income. Furthermore, the bank secrecy also applies to tax matters. This situation has contributed to the creation of a substantial but creditable withholding tax (roerende voorheffing/précompte mobilier) on these income types limiting the negative effects of their non-declaration in individual income tax returns. In 1962 its rate already reached 15%.

III. EVOLUTION OF THE SYSTEM OF INCOME TAXES

A. Silent increase of tax pressure

The individual income tax representing not more than 6.3% of GDP in 1965 reached 15.3% of GDP in 1986.[4] The share of indirect taxes remained rather stable. The increase in the relative importance of income taxes and especially the tax on individual income mainly resulted from the non-indexation of the income brackets to which the progressive tax rates were to be applied. Until 1978, the nominal tax rates remained mostly unchanged (e.g. 42.5% on income between 750,000 and 1,000,000 Bfrs.[5] A *general* increase of the nominal rates only took place as of 1979 (e.g. 47.5% on income between 750,000 and 1,000,000 Bfrs.).

The high inflation rates of the 60s and 70s, which were hardly corrected within the tax system, had already led to a silent but important growth in the revenue of the individual income tax. The average tax burden grew considerably although it did not always correspond to a real increase in taxable capacity of the taxpayer.

B. Formal changes of tax rates

The highest rate provided by the Tax Reform of 1962 was 55% for income over 5,000,000 Bfrs. The average rate applied on total income could not exceed 50%. In the following years, the highest rates were gradually increased to 72% on income over 4,000,000 Bfrs. whilst the maximum average rate was brought up to 67.5%.

The highest level of income tax rates existed from 1979 to 1983 and was as follows:

- on the first 750,000 Bfrs.: 252,500;
- on the next 250,000 (from 750,001 to 1,000,000): 47.5%;
- on the next 500,000 (from 1,000,001 to 1,500,000): 52.5%;
- on the next 500,000 (from 1,500,001 to 2,000,000): 57.5%;
- on the next 1,000,000 (from 2,000,001 to 3,000,000): 63%;
- on the next 1,000,000 (from 3,000,001 to 4,000,000): 69%;
- on the excess of 4,000,000: 72%; and
- the maximum average rate could not exceed 67.5%.

These rates are still to be increased by municipal surcharges of usually 6%, so that the effective rate, for example, on income between 750,000 and 1,000,000 Bfrs. reached 50.35%.

The Law of 1 August 1985 was the first to reduce the tax rates. For each of the years (1986 to 1990), these rates were slightly decreased. For 1990 the highest marginal rate would have been 70.4%.

The income brackets were also indexed as of the Law of 28 December 1983. Although it stopped any further silent increase in tax pressure as far as the income brackets were concerned, the effect of the previous years with a high inflation rate was not neutralized.

C. Increasing scope of fixed rates

Although the individual income tax was basically meant as a global tax with progressive rates, the relevance of the fixed rates has considerably grown. In 1962 3 different fixed rates

4. *Source:* OECD, "Revenue Statistics of OECD Member countries 1965-1986", Paris, 1987.
5. US$ 1 = ± 39 Bfrs.

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(15%, 30% and the average rate of a previous year) were created for specific income types, such as certain capital gains and salary arrears for which taxation at the progressive rates was considered exaggerated. Over the years, the number of fixed rates has been increased to 5: 16.5%, 25%, 33%, the average rate of a previous year and the average rate applied to the aggregate income of the same taxable period.

The income types that were subject to these fixed rates were also considerably extended. The main event in this respect was the Budget Law of 28 December 1983. This Law introduced a new 25% rate for all personal property income. In other words, income such as dividends and interest was as of then no longer aggregated with the other income types. Furthermore, the rate of the withholding tax on personal property income (roerende voorheffing/précompte mobilier) was increased from 20% to 25%. If the withholding tax was paid, the taxpayer was allowed to refrain from declaring this personal property income in his income tax return. The withholding tax became as much as a final maximum tax. Therefore, this system was referred to as "bevrijdende roerende voorheffing/précompte mobilier libératoire". Taxpayers were, however, still allowed to declare their personal property income, even after payment of the withholding tax. They only did so when this would result in a lower amount of tax through a combination of the deduction of interest paid, and the crediting of both the withholding tax and the tax credit meant to limit economic double taxation with respect to dividends (belastingkrediet/crédit d'impôt). After the Law of 28 December 1983 the tax burden on personal property income was considerably lower than that on earned income. Whenever personal property income exceeded certain amounts (e.g. 360,000 Bfrs. for interest and 1,100,000 Bfrs. for all types of personal property income) a special additional tax was due at progressive rates. However, an exemption was granted in case of qualifying reinvestment of the personal property income. The budgetary impact of this additional tax was rather limited.

The new system of taxation of personal property income introduced by the Law of 28 December 1983 has led to an increase of the proceeds of the withholding tax on such income, due to the increase in its rate. However, the same Law also constitutes an important exception to one of the basic principles of the Law of 1962. The principle of global and equal taxation was abandoned with regard to personal property income. Although the importance of this event out of a theoretical point of view is clear, it is remarkable that this issue was almost absent from the discussion in Parliament. It looks as if the political authorities accepted the fact that it was practically impossible to tax personal property income in excess of the withholding tax.

IV. TAX REFORM PLANS

Tax Reform is becoming a major political issue. A previous Government (a coalition between the Catholic and Liberal Parties) appointed a Royal Commission in 1986 to prepare the harmonization and simplification of the Belgian tax system. On 11 February 1987 the Commission presented what was meant as its first report. Highlights of its proposals with respect to individual income tax were:

- net distinction between local and national taxation of real property income;
- taxation of all types of income on the basis of their real amount wherever possible;
- taxation of dividend income at the progressive rates of individual income tax with full imputation of corporate tax relating to these dividends;
- separate taxation at a rate of 25% of interest; although the Commission advocates the globalization of all income types, it accepted the separate and limited taxation of interest on the grounds of Belgium's particular situation in the international context;
- replacement of the rather complicated specific deductions for insurance premiums, mortgages, etc. by an overall lump-sum deduction for private investment (50,000 Bfrs. per taxpayer and 100,000 for a family) in order to achieve a simplification of the existing tax system and a limitation of the tax deductions;
- separate taxation of husband and wife (two-income families) or splitting of the family income (for one-income families and when this system would be more advantageous also for two-income families); these systems would apply to all types of income;
- tax-free minimum of 150,000 Bfrs. for single persons and of 225,000 Bfrs. for spouses with an additional, substantial increase for family charges;
- limitation of tax rates to no more than 4 (in Bfrs.):
  0 – 300,000: 30%;
  300,000 – 750,000: 40%;
  750,000 – 1,500,000: 50%;
  over 1,500,000: 60%;
- introduction of a maximum average tax rate of 50%.

The report of the Royal Commission also contained proposals with regard to the corporate tax (one single tax rate, replacement of the dividends received deduction by a tax credit), the indirect taxes (increases of the rates of excise duties in view of harmonization within the EC) and the fiscal procedures. The Commission considered that its proposals had to be taken as a whole. Having noticed the reluctance of the Government to do so, the Commission collectively resigned. Before a Government Bill could be presented to Parliament, the Government also resigned. In March 1988 a new coalition Government was formed by the Catholic, Socialist and Flemish nationalist Parties. It was not before 26 September 1988 that a Government Bill on Tax Reform was tabled. It was passed with a remarkable speed and ratified by the King on 7 December 1988 and published in the Official Gazette (Belgisch Staatsblad/Moniteur Belge) on 16 December 1988. This Tax Reform Act mainly intends to reduce the individual income tax, and is partly inspired by the proposals of the Royal Commission. However, a series of compensating measures apply to both corporations and individuals.

V. TAX REFORM ACT OF 7 DECEMBER 1988

A. Reduction of the individual income tax

1. Taxation of spouses

Under the previous legislation husband and wife were generally assessed on their aggregate income. Only if their total annual income did not exceed 787,000 Bfrs. the separate taxation of their earned income (two-income families) or a system of income-splitting (one-income families) was granted. In the latter case, the income attributed to the non-working spouse was taxed at the effective average rate applicable to the rest of the family income. Higher joint incomes of husband and wife only qualified for a much more limited reduction of the income tax burden on aggregated income.

This system of taxation of family income in combination

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with Belgium's high tax rates led to a tax burden that was often thought of as excessive, especially by the middle classes. It was also considered that the existing system did not remain sufficiently neutral and that it affected the choice between either remaining single or marrying and between an outside professional activity for both husband and wife or one of them staying at home.

The Tax Reform of 7 December 1988 contains a new compromise between an individualistic approach of taxation of the income of spouses and one where their contributing capacity is appreciated on the basis of their aggregated income.[6] The new law confirms the basic principle of joint taxation of income of spouses. Non-married persons forming a household are taxed as singles. However, the earned income of spouses is partially no longer aggregated with the rest of the family income. For two-income families, the earned income of the spouse with the smaller amount is taxed separately without any limitation as to the amount of the income. The rates of the individual income tax ultimately apply separately on this smaller amount of earned income and to the greater amount although the latter is to be increased with the other income types of both spouses.

For one-income families, 30% of the earned income is imputed to the non-working spouse. This imputation of income is limited to a maximum of 270,000 Bfrs. (i.e. 30% of 900,000 Bfrs.). This splitting system is a variation of the "quotient" system, however, limited to spouses and to their earned income. In the new Belgian system of "quotient", 2 distinct taxable bases are calculated: the first is limited to the imputed earned income, whilst the rest of the family income constitutes the latter. Both masses are separately subjected to the progressive rates of the individual income tax. Note that as under the previous law the housekeeping by the non-working spouse is not considered to generate any tax claim on its imputed income. The "quotient" system will also be applied in the case of two-income families, whenever this system is more advantageous than the separate taxation of the lower professional income that is actually earned. Since the system of "quotient" is limited to a maximum amount of 270,000 Bfrs. that may constitute a distinct basis for taxation, its application to double income families will be rather exceptional and mostly limited to cases where one of the spouses has a part-time job.

Income types other than professional income are, in the present Belgian system of taxation of spouses, always aggregated with the greater amount of earned income in the case of "quotient" as well as in the case of separate taxation. Re-shuffling of property income between spouses has no influence on the amount of individual income tax.

The new system of taxation of spouses is completed by a specific allotment of deductible expenses other than business expenses over the two taxable bases created for individual income tax purposes. Life insurance premiums are for instance only deductible from the earned income of the spouse who subscribed to the contract.

Other expenses, that as under the previous law are deductible from the net amount of all types of income, are now divided into two groups: personal and community expenses. Personal expenses are for instance alimony and payments made to an individual retirement account (pensioensparen/épargne-pension). Gifts and certain expenses made for maintenance and renovation of buildings scheduled as landmarks, expenses for minding children (up to 3 years), etc. are considered to be community expenses. The deduction of the latter is proportionally divided over the 2 masses of income. Personal expenses of a spouse are first deducted from the taxable base to which his earned income has contributed. Any excess will be deducted from the other mass of income. The rules for the allotment of those expenses have an influence on the tax that must eventually be paid. Under the previous system, the effect of these deductions was normally determined by the highest marginal rate applicable to the family income. Under the present system with a double taxation base, the effect of the deduction will depend on the marginal rate applicable to either of them.

2. Tax rates

The Tax Reform Act limits the number of tax rates to 7. Note that the Royal Commission had proposed to limit the tax rates to 4 from a minimum of 30% to a maximum of 60% with a maximum average rate of 50%. The rates finally withheld in the Tax Reform Act show a substantial reduction of the higher rates (see Table I). The highest marginal rates which will be applicable to taxable income exceeding 2,200,000 Bfrs., amounts to 55%. This constitutes a quite important reduction compared to the previous maximum rate of 70.8% that was applied during the taxable period 1988 on income over 4,197,000 Bfrs. A maximum average rate which was for the taxable period 1988 fixed at 66.3% is not longer withheld under the Tax Reform Act.

TABLE I

Comparison of the previous and new rates

Previous rates until taxable period 1988			New rates as of taxable period 1989		
Brackets From	To	Rate	Brackets From	To	Rate
0–	120,000	0 %			
120,001–	209,500	24 %	0–	230,000	25 %
209,501–	262,000	27.7%			
			230,001–	305,000	30 %
262,001–	314,000	35.8%			
314,001–	419,000	39.4%			
			305,001–	435,000	40 %
419,001–	524,000	43.6%			
			435,001–	1,000,000	45 %
524,001–	787,000	45 %			
787,001–	1,049,000	46.6%			
			1,000,001–	1,500,000	50 %
1,049,001–	1,574,000	51.6%			
			1,500,001–	2,200,000	52.5%
			more than	2,000,000	55 %
1,574,001–	2,099,000	56.5%			
2,099,001–	3,148,000	61.9%			
3,148,001–	4,197,000	67.8%			
4,197,001–	14,585,097	70.8%			
more than	14,585,097				

3. Tax-free minima and indexation.

Under the previous system a tax-free minimum of 120,000 Bfrs. was granted per family. It is increased by the Tax Reform Act to 130,000 Bfrs. per spouse for married persons (i.e. 260,000 Bfrs. per family) and to 165,000 Bfrs. for single persons.

6. For an overview of the arguments that are internationally used in this debate see: Plasschaert, S., *Schedular, Global and Dualistic Patterns of Income Taxation* (Amsterdam, International Bureau of Fiscal Documentation, 1988) at 69-76.

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The tax-free minima are allocated to the lowest brackets of income. A single person who qualifies for a tax-free minimum of 165,000 Bfrs. will only pay income tax at the rate of 25% on his income between 165,000 and 230,000 Bfrs. (i.e. 16,250), his first 165,000 Bfrs. of income being exempted. He, therefore, enjoys a tax reduction of 41,250 Bfrs. This system of tax-free minima within the existing schedule of income brackets leads to an effective tax reduction that, since it is not influenced by the total amount of income of the beneficiary, is equal for all taxpayers. The amount of income subject to the higher rates remains unaffected by the tax-free minimum whenever the taxpayer's income exceeds the latter. This formula is, therefore, not meant as a correction of the progressivity of the rates on the remaining taxable income.

These tax-free minima are increased in accordance with the number of dependent children. Table II shows the amount of the increase of the tax-free minimum and the resulting total tax reduction for families. Note that the increase in the tax-free minimum is attributed to the higher of the two taxable bases withheld for spouses. If one of these amounts is reduced to zero by the deduction of the tax-free minimum, the excess will be deducted from the other taxable base.

Table II

Family situation	Increase per child in Bfrs.	Tax-free minimum in Bfrs.	Total amount of tax reduction
spouse	—	130,000	32,500
children	—	—	—
1	35,000	165,000	41,250
2	55,000	220,000	55,000
3	112,500	332,500	91,000
as of 4th	125,000	457,500	142,125

The tax-free minima qualify for an additional increase with regard to the specific situation of the taxpayer and his family, such as the presence of other dependent persons than children, the fact that the taxpayer is a widow or widower who has not remarried or a disabled taxpayer or dependant.

4. Automatic indexation

As mentioned above, the principle of a yearly indexation of the individual income tax has already been introduced by the Law of 28 December 1983. However, this indexation was limited to the income brackets. The present Tax Reform Act of 7 December 1988 extends the application of the indexation principle to practically all amounts mentioned in Belgian francs in the Income Tax Code such as tax-free minima, other deductions, exceptions, ceilings, income brackets, etc. Note that the indexation does not apply to the rate brackets of the corporate income tax. The indexation formula is explicitly stated in the new law. It is realized through the multiplication of all these "indexable" amounts with the prorata between the average price index of the year preceding the year of the income and the average price index over 1988. Therefore, the first indexation according to the new law will only take place with respect to the year of assessment 1991, i.e. taxable period 1990.[7] As with the previous indexation system introduced by the Law of 28 December 1983, the new provisions will not have any retroactive effect. Although any further silent increase in tax pressure is stopped, the effect of the previous years with a high inflation rate will not be neutralized.

B. Compensating measures

1. Compensation specifically limited to the individual income tax: reinforcement of the deglobalization of personal property income

a. *Limitation of tax deductions*

Under the previous law, all interest paid by private individuals for loans contracted in order to acquire real estate and personal property income was deductible up to the amount of movable and real estate income subject to the progressive rates of the individual income tax. The Tax Reform Act provides that interest paid on private loans only remains deductible if they are specifically contracted to acquire or retain real estate income. Interest on loans contracted to acquire personal property is not deductible anymore. As already mentioned, personal property income was not globalized any longer as of 1984, whereby the withholding tax was considered the final tax. Taxpayers mostly withheld from declaring this income in their annual individual income tax return, except if the globalization was more advantageous through the deduction of interest paid and the imputation of the withholding tax. The Tax Reform Act closes this loophole by refusing any further deduction of interest on private loans contracted to acquire or retain personal property. This measure reinforces the deglobalization of personal property income such as it had been introduced by the Law of 28 December 1983.

One of the basic ideas of the Tax Reform was to realize a reduction of the income tax rates through a limitation of the deductible expenses. The limitation of the deduction of private interest payments rejoins this aim. However, in contradiction to this basic idea the Government created new and increased certain existing deductions. Thus, the Tax Reform Act provides for the deduction from professional income of 80% of the expenses made for minding children (up to 3 years). If no such expenses are made, the tax-free minimum (supra, 3) is increased by 10,000 Bfrs. per child under 3 years. The existing deduction for premiums for life insurance which was limited up to a maximum of 45,000 Bfrs. is on the other hand increased to 60,000 Bfrs. Repayments of mortgage loans contracted as of 1 January 1989 also qualify for an increased deduction.

b. *Tax credit and lump-sum foreign tax credit*

Under the previous legislation, a *tax credit* (belastingkrediet/crédit d'impôt) could be set off against individual income tax in order to limit the economic double taxation with respect to dividend income received by private shareholders. The Tax Reform Act refuses this tax credit to individuals except if they hold the shares for a professional purpose. As a result, the total tax burden with respect to dividends can reach 57.25%, i.e. the sum of the corporate tax (normally 43%) and the withholding tax (usually 25%). This was, for the Government, sufficient reason to abolish the complementary tax on personal property income as far as dividends are concerned. This tax was introduced by the Law of 28 December 1983 when personal income was deglobalized. It was meant to reduce the considerable tax advantages for individuals owning substantial personal property enjoyed as a result of the deglobilization of personal income that was no longer taxed at the progressive individual income tax rates.

7. See Autenne, J., De Lame, J. and De Wolf, M., *La Réforme Fiscale du 7 décembre 1988 à la Lumière de l'Expérience européenne* (Brussels, Bruylant, 1989) at 96-99.

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The present partial abolition of the complementary tax has been thoroughly criticized.[8] The effective burden of corporate tax will often not reach 43% since it may also be levied at reduced nominal rates (e.g. 30%) in the case of smaller companies and may not be levied at all with respect to certain foreign companies such as Luxembourg holding companies. Furthermore, specific tax deductions and advantages (e.g. the investment deduction) may considerably reduce the effective tax burden with respect to corporate profits as it has been recently shown in an internal report of the Ministry of Finance known as the "Peeters report".

A lump-sum *foreign tax credit* (forfaitaire buitenlandse belasting/quotité d'impôt étranger) was, under the previous law, granted to all foreign personal property income. It was meant to reduce international double taxation and amounts to 15% of the foreign income also in cases where the foreign tax effectively paid does not reach this amount. This lump-sum character of the foreign tax credit was and still is subject to criticism, where it opens rather important loopholes.[9] The Law of 28 December 1983 deglobalizing personal property income still allowed the imputation of the foreign tax credit whenever the income was declared in the income tax return. Under the Law of 27 December 1984, the imputation of the foreign tax credit was virtually limited to cases of taxpayers with a modest income or paying deductible interest on private loans. As the present Tax Reform Act limits the deduction of private loans contracted in order to acquire or retain personal property income (supra, a) the imputation of the foreign tax credit with respect to privately held foreign personal property would lose its meaning. The legislator's logical conclusion was to abolish the foreign tax credit as far as privately held personal property is concerned. Note that foreign personal property that is held for business purposes by either individuals or corporations still qualifies for the foreign tax credit.

2. Compensation affecting both the business and corporate taxpayer: limitation of the deduction of business expenses

An important part of the compensation for the reduction of tax rates will come from the limitation of the deduction of business expenses. Under the new law, the deduction of costs relating to *clothing* is no longer allowed. A deduction remains possible only for specific professional clothing.

Deductibility of business expenses related to the use of *motor cars* is limited to 75% of the costs incurred. This limitation applies to all costs related to the use of motor cars, such as depreciation, insurance, repairs, motor vehicle tax, etc. However, costs of fuel remain fully deductible. Under the previous legislation, depreciation of motor cars was limited for accounting year 1988 to a maximum amount of 650,000 Bfrs. (excluding VAT), i.e. the value of a middle class car. Luxury cars could not be fully depreciated. The Tax Reform Act replaces this specific limitation by the general disallowance of 25% of professional costs for all cars. The official but not convincing explanation for the abrogation of the specific limitation on the depreciation of the bigger cars was that this measure could be easily avoided by the cross-border renting of these cars, which had a negative effect for the Belgian car dealers.[10] It has been argued that it would have been easy enough to take legal measures neutralizing such avoidance.[11]

The Tax Reform Act also provides that 50% of the professional part of *restaurant, reception and representation costs* are disallowed as business expenses.

The specific costs withheld for the limited deduction often raise difficulties in order to determine whether they are incurred for either professional or private purposes. The new law does not contribute to resolve this problem since the limitation to 50 or 75% applies to the professional part of the restaurant, reception and car costs. The problem of splitting these costs in private expenses that are anyhow not deductible from business income and professional expenses remains. The approach withheld for income tax purposes by the Tax Reform Act also differs from what is provided by the VAT code, where a similar problem exists. VAT paid on car costs may only be deducted for half of its amount whilst VAT with respect to restaurant and hotel costs is not creditable at all against VAT due. From a point of view of simplification of the tax system, it can be regretted that 2 different systems apply to income tax and VAT.

The limitation as provided for by the Tax Reform Act constitutes a further deviation from taxation of net income. Actually, tax is paid on expenses that are inherent to the conducting of a business. It might be argued that Belgian income tax where the deduction of certain business expenses is disallowed or limited somewhat loses its character of a tax on the net contributing capacity resulting from that activity and starts showing a development towards a business or a trade tax. The business activity by itself, irrespective of its resulting income, generates a tax liability with respect to the amount of the non-deductible business expenses. Unlike a separate business or trade tax, this liability may be neutralized by the other negative income components that remain deductible. On the other hand, this tax liability is not deductible as a business expense, which is usually the case for business or trade taxes as such.

The limitation or disallowance of particular expenses as deductible expenses may create problems with respect to the definition of these expenses. The Belgian experience can give an idea of these difficulties.

As mentioned before, the Tax Reform Law provides for the disallowance of up to 50% of restaurant, reception and representation costs. However, during the discussion in Parliament the Minister of Finance declared that all expenses made during business travels abroad – including restaurant costs – will remain fully deductible if their business purpose is shown.[12]

The Minister's statement, which is not based on any explicit statutory text, has been clearly inspired by his preoccupation to safeguard the interests of the export industry which is vital to the country. Regarding expenses made in Belgium on behalf of foreign businessmen invited to the country, the basic principles of deductibility remain applicable: deduction up to 50% with respect to restaurant and reception costs and up to 100% with regard to other expenses such as hotel costs. However, the Minister declared in the House of Representatives that if the restaurant costs are part of a global fee covering the organization of seminars or the reception of foreign clients and journalists, the full amount of the fee would remain deductible.[13] In the first months fol-

8. See Kirkpatrick, J., "Réflections Critiques sur les Compensations Budgétaires Prévues par la Loi de Réforme Fiscale du 7 Décembre 1988", *Revue Générale de Fiscalité* (1989) at 38 and 39.
9. See Hinnekens, L., "Internationale leningen en het F.B.B.", *Algemeen Fiscaal Tijdschrift* (1985) at 199 and 220.
10. See Report of the Commission of Finance of the House of Representatives, Doc. 597/7, G.Z./S.O. (1988-1989) at 132.
11. See Kirkpatrick, J., supra, note 8, at 34.
12. Report of the Commission of Finance of the Senate, Doc. 440/2, B.Z./S.E. (1988) at 113.
13. Report of the Commission of Finance of the House of Representatives, Doc. 597/7, G.Z./S.O. (1988-89) at 14.

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lowing the enactment of the Tax Reform Law, many more issues were raised by taxpayers claiming exceptions to the rule of the limited deductions.[14] A well known case concerns the deduction of costs for the rent of lodges and business seats in football stadiums. These expenses often include the cost of meals served during the sports events. The question was asked whether the limitation of the deduction up to 50% would apply to these expenses. The Minister of Finance agreed to exclude the full amount of these expenses from the limitation.[15] As one concession tends to lead to another, smaller football clubs that did not own lodges or business seats as well as other sports clubs also had their claims on behalf of business enterprises offering to their clients free tickets to games of such sports clubs. Often these free tickets also include free drinks and snacks. Eventually, all these costs were qualified as publicity costs for their full amount and therefore not subject to the limited deduction applied to restaurant, reception and representation costs.[16] All these "interpretations" may be criticized and can lead to a feeling of unequal application of the basic rules.

3. Other compensating measures

The Tax Reform Act contains several other measures aiming at compensating the reduction of the proceeds of the individual income tax resulting from the new system of taxation of spouses and families and from the reduction of tax rates. Some apply to the business taxpayer both individual and corporate. Thus, the new law introduces a substantial limitation on the investment deduction as well as additional conditions for the exemption of capital gains. Although the imputation of tax credits such as the foreign tax credit (forfaitaire buitenlandse belasting/quotité forfaitaire d'impôt étranger) and the withholding tax (roerende voorheffing/précompte mobilier) remains relevant for personal property that is held for business purposes, the first is to be grossed up with the amount of foreign income, thus reducing relief for foreign taxes available under the new law. Belgian withholding tax on interest with respect to bonds and securities acquired between dates for interest payments only remains creditable on a pro rata basis, taking into account the time the securities have been in possession of the taxpayer. This measure is intended to close specific loopholes related to techniques of "coupon-stripping". Note that such a pro rata rule is not yet applied to the foreign tax credit available to interest from foreign bonds.

Other compensating measures provided for by the Tax Reform Act only affect the corporate taxpayer. They reach from the introduction of a new tax on insurance companies over a new computation of the special secret commissions tax to a limitation of the dividends received deduction with respect to permanent shareholdings (holding privilege).

Since all these measures aiming at financing the reduction of the individual income tax are sufficiently discussed elsewhere[17] we will not insist any further upon them in this article.

Note that further compensation has also been found in the Royal Decree of 9 December 1988, increasing excise duties on several oil products, on tobacco and liquor.

VI. CONCLUSION

The Tax Reform aspect of the Law of 7 December 1988 is limited to the individual income tax although a certain impact on the corporate tax mainly through its modification of the concept of effectively taxed business income is undeniable. The new law makes a number of necessary adjustments, especially with respect to the taxation of spouses and families. The tax rates are also reduced, particularly the higher rates. The automatic yearly indexation of practically all amounts relating to the individual income tax will be welcomed by all those who oppose any silent increase of the tax pressure.

The basic structures of the individual income tax as they had developed over the years remain practically unchanged. This is especially the case with the great number of income types excluded from the scope of the progressive income tax and subjected to one of the fixed rates of this tax. It is remarkable that the deglobalization of personal property income that was decided in 1983 under a Catholic-Liberal coalition Government has been confirmed and even reinforced by the Tax Reform Act enacted under a Catholic-Socialist Government. Several other problems of the Belgian income tax system we have referred to in this article such as the lump-sum assessment of particular types of income and deductions are also not considered in the Tax Reform Law. What distinguishes the Law of 8 December 1988 from other laws modifying the individual income tax is the fact that the measures it contains are not directly translated into modifications of articles of the actual Income Tax Code. As it has been with the Tax Reform Act of 1962, the Law of 7 December 1988 provides that a Royal Decree coordinating all legal provisions will establish a new text of the Income Tax Code. Such a Royal Decree has not been published at the time this article was written.

The Law of 8 December 1988 has not set a term to the frequent modifications of tax legislation. It has been followed by an increase in excise duties and measures designed to increase the effectiveness of taxation of building contractors. A reform of tax procedures, corporate tax, non-resident income tax and even modifications with respect to registration duties, inheritance tax, excise and stamp duties and VAT were also announced. In the last few months, several ideas that were discussed within the Government leaked out in the press. It has been rumoured that the new draft Government Bill for a Programme-Law introducing these measures will contain over 500 articles. However, one cannot lose the impression that a real master plan for all these modifications is lacking.

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14. For an overview see: *Algemeen Fiscaal Tijdschrift/Revue Générale de Fiscalité,* weekly newsletter, No. 32 (29 September 1989) at 6 and 7.
15. See *Algemeen Fiscaal Tijdschrift/Revue Générale de Fiscalité,* weekly newsletter, No. 19 (26 May 1989) at 5. For a remarkable rather ironic view on the backgrounds of this decision, see J.V.D., "Tweeëntwintig paar blote billen garanderen volledige aftrekbaarheid", *Fiskoloog,* No. 245 (30 March 1989) at 1-3.
16. See the answer on a parliamentary question: Vr. en Antw./Q. et R., Senate, 1988-89 (13 June 1989) at 1779, Question N16. 193 by Senator Peeters of 13 April 1989.
17. See Verjans, P., "Belgium: Tax Reform 1988", 28 *European Taxation* 10 (1988) at 334; Spruyt, supra, note 2.

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INTERNATIONAL:

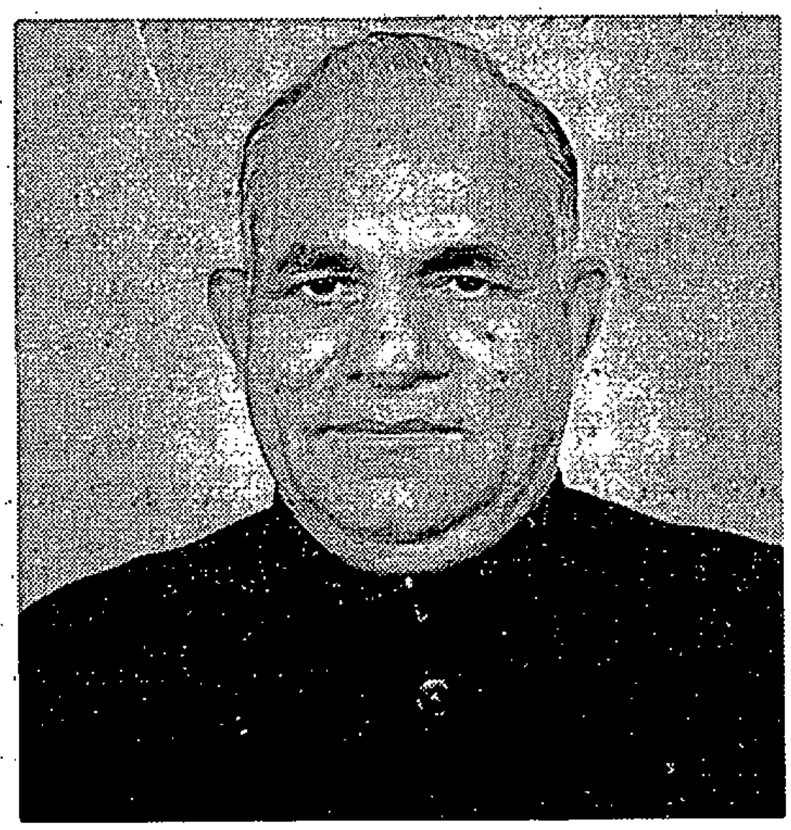
Disregard of Legal Entity:

The International Scene

Har Govind

I. INTRODUCTION

The modern "company" originated as a legal entity around 1100 A.D. By the close of the 19th century, it became a commercial instrument of great effectiveness. Lord Denning compared a "corporation" with the human body,[1] i.e. it has hands, a brain and a nerve centre which control its actions. Its immense role in economic development has been extolled for its capacity to get things done. Today, the company is a powerful instrument for the expansion of trade and commerce, the production of goods and the provision of services. With proper guidance, it ushers in growth with social justice. During the long period of its evolution, however, the company has also acquired some questionable characteristics. This article studies and analyzes the situations in which the legal personality of a corporation is disregarded by legislative measures or court decisions in India and other countries. Disregard of the legal entity is used to check tax avoidance and other legal infringements or to promote planned socio-economic objectives.



II. CONCEPT OF CORPORATE ENTITY

In India, a company is defined for tax purposes in the Income Tax Act 1961 (ITA) and for company law purposes in the Companies Act, 1956.[2] The basic concept under both Acts is that a company is a legal entity separate from its members. It has perpetual existence and never dies a natural death. A company can own property and assets. It has its own seal. It can sue and be sued in its own name. Under the Companies Act, a right to claim dividends arises only after a dividend is declared by a company in a general meeting. Until such a declaration is made, no shareholder can claim any dividend or part of the profit from the company.[3] The liability of the shareholders is limited to the face value of their shares. In the event of a liquidation, shareholders are not liable for the debts of the company if they have fully paid for the value of their shares. If the shares are partly paid, shareholders can be called upon to pay the unpaid portion.

III. QUESTIONABLE TRANSACTIONS

Transactions entered into for the avoidance of taxation, exchange control or other laws take many forms. Besides transactions between a company and its directors and shareholders, the most common arrangements are inter-company transfers. One well-known category of inter-company transactions is known as "transfer pricing" arrangements.

A. Transfer pricing

The primary characteristic of inter-company transfer pricing is that the price is not established on an independent, arm's length basis. It is determined by a single multinational enterprise (MNE). Transfer pricing generally refers to the value fixed for the transfer of goods, services or technology between related entities, such as (i) parent and subsidiary corporations; (ii) sister corporations; or (iii) parties which are controlled by a common entity. Transfer pricing manipulations are arranged by fixing the prices outside the range of defensible prices, i.e. prices which cannot be supported by independent data or evidence. The net result is the shifting of profits, properly attributable to a high tax jurisdiction, to a no tax or low tax area.

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1. *Bolton Engineering Company Ltd v. T.J. Graham & Sons Ltd.*, (1956) 3 All E.R. 624.
2. Income Tax Act 1961 (ITA) Sec. 2(17); Companies Act Sec. 3.
3. *Mathai Chandy v. Hill Land Transport Union Ltd.*, (1955) *Indian Law Reports*, Travancore 73.

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1. Use of low tax jurisdiction

There are many instances where MNEs channel their profits to subsidiaries or associates located in tax haven countries through deflated pricing. This is done to avoid taxation, circumvent exchange controls or reduce exposure arising from political uncertainties. An MNE having a manufacturing or purchasing subsidiary or associate in one country may float a marketing agency or subsidiary or associate in a tax haven country. For example, when the goods manufactured or purchased in one country are to be sold to third parties in another country pursuant to instructions from or on behalf of the subsidiary in the tax haven country, the subsidiary in the exporting country forwards goods to the third parties and debits the subsidiary in the tax haven country at less than the fair market price. The subsidiary in the tax haven country would charge the third parties the real market price and pocket the difference. Very little would have been done by the entity in the tax haven country by way of market exploration or any other work to justify taking a large share of the profit.

Normally, it would be difficult for the tax authorities of the exporting country to ascertain whether the export price is a fair market price for the goods. Nevertheless, if any such transaction is sought to be routed through a tax haven country, provisions must be made regarding the transfer price. The transaction is channelled through the tax haven country only to divert income from the exporting country to the tax haven country. It has been found in some cases that the prices of exported goods are declared in the bills of lading by the exporting enterprise. Examination of the bills of lading may reveal that the actual prices charged to third parties for these goods are much more than the prices charged from the subsidiary.

IV. HISTORICAL PERSPECTIVE

The debate on the disregard of the corporate entity began in the late 19th century. The U.K. House of Lords issued a traditionally conservative opinion in 1897 in the case of *Aron Salomon v. Salomon & Company*.[4] Salomon formed a company comprising himself, his wife and their 5 children. He then sold his own business to the company at an exorbitant price and was compensated in the form of fully paid shares and debentures. The company inevitably went bankrupt, and Salomon claimed precedence for his debentures over the firm's unsecured creditors. The trial judge and Appellate Court saw through the game and rejected Salomon's claim. However, their judgement was reversed by the House of Lords which held that the company was distinct from Salomon (the individual) and that Salomon had a prior claim on the company's assets as a secured creditor. Refusing to identify a company by reference to its controlling interest, Lord Mac Naughten observed that it has become the fashion to call companies of this class "one-man companies". He held that if it is intended to claim that a company, which is under the absolute control of one person, is not a legally incorporated company, such a view is inaccurate and misleading. Lord Halsbury added: "It is impossible to say at the same time that there is a company and there is not".

A. Departure from Salomon case

Some time after the Salomon decision, the courts began to consider existing economic realities. Two English cases which make a complete departure from *Salomon* and disregard the sanctity of the corporate personality may be briefly noted.

1. Shoenhofen Brewery[5]

In this case, all the property of a New York company, except its land, was transferred to an English brewery company. The New York company continued to exist only as a land-owner because under New York law aliens were not allowed to own land. All the shares of the New York company, except 3, were held by the English company. On the basis of these facts, it was held that the business of the New York company was in reality the business of the English company, and thus subject to U.K. income tax.

2. Firestone Tyre[6]

Here Firestone, a U.S. company, had a U.K. subsidiary. Under an arrangement with its distributors in Europe, all the supplies to Europe were delivered by the U.K. subsidiary. The U.K. subsidiary credited Firestone with all the sale proceeds and deducted its cost plus 5%. Firestone claimed that the subsidiary was a separate legal entity and that it was selling its own goods as principal to the distributors. The House of Lords, nevertheless, held that the substance of the arrangement was that Firestone traded in the U.K. through the agency of its subsidiary, that the trade of selling tyres to persons outside the U.K. was carried on in the U.K. and was exercised by Firestone through the subsidiary. Therefore, tax was chargeable in respect of the profits of that trade.

B. Tearing the veil: Leading Indian case

There is a catena of case law explaining the circumstances in which the corporate veil can be pierced in order to check tax avoidance schemes when necessary. Income tax officers and other law enforcing authorities are entitled to pierce the corporate veil in view of economic realities and attendant circumstances. In the case of collusive arrangements, the courts will not allow company promoters to syphon off profits which they are making by operating through dummy companies.

In *Juggilal Kamlapet v. CIT,*[7] the taxpayer was a partnership constituted by members of the Singhania family. The firm promoted a company called J.K. Iron and Steel Co. Ltd. in which the partners held the majority interest. The firm was appointed as managing agents of the company. The newly formed company borrowed money from Juggilal Kamlapat Bankers, another associated concern of the Singhania group. Under the pretext that the managing agents were unable to provide the company with finances to repay loans due to the bankers, the managing agency was terminated with a payment of 200,000 Rs. as compensation to the firm Juggilal Kamlapat. A new company, J.K. Commercial Corporation Ltd., in which the Singhania brothers, their wives and children held a large majority of shares, agreed to provide the finances, and were appointed the new managing agents of the company. The issue was whether the compensation of 200,000 Rs. paid to Juggilal Kamlapat was income chargeable to tax.

The Tribunal, after considering all facts and circumstances, concluded that the termination of the managing agency was a collusive device used for the purpose of evading income tax, that the partnership continued to enjoy the benefits of

4. (1897) AC 22(HL).
5. *Althorpe v. Peter Shoenhofen Brewery Co. Ltd.,* (1899) 4 TC 41.
6. *Firestone Tyre and Rubber Co. Ltd. v. Lewellin,* (1958) 33 ITR 741 (HL).
7. (1970) 73 ITR 702 (SC).

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the managing agency as shareholders and directors of the new managing agency – namely, J.K. Commercial Co. Ltd. – that there was only a change of personnel in the managing agency and not a change of office and that the sum of 200,000 Rs. was received in the course of business, subject to tax in the hands of the firm, Juggilal Kamlapat. Agreeing to these findings, the Supreme Court held that the income tax authorities were entitled to pierce the corporate veil and examine the substance of the transactions. In reaching this conclusion, the Supreme Court referred to the 2 English cases discussed above. The ratio of these 2 English cases fully supports the Supreme Court's decision in the Juggilal Kamlapat case.

C. One who sets the mask cannot lift the veil

Persons who create corporate entities cannot subsequently claim that such entities may be disregarded. Two representative court decisions, one an Indian tax case and the other a U.K. stamp duty case illustrate the approach of courts in dealing with such attempts.

1. Bihar newspapers[8]

The taxpayer, an individual, owned 2 newspaper businesses. A company was formed to acquire the businesses as a going concern, with all their assets and liabilities. The consideration for the transfer was satisfied by fully paid shares of the requisite amount. The transaction resulted in a gain of over 130,000 Rs., i.e. the excess of the sale price over the discount.

The question raised was whether the profit was taxable under Sec. 10(2)(vii) of the 1922 Act corresponding to Sec. 42(2) of the Income Tax Act 1961. The taxpayer argued that the company was not distinct and separate from himself. He owned practically all the shares of the company, and it was open to the Court to lift the corporate veil in order to ascertain who were the real parties to the transaction. The Patna High Court did not accept this plea. It decided that the company was separate and distinct from its members and that it was capable of receiving certain rights, privileges and obligations not available to its members. The High Court observed that it was the duty of the Court to review the economic realities. The doctrine that no man can make profit out of himself does not apply to transactions between a person and limited company.

2. U.K. stamp duty[9]

In this case, an agreement was entered into between 8 partners. Under the agreement, the partners stipulated to transfer the property, assets and liabilities of their partnership to a corporation formed by all the partners exclusively for the purpose of taking over the same. In return, the partners were to receive shares in the corporation in proportion to their interest in the partnership. The partners conveyed and assigned to the corporation the real estate, trade marks and other properties of the partnership. The issue was whether there was a transfer of property from the partnership to the corporation within the meaning of the Stamp Act.[10] It was argued that the corporation had no other property except what it took under the conveyance. The conveying partners received no consideration for the conveyance, except the value of the shares derived from the property conveyed. The Court held that the conveyance by sale was chargeable with ad valorem duty, notwithstanding the fact that the partners who conveyed the property were also the individuals who constituted the corporation. The Court observed that the claim was fallacious from the beginning to end. First, a corporation is a different entity from the individuals who comprise it. Secondly, the shares and debentures of a corporation are not the same as the property which the corporation owns.

D. STATUTORY PROVISIONS

Legislatures in various countries often pierce the corporate veil by enacting specific provisions in taxation or allied statutes, depending upon the situation at hand. Sometimes the corporate mask is unveiled to check tax avoidance or other legal abuses. A U.K. court has very appropriately observed[11] that the legislature can forge a sledge-hammer capable of cracking the corporate shell; and it can, if it so chooses, demand that the courts ignore all the conceptions and principles which are at the root of company law.

Generally, legislation is enacted for the following purposes:
(1) to prevent tax evasion or avoidance;
(2) to combat transfer pricing manipulations;
(3) to tax groups; and
(4) to promote economic growth.

To deal with problems arising from transfer pricing arrangements, most countries follow the arm's length pricing standard. Group taxation makes an automatic adjustment for transfer pricing in the group. Group taxation is also aimed at conferring some tax benefits to promote economic growth. The legal position in some selected countries is analyzed here with the aid of some leading court decisions.

A. Australia

The anti-avoidance legislation in Australia is contained in Part IVA of the Income Tax Assessment Act, 1936 (ITAA). This part applies to any agreement, arrangement, understanding, promise or undertaking, whether express or implied, legally enforceable or not.[12] It applies when the Commissioner is satisfied by certain express criteria that the taxpayer's dominant purpose was to obtain a tax benefit, and a tax benefit was in fact obtained.

1. *Shareholders held liable for company tax*

One Australian court decision against tax avoidance deserves special mention. Measures have been introduced in Australia to deal with what is known as "bottom-of-the-harbour companies". They are in effect sham companies, rarely in existence long enough to discharge their liabilities and in any event lacking the assets to do so. The general effect of the anti-avoidance legislation has been to render the shareholders and/or scheme promoters responsible. Severe penalties in the form of fines or imprisonment may also be imposed under the provisions of a separate act.[13] In a recent case,[14] the shareholders who were admittedly under duress paid tax assessments levied by the Commissioner of Taxation. The question which the court had to consider was

8. *Maharajadhiraj Sir Kameshwar Singh v. CIT,* (1963) 48 ITR 483.
9. *John Foster & Sons Ltd v. Commissioners of Inland Revenue,* (1894) OB 516.
10. *Editor's note:* "The Stamp Act 1891 makes provision for valuing the consideration for a sale where it consists of stock or securities (marketable or non-marketable), and it has been held that this impliedly converts a transfer of property in consideration for shares (or presumably securities) into a sale for purposes of stamp duty." Nock, R.S., Monroe and Nock on the Law of Stamp Duties (London: Sweet and Maxwell, 1986).
11. *Bank Voor Handel en Scheepvart N.V. v. Statford,* (1984) OB 248.
12. Sec. 177A (1) ITAA.
13. The Crimes Taxation Offences Act 1980.
14. *Re Gasbourne Pty Ltd.,* (1984) 15 ATR.

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whether the shareholders could recover this money from the promoters of the scheme under which the company in question had been established or, if it had sufficient assets, from the company itself.

The shareholders lost on both counts. They paid the tax owed by the company in order to avoid the penalties which they suspected, no doubt quite rightly, would in due course be applied against them. However, because the assessments were still against the company and not the shareholders individually, the judge ruled that they had paid the tax in question voluntarily rather than compulsorily. There was, therefore, no strict legal obligation to pay, and so no common law right of recovery against the company either while it continued to trade or when it was in liquidation.

The issue of unjust enrichment was also raised as one way the shareholders might recover their money. However, they failed on this ground, too. The judge observed that this was an equitable doctrine, and not applicable in this case because the shareholders had willingly pursued a strategy with the "bottom-of-the harbour" companies whereby those companies could not pay the tax due. There were also considerable irregularities in the creation and administration of the companies.

B. Brazil

Currently, income tax legislation in Brazil consists of Laws, Decree-Laws and Decrees. These documents are consolidated from time to time into a single text[15] which is issued by means of a decree. The Brazilian law lists 4 important circumstances in which transactions with related persons (which includes a corporation) are regarded as a disguised distribution of profit. These are:

(1) a company sells any property to a related person at a price significantly below market value or purchases any property from a related person at a price significantly above the market price;
(2) a company fails to exercise a right (and thereby loses money already paid out) with the result that the related person obtains a benefit;
(3) a company pays rent, royalties or fees for technical services to a related person at a rate significantly above the fair market rate; and
(4) a company enters into any other business transaction with a related person on terms that would not prevail between independent parties.

In cases (1) and (3), the difference between the fair market price and actual price or rate is added to the taxable income of the company. In case (2) the money lost is not deductible. In case (4) any tax advantage to the company is cancelled.

1. *Group of companies in Brazil*

The joint taxation of a group of companies which was earlier established in Brazil has since been revoked.[16] In general, Brazilian tax law treats every company in a group as an independent unit. No provision is made for affiliated companies to file a consolidated tax return or for the losses of one company in a group to be deducted from the profits of others in the same group. When fixed assets are transferred between related companies, a taxable capital gain cannot be avoided by fixing the transfer price below fair market value. Market value will be adjusted by the tax authorities. Moreover, no relief from dividend withholding tax is available for dividends paid between affiliated companies.

2. *Reorganizations*

Brazilian law has special rules for reorganizations. The 3 major types of corporate reorganization are:

- Mergers (incorporaçãos) – the absorption of one or more business entities by another existing entity;
- Consolidations (fusãos) – the union of 2 or more existing entities to form a new entity;
- Spin-offs (cisãos) – the transfer by a legal entity of part of its assets and liabilities to one or more entities already in existence or formed for this purpose.

In any of these types of reorganisation, if assets and liabilities are transferred at their existing book values, the transfer will normally be free of income tax. If assets are revalued incidentally to a reorganization, any surplus arising will be subject to income tax immediately unless it is maintained in a revaluation reserve account in the books of the surviving enterprise. A revaluation reserve account becomes taxable either when capitalized (except to the extent that the reserve was generated by a revaluation of real estate) or realized through depreciation or disposal of the underlying assets. Unabsorbed tax losses resulting from a transfer or reorganization cannot be utilized by the transferee enterprise for set off against its own taxable profits.

C. Canada

There is a brief statutory provision in Canadian tax law on transfer pricing arrangements.[17] It provides that transactions between affiliated parties must be governed by the arm's length principle in terms of the "fair market value". The provision[18] also enunciates the "reasonable amount" concept.[19]

Revenue Canada has published an information Circular[20] entitled "International Transfer Pricing and Other International Transactions" which provides detailed official guidelines on how Revenue Canada approaches intercompany transfer pricing arrangements. The Circular has no legal force. It does not affect rights of appeal by the taxpayer. The Circular consists of 3 parts, i.e. law, pricing methods and audit. In para. 6, the Circular states in effect that establishment of the "reasonable amount" is preferred as compared to fixation of the "fair market value" in arriving at the arm's length price.

1. *Corporate groups*

Consolidated tax returns for groups of related corporations are not permitted for Canadian tax purposes. For certain purposes (such as eligibility for the reduced rate of tax on business income of certain Canadian controlled private corporations), the relationship of various corporations and/or their shareholders is considered in determining whether or not the corporations are associated with one another. Some instances are (a) small business deductions, (b) tax-free intercorporate dividends, and (c) the benefits of the "rollover" (non-recognition) provisions which are available, particularly for corporate reorganization.

2. *Aluminium billet*[21]

A recent decision provides a strict warning that it is difficult to avoid Canadian taxation through artificial or unreasona-

15. Income tax Regulation (Regulamento do Imposto de Renda). The latest income tax reform was introduced through Law 7450 of 23 December 1985. In general it applies to income arising as from 1 January 1986.
16. Decree-Law 1598/77, repealed by Decree-Law 1648/78.
17. Canadian Income Tax Act, Sec. 69(1).
18. Canadian Income Tax Act, Secs. 69(2) and (3).
19. *Editor's note:* The "reasonable amount" is the amount that would have been reasonable in the circumstances if a non-resident person and the taxpayer had been dealing at arm's length.
20. Circular No. IC87-2 of 27 February 1987.
21. *Indalex v. The Queen,* 86 DT 6039.

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ble pricing arrangements involving transhipment companies. Revenue Canada assessed a Canadian company, Indalex Ltd., for allegedly paying more than the fair market price to a sister company established in Bermuda, Pillar International Services Ltd. (Pillar). Aluminium billet used by Indalex for its processing activities were purchased through Pillar from Alcan Ingot, an independent Canadian company.

The issue which finally emerged for decision was whether the transaction was subject to Sec. 69(2) of the Income Tax Act. Reed J. took into consideration the testimony of the Crown's expert witness relating to profit mark-ups earned by entities performing functions similar to Pillar. Relying partly on the expert's evidence, Reed J. made her own assessment of the services of Pillar in supplying the billet. In conclusion, Reed, J. held that the reasonable prices between Indalex and Pillar should be the amount which reduces roughly by 80% of the net profit earned by Pillar in supplying the billet to Indalex.

D. China (People's Republic)

The People's Republic of China (PRC) is now evolving as a mixed economy, based considerably on market forces. The PRC has built up a sophisticated income tax regime[22] since the death of Mao Zedong. It has also embarked on the establishment of a network of tax treaties to encourage foreign investment. However, the current Chinese tax legislation codified during 1980-81 is still in the evolutionary stage. No provisions have been enacted to deal with transfer pricing arrangements. There are also no provisions in the present Chinese tax system for group taxation.

E. France

For inter-company pricing, relevant French law[23] provides that in assessing the income tax due from enterprises which are controlled by or which control enterprises situated outside France, any profits indirectly transferred to the latter, whether by an increase or reduction in the purchase or sales price or by any other means, must be added back to the balance shown in the accounts. The same procedure applies to enterprises that are controlled by an enterprise or group of enterprises which also control enterprises situated outside France. Stated very briefly, the law permits the authorities to add back profits improperly transferred by a company to its non-resident affiliate through unacceptable transfer pricing arrangements.

1. *Sham Swiss subsidiary disregarded*[24]

During the years under litigation (1969-1971), a French corporation P had as its main purpose the production and sales of records of a singer Ms. Q. The French corporation P possessed the exclusive right to sell her records in Belgium, Luxembourg, the Netherlands, Switzerland and the former French territories. P created a Swiss subsidiary R, which had its seat of management in Geneva. Q concluded 2 contracts with R under which R was entitled to organize Q's tours abroad. The contracts gave R the exclusive right to sell Q's records in all countries other than those indicated above. Between 1969 and 1971, R received income from the contracts concluded with Q. In those same years, R incurred a number of expenses including:

- expenses connected with the construction of a recording studio on the premises of a second home belonging to Mr. D, director of P;
- a fee paid to an attorney and to several persons who had rendered services to P;
- premiums for a life insurance contract on the life of Q;
- travel, advertisement and entertainment expenses refunded to 2 shareholders.

D, the director of P, had been involved in a criminal case regarding the violation of the French exchange regulations and, during these proceedings, it was established that D had (de facto) the power to make decisions for R and that he had taken various initiatives and had concluded engagement contracts in order to execute the contracts concluded between R and Q. Apparently, the persons shown as R's directors had no say in these decisions.

The first issue to be decided was whether R was merely a sham company and whether its income should be attributable to P. The second issue was whether the expenses incurred by P were genuine or whether they were expenses unrelated to P's business and should be added to P's income.

The French Code[25] provides that transactions which dissimulate the real purpose of a contract by stipulating provisions which disguise either the realisation of income or its transfer to other persons may be disregarded by the tax authorities. However, the French-Swiss tax treaty[26] provides that the profits of an enterprise of a Contracting State may be taxable only in that State, unless it has a permanent establishment in the other State. In such a case, the income attributable to that permanent establishment is taxable in the other State. This posed a problem for the French tax authorities. Even though they could prove that R was a sham company so that its existence could be disregarded under the French Code,[27] the taxpayer could still argue that P had a permanent establishment in Switzerland and its Swiss income derived in the name of R was not taxable in France in view of the treaty provisions.[28]

After considering the rival arguments, the French Supreme Administrative Court (Conseil d'Etat) held that R was a sham company whose existence should be disregarded by the French tax authorities. It based its decision primarily on the fact that D apparently exercised complete control over R. The Court found that P and Q had benefited from the contracts concluded by R. The Court also rejected the view that if R's existence were to be disregarded, P possessed a permanent establishment in Switzerland. In those cases where a French corporation creates a foreign corporation for the sole purpose of serving as a cover for part of its own operations, the French corporation cannot invoke the provisions of a tax treaty. The Court also disallowed the deduction for the expenses claimed by P because P had not given any supporting proof that they had been incurred by it for purposes of its business. With regard to the life insurance premiums, it was very clear that the expenses were alien to P's business since P did not benefit from the insurance contract in the event of Q's death.

2. *Sparkplug case*[29]

This recent case has a far-reaching impact on transfer pricing transactions connected to exporting French goods. The case involves the shifting of profits between a French subsidiary

22. Income Tax Law on Equity Joint Ventures, 10 September 1980; Foreign Enterprises Income Tax Law, 13 December 1981.
23. Code Général des Impôts (CGI), Art. 57.
24. Conseil d'Etat, No. 27.846, 22 December 1989, *Revue de Jurisprudence Fiscale* 2 (1983) at 130.
25. CGI, Art. 1649.
26. French-Swiss tax treaty of 9 September 1966, Art. 7.
27. See note 22.
28. See Note 24.
29. Conseil d'Etat, Nos. 34.430-36.880 (36) *Droit Fiscal* 45-46 (1984) at 1352.

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and its sister non-resident affiliates. The subsidiary entered into agreements with 4 non-resident affiliates for the distribution of sparkplugs purchased by it from the manufacturing parent. It paid a commission to the 4 affiliates, equal to the difference between the sales price and purchase price. The French tax authorities made adjustments to the subsidiary's tax returns. The subsidiary appealed. The Court ruled that French tax authorities were not entitled under Art. 57 of the Code General d'Impôts to adjust the taxable income of the sales subsidiary in respect of transfer pricing among associated companies. The Court considered that the abandonment of the total profit on the foreign sales of a product during a period of market penetration constituted an act of normal management. This decision is in conformity with the thinking of the OECD Committee on Transfer Pricing. Developing an export outlet in a competitive situation is, according to the Committee, a case where the transfer of a profit margin is justifiable for a few years.

3. *Group taxation in France*

A major shift pertaining to taxation of French "groups" was undertaken in 1988.[30] The new regime of group taxation consists of fiscal integration (intégration fiscale) of a French resident parent (tête de groupe) and its French resident 95% subsidiaries. From 1 January 1988, the group can consolidate its results for corporate income tax purposes. The French parent may become the only taxpayer of the group. The tax is charged on the consolidated net income of all companies of the group. It should be noted that losses suffered by a group company in accounting years prior to its entry into the fiscal integration are not deductible from the profits of other group members. To qualify as a group member, a company must satisfy certain conditions, including the following:

(i) member companies must have their registered office in France[31];
(ii) they must be subject to French Corporation Tax at the normal rate[32];
(iii) they must have a common accounting year; and
(iv) all companies must have consented to fiscal integration.

The option to be members of the group is valid for 5 years.

4. *Tax consequences of group operations*

The tax implications of some specific operations within a group may be noted briefly.

(1) Debts forgiven (written off) within a group are not taken into account in computing the group taxable income. The forgiven debt is excluded from the profits of the beneficiary company. Conversely, it is not deducted in working out the profit of the creditor company.
(2) Capital gains or losses on asset transfers between members of a group are also neutralized, except when they result from a merger benefiting from the favourable tax provisions under French law.
(3) Transfer pricing arrangements between the members of the group are automatically neutralized.

The position under VAT is quite different from corporate income tax. Intergroup sales are not exempt from value added tax.

F. Germany (Federal Republic)

In Germany, the problems involving inter-company pricing are resolved by the application of a set of specific Administrative Rules.[33] These Rules are comparable with the provisions of Sec. 482 of the U.S. Internal Revenue Code. However, these rules are more refined in respect of management charges and royalties. They require strict documentation and compliance with numerous formalities with one important exception: the documentation can be replaced by a certificate of a German or well-known international chartered accountant or tax adviser.

The German Rules recognize the methods discussed in the OECD Report[34] for determining the proper transfer pricing. However, there is no obligation to follow a particular sequence for applying any method mentioned in that Report. The price is to be established by the exercise of sound business judgement on the basis of data available under the circumstances of the case under examination.

1. *Group taxation in Germany*

Under the interlocking relationship (Organschaft) rules, the entire profits and losses of controlled resident companies, (which basically must be corporations or limited liability companies)[35] may be pooled with those of their domestic parent entity, regardless of its legal form. Thus, the consolidated income is taxed in the hands of the parent. To qualify for the interlocking relationship, the following conditions must be satisfied:

(i) the parent entity must hold directly or indirectly more than 50% of the voting rights of the controlled company throughout the accounting year;
(ii) the parent and controlled company must be integrated throughout the accounting year in both an economic and organizational sense to such an extent that the controlled company has no substantial freedom of decision; and
(iii) a binding agreement must have been made before the end of the first year of the operative period between the 2 entities whereby the parent takes over the profits and assumes the losses of the controlled company for a period of at least 5 years.

A German branch of a foreign company can also become a parent of an interlocking group if the branch satisfies the 3 conditions mentioned above and holds the shares of the controlled companies.

In Germany, no value added tax (VAT) is payable on transactions between members of a group since taxable transactions are attributed to the parent.

G. India

The Indian Income Tax Act (ITA) contains a direct provision[36] which attacks collusive transactions with non-residents. It grants power to tax authorities to determine the reasonable amount of profit arising in India if it appears that a resident taxpayer has transferred his Indian-source income to a closely connected non-resident by collusive invoicing or

30. The major change was brought about by the French Finance Act 1988.
31. The only requirement is that the registered office of the parent must be in France. It may in its turn be totally controlled by a foreign company wherever its main office is situated. The French branch of a foreign company can also qualify as a parent company provided its interests in French subsidiaries are booked as assets of the branch.
32. The normal rate under common right conditions is 42% for tax years starting from 1 January 1988.
33. The Rules formulated in 1983 are known as Principles relating to the examination of Income Allocation in the case of Internationally Affiliated Enterprises.
34. The 1979 Report of the Organisation for Economic Co-operation and Development.
35. A corporation (Aktiengesellschaft) is abbreviated as AG. A limited liability company(Geschäft mit beschränkter Haftung) is referred to as GmbH.
36. ITA, Sec. 92.

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any other arrangement of business operations. What is sought to be taxed is the business of the resident and not that of the non-resident.

The substantive provisions are elaborated and strengthened by Income Tax Rules. Under these Rules[37], notional taxable income may be determined as follows:

(a) as a percentage of the turnover so accruing or arising as the income tax officer may consider to be reasonable;
(b) by an amount which bears the same proportion to total business profits as receipts (accruing or arising) bear to total business receipts; or
(c) in any other manner as the tax authorities may deem suitable.

1. *No group taxation in India*

The Indian ITA forbids any form of consolidated income tax return from combining the profits and losses of affiliated companies.

2. *Buying of losses*

In the case of a public company, the benefit of carrying forward and setting off losses is permissible without any reference to the shareholding. The legal position is different for a private company. The carrying forward and setting off of losses is available subject to certain conditions.[38] The Supreme Court of India explained in a case[39] that if not less than 51% of the voting power remains beneficially held by the same persons on the last day of the accounting year and the immediately previous accounting year, the benefit is available, notwithstanding the change in the shareholding in the accounting year if the change was not effected with a view to avoiding or reducing any liability to tax.

The question is, why should the changes in shareholding affect the right to carry losses forward? The legal provisions were incorporated into the statute to curb the tendency of acquiring companies which had sustained losses in earlier years. Persons carrying on a profitable business could reduce their tax liabilities by setting off the earlier losses of such companies when the shares were held by different persons. It was thought by the Government that such setoffs against subsequent profits should be allowed only if the shareholders in the year in which the income was earned are substantially the same as those in the years in which the losses were incurred. In other words, the provision was enacted to prevent the practice of "buying losses" by acquiring the controlling interest in companies which had accumulated losses and were eligible to benefit from carry forwards. The tax law looks at the substance and disregards the form of the corporate personality.

3. *Tax recovery*

In certain cases, a personal liability is imposed on the directors of a private company in respect of the tax payable by the company. Under this provision[40], which transcends the corporate boundary, where a private company is wound up on or after 1 April 1962 and it is found that any tax assessed on the company whether before, during or after the liquidation cannot be recovered from the company, every person who was a director of the company at any time during the relevant previous year is held jointly or severally responsible for the liability. The director's liability does not extend to arrears of tax dues of the company for assessment year 1961-62 and earlier.[41] A director can escape vicarious liability if he proves that the non-recovery cannot be attributed to gross negligence, misfeasance or breach of duty on his part.

The scope of this provision was amended in 1975,[42] so as to impose personal liability on the directors of a private company in respect of any tax payable by the company when a private company is converted into a public company. The tax assessed in respect of any income of any previous year during which such company was a private company cannot be recovered from the company, persons who were directors of the company in any such previous year will be jointly and severally responsible for the payment of such unrecovered tax.

4. *Growth and development*

Tax legislation in India has adopted a flexible approach in protecting or piercing the corporate veil. The approach is determined by particular objectives which the law seeks to achieve. Broadly speaking, where incentives for industrial growth and development need to be provided, the corporate cover is carefully regulated. When it comes to tax avoidance or prevention of any other legal abuse, the law reaches out to those behind the corporation.

5. *Amalgamation of companies*

The Companies Act regulates all matters pertaining to amalgamation and mergers of companies. The Act contains provisions[43] for facilitating the reconstruction and amalgamation of companies with the sanction of the Court. The scheme of amalgamation is approved by the Court after hearing the shareholders, creditors, the Income Tax Department and the Department of Company Affairs. The Court may refuse to sanction a scheme of amalgamation if it is not in the public's interest. In one case it was found that a transferor company was formed only for the purpose of transferring a building to the transferee company in order to avoid capital gains tax liability. The High Court refused to approve the amalgamation scheme, even though all formalities under the Companies Act were complied with. The Court observed that it could not support a lawsuit the sole purpose of which is to avoid taxation.[44]

6. *Tax implications of amalgamation*

The Act contains some specific provisions to facilitate the amalgamation of companies in the public's interest. Some important provisions may be noted for ready recapitulation. They illustrate some of the examples where the legislation disregards the technicalities of the corporate barrier to promote the public interest.

(a) *Investment allowance*

When the amalgamating company makes use of the investment allowance benefit after fulfilling the eligibility conditions and the asset is subsequently transferred, the unabsorbed investment allowance will not be lost. It will be allowed to be used by the amalgamated company to the extent the amalgamating company would have enjoyed it had it continued to own the asset. The benefit of the carry-

37. Indian Income Tax Rules (1962), Nos. 10 and 11.
38. ITA, Sec. 79.
39. *Commissioner of Income Tax (IT) v. Italindia Cottong Co. (P) Ltd.*, (1988) 174 *Income Tax Reports* (ITR) 160.
40. ITA, Sec. 179.
41. Decision of the Bombay High Court in the case of:
(i) *Union of India v. M.D. Lotlikar,* (1988) 172 ITR 1 and
(ii) *Union of India v. Praveen D. Desai,* (1988) 173 ITR 303.
42. ITA, Sec. 179, as amended by the Taxation Laws (Amendment) Act 1975.
43. Companies Act (1956), Secs. 394 and 394A.
44. *Wood Polymers Ltd.* (1977) 109 ITR 177.

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forward and set-off of the unabsorbed investment allowance is available to all amalgamated companies whether Indian or foreign.[45]

(b) *Capital gains*

The ITA[46] does not regard it as a transfer for the purposes of capital gains tax if the amalgamated company is an Indian company. Similarly, in the case of shareholders of an amalgamating company, the transfer by them of any shares held in the amalgamating company in consideration of allotment to them of the shares in the amalgamated company is not regarded as a transfer[47] and accordingly there is no capital gain resulting from such transfer.

(c) *Set-off of accumulated business losses and unabsorbed depreciation*

The ITA contains very significant provisions[48] for revival of ailing industrial units by way of tax concessions. Ignoring the separate entities of the amalgamating and amalgamated companies, ITA ensures that the accumulated business losses or unabsorbed depreciation of the amalgamating company may be treated as those of the amalgamated company. This means that the losses could be carried forward for 8 years after the close of the year in which the amalgamation takes place. Unabsorbed depreciation can be carried forward indefinitely.

These carry-forwards and set-offs are subject to certain conditions. The amalgamation can be effected only after approval by the Board for Industrial and Financial Reconstruction.[49] The Board has been vested with the powers of the Central Government to approve proposals for the amalgamation of a sick industrial company with a healthy company.

H. Japan

Japanese inter-company pricing law[50] was adopted in March 1986. It entered into force from 1 April 1986. The law provides[51] that if a transaction between a Japanese corporation and a foreign related party is entered into at a price which is less than, or more than, an arm's length price, the transaction must be adjusted to an arm's length price for computing taxable income. A related party is defined as a foreign corporation which is at least 50% owned directly or indirectly by the Japanese corporation or which owns directly or indirectly at least 50% of the Japanese corporation. This provision applies only to entities which are "corporations" under Japanese tax law and not to other entities.

The statutory provision has been supplemented by a Cabinet order which provides that the level of 50% ownership is established when one of the following 2 conditions is satisfied:

(i) the Japanese corporation has direct or indirect ownership of 50% of the issued shares or contributed capital of the foreign corporation, or
(ii) half or more of the issued shares or contributed capital of both the Japanese corporation and the foreign corporation are owned by the same person.

No group taxation under Japanese law

Japanese tax law does not permit consolidated tax returns. Each affiliated corporation must calculate its taxable income on the arm's length principle. Losses in one corporation cannot be set off against the taxable income of other related corporations. There is one exception to this general rule: when a loss making company is liquidated and unable to pay its debts, the company owning its shares or having made the loan to it can write off the unpaid debts for tax purposes.

I. Netherlands

There are no specific rules regarding inter-company transactions in the Netherlands. Payments to related parties whether resident or non-resident are deductible provided that arm's length conditions are deemed to prevail. If transactions with related parties are not at arm's length, taxable profit may be adjusted. If such an adjustment has to be made, the excess payment is treated as a hidden distribution and added to taxable profit.

The Dutch Supreme Court (Hoge Raad) has also decided a case similar to the Swiss subsidiary case discussed under French law (see above). However, in the Dutch case, the Hoge Raad allocated the profits which were allegedly derived by the Swiss company to its Dutch permanent establishment.[52]

Group companies in the Netherlands

Profits and losses of resident group companies with the legal form of BV or NV[53] may be combined by filing a consolidated tax return. The term for a group of companies which submits a consolidated return is a "fiscal unity" (fiscale eenheid).

In order to be entitled to file a consolidated tax return for a particular year, one company must hold at least 99% of the issued share capital of the other company throughout the accounting year, or since the date of incorporation of the other company, if later. The Finance Ministry's approval is required, and is given only if both companies accept conditions imposed by the Ministry.

The advantages of the fiscal unity are that profit and losses of group companies concerned can be offset against each other, and assets can be transferred between those companies without regard to capital gains or losses. In general, therefore, a very flexible situation exists. Losses incurred prior to fiscal unity can be carried forward only against future profits of the same company and cannot be offset against the total profits of the fiscal unity. Converse rules apply to the carry-back of losses incurred by the fiscal unity.

J. Nigeria

Transactions between parent companies and subsidiaries or sister companies or relatives (in the case of individuals) are deemed to be artificial or fictitious if, in the opinion of the Revenue, they were not made at arm's length. In such a case, the Revenue must use arm's length prices instead of the actual prices invoiced to determine taxable profits.

No group taxation

It is not possible under Nigerian law for groups of com-

45. ITA, Sec. 32(A).
46. ITA, Sec. 47(v).
47. ITA, Sec. 47 (vii).
48. ITA, Sec. 72A.
49. The Board is constituted under the provisions of a separate legislation known as "Sick Industrial Companies" (Special Provisions) Act, 1985.
50. Special Taxation Measures Law 1986 (Sozei Tokubetsu Sochi Ho).
51. Special Taxation Measures Law, Art. 66-5, Sec. 1.
52. For full details of this Dutch case, see 23 *European Taxation* 6 (1983) at 199.
53. A BV (besloten vennootschap met beperkte aansprakelijkheid) is a private limited company and a NV (naamloze vennootschap) is a public limited company.

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panies, however related, to combine their results for tax purposes in any way, to transfer assets between companies, tax-free, or to pay inter-company dividends without any tax consequences.

K. United Kingdom

The law relating to transfer pricing issues is contained in more than one Act.[54] Most U.K. tax treaties also contain a provision on "Associated Enterprises". Stated briefly, the law[55] provides for determination of an arm's length price when property has changed hands between parties, where one has control over the other or both are under common control. These legal provisions confer power on the Inland Revenue (IR) to adjust the taxable income of the U.K. party, if the IR finds that a higher or lower price was set on the transaction as compared to the price that would have been applied by independent parties dealing at arm's length.

There is very little case law in the United Kingdom on transfer pricing. Practically all cases are settled by negotiation. In this context, the IR published Notes called "The Transfer Pricing of Multinational Enterprises" which provide valuable practical guidelines on arm's length pricing. In general, the IR follows the guidelines contained in the 1979 OECD Report. Transfer pricing issues are examined and settled on a case-by-case basis.

Group taxation in the United Kingdom

Corporation tax is assessed separately on each company of a group. However, the group structure becomes significant for purposes of (1) inter-company dividends, (2) loss relief and (3) asset transfers.

L. United States

Sec. 482 of the U.S. Internal Revenue Code contains the general provision of the tax law on transfer pricing. Under this section, the arm's length standard is adopted. The arm's length price means the amount which would have been paid by an independent unrelated party for property under the same circumstances. The law authorizes the Internal Revenue Service (IRS) to make suitable adjustments in accordance with the arm's length price when one member of a controlled group sells tangible property to another member of the group and the price charged is either more than, or less than, the arm's length price. Inter-company transactions which fall within the purview of Sec. 482 must be reported by filing forms issued by the IRS (Nos. 5471 and 5472).

There is a catena of administrative rulings and court decisions on the scope of Sec. 482. It is not necessary to summarize them because the 1986 Tax Reform Act has considerably changed the old law by significantly amending Sec. 482. It is, however, appropriate to discuss the decision in a case which has an important bearing on the U.S. transfer pricing law.

1. *Hospital Corporation case*[56]

The Hospital Corporation of America (HCA) assumed management of the Faisal Medical complex in Saudi Arabia. It managed the project through a related corporation established in the Cayman Islands (Cayman Corporation). According to its plan, HCA stood to gain substantial tax benefits through the Cayman route. The essential facts found were (i) though the management contract was not formally signed at the time of establishment of the Cayman Corporation, the Contract had been completely negotiated by that time, (ii) the agreement was signed when the Cayman Corporation was established, (iii) all the transactions concerning management of the Faisal complex were carried on through the Cayman Corporation, (iv) the name and the know-how of the personnel of the Cayman Corporation were derived from HCA, and (v) the services on behalf of the Cayman Corporation were performed by HCA personnel.

The ultimate question that arose between HCA and the IRS was the amount of reasonable compensation due to the parent company from the Cayman affiliate. After reviewing the available documentation, the Court allocated 75% of income arising from the first year of operation to the parent company.[57] There is a marked similarity between this HCA case decided under the U.S. law and the decision in the Aluminium billet case under the Canadian Income Tax Act.

2. *Tax Reform Act 1986*

Sec. 482 was amended by the 1986 Tax Reform Act. The IRS is now empowered to levy a deemed periodic, fair market royalty on sales or licences of intangible property to domestic or foreign related entities of U.S. corporations. Some experts are of the opinion that this new fair market royalty, called "super royalty" heralds the end of the arm's length standard. However, U.S. Treasury's International Tax Counsel Stephen Shay thinks differently.[58] Shay thinks that while amending Sec. 482, the U.S. Congress had no intention of abandoning the arm's length standard. According to him, the pre-amendment arm's length rules will continue to apply to transfer of intangible property by U.S. corporations to related entities established in foreign countries. Shay's opinion represents the official view and indicates that the IRS will continue to apply the arm's length tests to transfer pricing problems even after the amendment of Sec. 482. The impact of this new amendment as a revenue raiser is being watched with interest.

In 1988, the U.S. Treasury Department and the IRS issued[59] a joint discussion draft widely known as the "Sec. 482 White Paper". It was issued in response to amendments made by the Tax Reform Act 1986 in respect of transfers of intangible property between related parties. After considering the comments received from interested parties, IRS is expected to amend the current Regulations to Sec. 482.

3. *Consolidated tax returns*

A group of domestic affiliated companies can elect to file a consolidated tax return that combines the separate taxable incomes of the members in the group while eliminating the results of inter-company transactions, including dividends. For eligibility to file a consolidated return, the following 2 conditions must be satisfied:

(i) a common parent corporation must own directly at least 80% of the voting power of all classes of stock and at least 80% of each class of non-voting stock of at least one other includable corporation in the affiliated group;
(ii) each corporation in the affiliated group, other than the common parent corporation, must have at least 80% of the voting power of at least all classes of its stock and at least 80% of each class of its non-voting stock, owned

54. Income and Corporation Taxes Act (ICTA) (1970) Sec. 485; Finance Act (1975) Sec. 17.
55. ICTA, Sec. 485.
56. Hospital Corporation of America (1983), 81 T.C. 520.
57. Id.
58. Stephen Say's speech before the International Fiscal Association in February 1987.
59. The Sec. 482 White Paper was issued on 18 October 1988.

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directly by one or more of the other corporations in the affiliated group.

Consolidated tax returns are advantageous in some respects. The possible advantages may be briefly listed:
(a) ordinary losses of some member companies can be offset against others' profits;
(b) capital losses of one member can be offset against the capital gains of another;
(c) tax on certain inter-company profits can be deferred; and
(d) tax credits may be more currently utilized by the group.

4. *Leading case under U.S. captive tax law*

The Gulf Oil decision[60] is a major turning point in the development of U.S. captive tax law. The "economic family concept" was rejected by the court, and it was stated that emphasis should be placed upon the insurance premiums contributed by policyholders and not on the capital structure of the captive. This could be interpreted as a "drawing down" of the corporate veil, effectively divorcing capital ownership from policyholder status. The decision was not all good news, however, in that the taxpayer lost because during the years in question third party business was de minimis. However, in subsequent years substantial third party business was written and, whilst the court expressly reserved judgement on these years, the court recognized through dicta that third party business and the concomitant operation of the law of large numbers can render the captive a separate viable entity financially capable of meeting its obligations. It is important to note that for the first time, the Tax Court enunciated the circumstances under which the writing of unrelated risk by a captive may be sufficient to constitute a transfer of risk between a parent (and/or its affiliates) and its captive.

VI. CONCLUSION

The subject of disregard of the legal entity is vast and varied. The scope of this article is limited to disregard of the corporate entity. The area of "reorganizations" which includes amalgamation, also involves many situations of disregard of the corporate entity. However, the comments on this point are confined, for brevity, to only 2 major developing countries, namely Brazil and India.

60. *Gulf Oil Corp. v. Commissioner,* (1987) 89 T.C. 1010.

CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

We welcome the submission of articles which are of interest to tax professionals, executives and scholars to be considered for publication. The author should ensure that the significance of the contribution will also be apparent to an international readership.

The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

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CYPRUS:

Double Tax Treaties

Tonis Shakallis

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I. INTRODUCTION

Since the introduction of tax incentives for non-residents[1] Cyprus has developed into a major business centre in the Middle East. Tax incentives are primarily available to non-resident companies (and other legal entities) which do not carry on any trading activities within Cyprus.

Several other factors have influenced the development of Cyprus, i.e. the island's key geographic position[2], its excellent infrastructure[3] and an increasing network of tax treaties (a rare occurrence among tax havens or "low tax" jurisdictions).[4] By using Cyprus tax treaties[5] in conjunction with the tax advantages of "offshore" Cyprus entities[6], not only is double taxation prevented but, in many instances, tax liability may be considerably reduced or even avoided. This article highlights the advantages of using Cyprus-registered non-resident entities in conjunction with tax treaties.

II. TYPES OF NON-RESIDENT ENTITIES

Non-resident entities which can be established in Cyprus include limited liability companies, partnerships, branches of foreign companies, trusts, shipping companies[7], captive insurance companies and offshore banking units.[8]

A. Non-resident limited liability company (offshore company)

A non-resident limited liability company (qualified company) must be exclusively owned, directly or indirectly, by non-residents, and it must not derive any income from sources within Cyprus.[9] A qualified company will enjoy full exemption from exchange control (after permission from the Central Bank of Cyprus) and will be taxed on its net profits at 10% of the normal company income tax rate of 42.5%, i.e. at 4.25%.[10]

Various other incentives are also available, such as duty-free import of office equipment, automobiles, household goods, etc. for the company and its non-Cypriot employees. Reduced income tax rates apply to the non-Cypriot employees.

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1. Tax incentives were first introduced in 1975, but were later modified in 1977 by Law 15.
2. Cyprus is the third largest Mediterranean island. It has a total area of 9,251 square kilometers, and is situated between 3 continents, at the crossroads of one of the most ancient and traditional sea lanes of the world. Cyprus is within 3 hours flying distance from central Europe, the Middle East and Gulf States and North Africa.
3. Cyprus has probably the best infrastructure in the region. For example, it offers:
(i) low operational costs and a relatively low cost of living;
(ii) first class telecommunications (Cyprus is rated fourth world-wide in this field);
(iii) daily air connections to almost every country in the region;
(iv) high level professional, banking and managerial services as well as efficient staff available at all levels;
(v) pleasant living conditions and European standards of living;
(vi) efficient government services, good industrial relations, etc.;
(vii) excellent shipping services and all facilities available for transit trade, bonded storage, etc.; and
(viii) the English language is widely spoken and used, particularly in business.
4. The Cyprus government is eager to expand the country's treaty network. Thus far, Cyprus has concluded income tax treaties with the following countries: Bulgaria, Canada, Czechoslovakia, Denmark, the Federal Republic of Germany, France, the German Democratic Republic, Greece, Hungary, Ireland, Italy, Kuwait, Norway (under renegotiation), Romania, Sweden (entered into force 13 November 1989 with retroactive effect from 1 January 1988), the United Kingdom, the United States, the U.S.S.R. and Yugoslavia. The treaty with Norway dates from before 1960 when Cyprus was still a British colony; the Norway–U.K. treaty therefore included Cyprus as a partner. Cyprus has now negotiated its own treaty with Norway which closely follows the OECD Model treaty. However, the treaty has not yet been entered into force; it must still be signed and ratified. Treaties with Austria and Egypt have been signed but both treaties still require ratification. Treaties are being negotiated with Belgium and Finland. Discussions are being conducted with a number of other countries, including the People's Republic of China and Japan. All new treaties which have been signed or renegotiated closely follow the OECD Model, with no limitation of benefits for companies paying a lower rate of tax. It is expected that the same terms will be achieved in the case of future treaties.
5. In addition to the benefits arising from the treaties (low tax rates for non-Cypriot employees, exemption from customs duties on motor vehicles, office and household equipment and low operational costs), Cyprus has much more to offer non-residents, particularly if an actual presence in Cyprus is envisaged, i.e. if the non-resident entity will have offices in Cyprus and will have non-Cypriot employees living in Cyprus.
6. Law 15 of 1977 provides special treatment for offshore companies: (a) they are taxed at one tenth of the normal company rate of income tax (4.25%); (b) non-Cypriot employees are subject to reduced or zero tax rates; (c) full exemption from exchange control; (d) registration under nominees with anonymity guaranteed; and (e) exemption from various other charges such as stamp duties, etc. In order to be eligible for this special treatment, offshore companies must fulfill certain conditions: the activities of the company must be outside Cyprus; the share capital of the company must be held by non-residents; the company should not obtain any finances from local sources; all local expenses of the company should be covered by funds imported from external sources; and the company should annually submit copies of its balance sheet and profit and loss account to the Central Bank.
7. Shipping profits are exempt from income tax.
8. Captive insurance companies and offshore banking units are governed by special regulations which offer a number of advantages: (in the case of captive insurance companies) (a) minimum paid-up capital of only C£ 10,000 and (b) a tax rate of 10% of the normal corporate rate; (with respect to offshore banking units) (a) registration as a branch or subsidiary or the establishment of a representative office in Cyprus. The tax position of an OBU is the same as that of normal offshore companies or branches, provided their income is derived from offshore banking activities (which in this case includes doing business with Cypriot Registered offshore entities). By special permission from the Minister of Finance, an OBU can transact local business as well, but in such cases its profits from those transactions will be taxed at the full rates (with the exception of interest on loans to Cypriot residents approved by the Minister of Finance under Sec. 10 of the income tax laws).
9. The legal requirements of forming and operating a limited liability company are set forth in the Companies Law, Chapter 113 of the Laws of Cyprus.
10. Non-resident companies which are not shipping companies or offshore companies are generally subject to income tax at the normal company rate of 42.5%. (New legislation has been proposed to replace the 42.5% rate by a 20% corporate tax rate, and the rate for offshore entities would be 20% of that rate, i.e. 4%.)

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B. Non-resident partnership

A non-resident partnership must be comprised exclusively of non-residents whose activities are conducted outside Cyprus. An offshore partnership is also granted the full exchange control exemption (after permission from the Central Bank); it is exempt from all taxes and enjoys all the other incentives applicable to an offshore company.

C. Branch of an overseas company

The above exemptions also apply to branches, provided the branch does not derive any income from sources within Cyprus. The profits of an offshore branch are exempt from tax unless the foreign company exercises its management and control in Cyprus, in which case the branch is taxed at 4.25%.

D. Non-resident trusts

Non-resident trusts can also be established in Cyprus with a non-resident settlor and beneficiaries but the majority of the trustees must be Cypriot residents. The income of such a trust is free from tax provided all trust property (except bank acounts) is situated outside Cyprus.

III. TAX TREATIES

A. General

Most Cyprus tax treaties (in particular those drafted within the last 10 years) closely follow the OECD Model Convention.

Standard provisions are only changed to reflect the tax systems and economic needs of the treaty partners.

Cyprus is the only country offering tax advantages to non-residents whose resident country has concluded taxation treaties with Eastern European countries providing for substantial tax reductions or exemptions from tax in such countries. Furthermore, Cyprus has concluded treaties with probably more Eastern European countries than any other country in the world.[11] In view of the expected continuing increase of trading activities between Eastern European countries and the rest of the world, double taxation treaties with these countries are becoming more important. At present, Cyprus appears to offer tremendous possibilities for either direct investment or for use as a "stepping stone" for business with the Eastern bloc.

B. Personal scope

Under the standard Art. 1, the treaty applies only to persons who are resident of one or both Contracting States. A "person", under Art. 3, includes "an individual, a company or any other body of persons"; a "resident of a Contracting State" under Art. 4(1) is defined as "any person, who under the law of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". Some treaties include in the definition of "resident of Cyprus" "any company whose business is managed and controlled from Cyprus" (treaty with Ireland) or a "Cypriot corporation" (treaty with the United States).

In all of the above cases, the treaties apply to a Cyprus-registered offshore company. The treaty with Ireland, however, also requires that the company be managed and controlled from Cyprus.[12] Some treaties, however, exclude offshore companies from all (the United States, Canada) or some (France, the Federal Republic of Germany, the United Kingdom) treaty benefits.

C. Business profits

The business profits article (Art. 7) prevents tax from being levied by a treaty country on a Cyprus company (including an "offshore" company) unless that company has a permanent establishment in the other country and carries on business in that country through the permanent establishment. This article is important since its benefits are not limited in any way by the treaties, even in the case of offshore companies (with the exception of the United States and Canada).

1. Permanent establishment[13]

The permanent establishment article (Art. 5) in treaties concluded between Cyprus and other countries closely follows the OECD Model Convention, except with respect to building sites, construction and installation projects.[14] In addition to its direct benefits, Art. 5 is useful where activities are to be carried on in a country by a resident of another country with which no double taxation treaty exists. For example, a resident of a country which has no treaty with the United Kingdom but wishes to have a U.K. office to carry on activities which do not constitute a permanent establishment will probably be taxed in the United Kingdom on its world-wide income as the U.K. office will be deemed a permanent establishment (or alternatively the management and control of the company will be deemed to be in the United Kingdom because of the presence of the U.K. office). However, by using a Cyprus-registered "offshore" company which will be effectively managed and controlled in Cyprus, U.K. taxation will be avoided, and the only tax payable will be a tax at the rate of 4.25%.

2. Shipping and air transport

Shipping and air transport profits are only taxable in the State in which the place of effective management is situated (Art. 8). Some treaties (particularly those with the United Kingdom and the United States) exempt from taxation in a Contracting State those profits earned from the operation of ships and aircrafts in international traffic by residents of the other State. Since residency and effective management are easy to establish, Art. 8 allows considerable benefits to be derived from the use of Cyprian shipping companies, in view of the fact that, under Cyprus law, the profits from the operation of a Cyprus-registered vessel are not taxable in Cyprus. Moreover, since the exemption from Cyprus taxa-

11. It has treaties with Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Romania, the U.S.S.R. and Yugoslavia.
12. This requirement is met by having the majority of directors resident in Cyprus.
13. The term permanent establishment is not defined under Cypriot tax law.
14. The majority of treaties provide that these activities will not constitute a permanent establishment unless they last more than a certain period of time. This period is 6 months in the case of Canada, Czechoslovakia, Denmark, the Federal Republic of Germany, Italy, Sweden, the United Kingdom and the United States. With respect to treaties concluded between Cyprus and France, the German Democratic Republic, Hungary, Kuwait, Romania, the U.S.S.R and Yugoslavia, the period is 12 months. The period is 18 months in the case of Bulgaria. There is no exemption in the treaties with Greece and Ireland.

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tion on shipping profits is included in the Merchant Shipping Laws and not in the Income Tax Laws, this article appears to escape the exclusion from treaty benefits which applies to companies entitled to special tax benefits under Secs. 8(w) and 28A of the Income Tax Laws (i.e. "offshore" entities) in the treaty with Canada.

D. Withholding taxes

All Cyprus treaties include provisions which clarify whether a country has a right to tax income derived from dividends, interest and royalties from a source in that country and which, in the case where standard withholding taxes are imposed on the payment of such income, reduce the rate of tax or exempt the income completely from withholding tax when payment is made to treaty residents.

1. Dividends[15]

The withholding tax on dividends from treaty countries is low and, combined with the low tax on Cyprus "offshore" companies, makes investments in treaty countries through Cyprus attractive (see Table A). In addition to direct investments, Cyprus may be used as a "stepping stone" for investment in a country with which Cyprus has a treaty but the investor's country does not or where the investor's country does have a treaty but it is not as beneficial as Cyprus' own treaty with that country. For example, a U.K. company investing in Greece would suffer a withholding tax of 47% on dividends from the Greek company under the Greece–U.K. double taxation treaty. If the investment was made through Cyprus, however, the tax is reduced to 25% under the Greece–Cyprus treaty. Similar benefits can be obtained from investments in Italy and Eastern European countries.[16] Since Cyprus does not levy any withholding tax on dividends, a Cyprus company can be used as a "stepping-stone" for investment in a treaty country even if the investor is a resident of a country with which Cyprus has no treaty.

TABLE A

WITHHOLDING OR OTHER TAXES PAYABLE IN THE SOURCE COUNTRY IN THE ABSENCE OF A PERMANENT ESTABLISHMENT

Country	Dividends(1)	Interest	Business profits
Bulgaria	None	None	None
Canada	15%	15% or none(9)	None
Czechoslovakia	10%	10%	None
Denmark	15% or 10%(2)	10%	None
France	15% or 10%(3)(4)	10%	None
German Democratic Republic	None	None	None
Federal Republic of Germany	15%-27%	10%	None
Greece	25%	10%	None
Hungary	15% or 5%(2)	10%	None
Ireland	None	None	None
Italy	15%	10%	None
Kuwait	10%	10%	None
Norway	5% or None(5)	No provision in treaty(11)	None
Romania	10%	10%	None(6)
Sweden	15% or 5%(2)	10%	None
United Kingdom	15% or None(7)(8)	10%(8)	None
U.S.A.	15% or 5%(10)	10%	None
U.S.S.R.	None	None	None
Yugoslavia	10%	10%	None

(1) Restricted to tax in the other Contracting State as Cyprus has no separate tax on dividends.
(2) When the recipient Cyprus company holds directly at least 25% of the capital of the paying company.
(3) When the recipient Cyprus company holds directly at least 10% of the capital of the paying company.
(4) If the recipient is a Cyprus offshore company, normal tax is payable in France.
(5) When the recipient Cyprus company controls, directly or indirectly, not less than 50% of the entire voting power in the paying company.
(6) Taxable at 5% if profits are payments of commission.
(7) None, if the recipient, individual or company, controls directly or indirectly 10% or more of the voting power in the paying company. Otherwise, there is a withholding tax of 15% with entitlement to U.K. tax credit, but the withholding tax is imposed on the aggregate of the dividend and the tax credit.
(8) If the recipient is a Cyprus offshore company, normal tax is payable in the United Kingdom.
(9) If it is paid in respect of a loan made, guaranteed or insured by the Export Credit Insurance Service of the Ministry of Commerce and Industry.
(10) If the recipient is a corporation owing at least 10% of the voting shares of the paying corporation and the income of the paying corporation from interest and dividends does not exceed 25% of its gross income.
(11) Normal rate, when Cyprus is the source country, is 42.5%. However, under the new treaty negotiated at present the rate will be 10%.

2. Interest[17]

The right to levy tax on interest is allocated to the State of the recipient although the source State retains this right if domestic legislation so provides. The foreign withholding tax has been eliminated in several of Cyprus' treaties (Bulgaria, German Democratic Republic, Ireland and the U.S.S.R.). If the interest withholding tax is not eliminated, generally a 10% ceiling is imposed (treaties with Czechoslovakia, Denmark, France, the Federal Republic of Germany, Greece, Hungary, Italy, Kuwait, Romania, Sweden, the United Kingdom, the United States and Yugoslavia). The treaty with Canada, however, provides for a 15% limit (see Table A).

As in the case of dividends, considerable benefits may accrue from using a Cyprus finance company as an intermediary when arranging group financing in respect of countries with which Cyprus has a more beneficial treaty than the country where the lending company is situated.

3. Royalties

Under Cypriot domestic legislation, a 10% withholding tax is imposed on royalties paid to non-residents for the use of patents, know-how, trademarks, etc. The majority of Cyprus' treaties, however, adheres to the view expressed in the 1977 OECD Model Convention that no withholding tax should be imposed on royalties paid to a licensor established abroad (Bulgaria, Canada, Denmark, France, the German Democratic Republic, the Federal Republic of Germany, Ireland, Italy, Norway, Sweden, the United Kingdom, the United States and the U.S.S.R.) (see Table B).[18]

It must be noted further that, even in cases where Cyprus does not have a double tax treaty with a particular country, the 10% withholding tax will not apply as long as the royalties have no connection with local businesses. By using licensing and sub-licensing arrangements, royalties can therefore be received by a Cyprus offshore company and paid out to a tax haven country without any further tax

15. There is no separate withholding tax on dividends because the tax is already paid by the company on its net profits.
16. The U.S.S.R. is probably the best example, as Cyprus is one of the few countries where dividends from the U.S.S.R. can be received with zero rate withholding tax.
17. The withholding tax on interest paid to non-residents is 42.5%, i.e. the normal income tax rate. Offshore companies, however, are exempt from this tax.
18. Some treaties, however, do provide for a withholding tax on film royalties (Canada, France, the Federal Republic of Germany, Italy and the United Kingdom).

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TABLE B

ROYALTIES

Country	Withholding tax in source country	Reference to beneficial owner	Offshore companies excluded
Bulgaria	Nil	No	Yes
Canada	Nil	Yes	Yes
Czechoslovakia	Nil (Except 5% on patents and other Industrial uses)	No	No
Denmark	Nil	Yes	No
France	Nil (Except 5% on films, excl. T.V.)	No	Yes
German Democratic Republic	Nil	No	No
Federal Republic of Germany	Nil (Except 5% on films, excl. T.V.)	No	No
Greece	Nil (Except 5% on films, excl. T.V.)	No	No
Hungary	Nil (Except 5% on patents and other industrial uses)	No	No
Ireland	Nil (Except 5% on films, excl. T.V.)	No	No
Italy	Nil	No	No
Kuwait	Nil (Except 5% on patents and other industrial uses)	No	No
Norway	Nil	No	No
Romania	Nil (Except 5% on patents and other industrial uses)	No	No
Sweden	Nil	Yes	No
United Kingdom	Nil (Except 5% on films, incl. T.V.)	Yes	Yes
U.S.A.	Nil	No	Yes
U.S.S.R.	Nil	No	No
Yugoslavia	10%	No	No

except for the 4.25% income tax in Cyprus. Of course, this will not work in cases where the treaty specifies that the recipient of the royalty must be the beneficial owner (treaties with Canada, Denmark, Sweden, the United Kingdom) but in such cases the income can remain with the Cyprus company and either reinvested or paid as dividends (if the shareholders will not be taxed in their country of residence or if the shares are registered under nominees; therefore, the dividend can be paid anywhere in the world in secrecy).

E. Tax sparing

Several of Cyprus' double taxation treaties contain a tax sparing clause, i.e. a credit is granted for notional tax deemed to be payable in Cyprus on certain types of income where Cyprus, for purposes of economic development or otherwise, does not impose any tax or imposes a reduced tax (France, the Federal Republic of Germany, Greece, Ireland and the United Kingdom). Tax sparing credits are usually available to residents of the other Contracting State in respect of dividends, interest, royalties and other types of income.

Tax sparing credits are important because they can reduce or eliminate tax payable where the credit method applies.[19]

The position in the various treaties regarding tax exemption through tax sparing credits is listed below.

○ Concerning the treaties concluded with Czechoslovakia, Greece, Ireland, Italy and Romania, the total of any tax that would have been payable on income subject to a tax exemption or relief in Cyprus but is not payable because of the tax incentive exemption or relief is allowed as a credit against any tax payable in the other State on that income. Since the normal tax rates in Cyprus are usually higher than those of the other countries, this effectively exempts such income from being taxed in the other State.

○ In the case of Denmark the tax sparing credit is limited to 15% in the case of dividends and 10% in the case of interest. The same tax sparing credits apply to the Federal Republic of Germany in circumstances where the credit method applies.

○ With respect to Sweden, the tax sparing credit is limited to 20% in the case of dividends and 15% in the case of interest.

○ In the case of Canada, France and the United Kingdom there are tax sparing credits equal to the tax that would have been payable in Cyprus but for the investment allowances granted under the Income Tax Law of Cyprus in respect of "approved capital expenditure". In addition, credit is given for the tax that would have been payable normally for interest exempted from tax under Sec. 10 of the Income Tax Law.

F. Personal services

The articles covering independent personal services, dependent personal services and directors' fees are the standard OECD Model articles. Although these articles do not prevent the country in which an individual is resident from taxing income earned in the other treaty country, a careful combination of the treaty provisions with local tax laws and residency rules can enable individuals to benefit from the special concessions given to non-Cypriots working for Cyprus "offshore" entities and therefore limit their tax to the lower Cyprus tax.

G. Other types of income

The "other income" articles (i.e. public entertainers, athletes, teachers, government income, etc.) are usually based on the OECD Model Convention. The most important is the article on pensions which enables non-Cypriots retiring in Cyprus to benefit from the low tax rate (1/10 of the normal rates) payable on pensions received from abroad, without paying any tax in the country of origin.[20]

H. Limitation of benefits

As mentioned above, a few of Cyprus' double taxation treaties exclude certain persons from some or all of the benefits of the treaty, as in the case of the United States and Canada. However, even in these 2 cases there are still a number of possibilities for using Cyprus in international tax planning in conjunction with these countries.

19. Without the tax sparing credit, the only tax credit available to offset tax payable in the country of residence of the recipient of the dividend would be the 4.25% tax payable or paid by the non-resident company on its profits. With the tax sparing relief, the recipient of the dividend can claim relief for a notional rate which is normally higher than the 4.25% (see discussion of Denmark and Sweden).

20. The pension may be taxable in the country of origin in the cases of Canada (if the total income in a year is over 10,000 Canadian dollars), the United States (if the recipient is a U.S. citizen) and Demark (taxable only in the country of origin).

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1. United Kingdom

The 1980 Protocol to the Cyprus–U.K. treaty introduced Art. 24(a) which prevents the benefits under the articles dealing with dividends, interest and royalties from applying to companies entitled to special tax benefits under Secs. 8(w) and 28A of the Cyprus Income Tax Laws. Sec. 8(w) deals with profits from businesses carried on outside Cyprus by Cypriots, while Sec. 28A is the "offshore" companies legislation.[21]

Since the limitations affect only dividends, interest and royalties this still leaves a wide scope for use of the treaty. In addition, as the limitations do not apply to resident companies, the benefits of these articles can still be obtained by using, in some cases, a company with no special tax concessions.

2. France

Similarly, Art. 13 of the Cyprus–France treaty excludes from the application of the dividends, interest and royalties articles companies in which non-residents have directly or indirectly a substantial interest and which are subject, by virtue of special measures, to tax at a rate which is substantially lower than that usually imposed on the profits of companies in the State in which they are resident. Again, this leaves scope for use of the treaty as all the other beneficial articles apply to all cases without restriction.

3. Federal Republic of Germany

The treaty with the Federal Republic of Germany contains no "excluded persons" provision as such. However, the Protocol to the treaty specifies that, instead of the exemption method provided in Art. 23 of the treaty, the credit method will apply to dividends paid to a German resident by a Cyprus company, unless it can be proved that the profits of the company are derived from sources within Cyprus (which effectively eliminates "offshore" companies). The same restrictions apply to profits from a permanent establishment in Cyprus and certain types of capital gains.

These restrictions are rather limited and all other articles apply without restriction, thus allowing the treaty to be used beneficially in a number of ways. In addition to the general benefits under the treaties discussed above, the provisions of Art. 15(3) regarding seamen's remuneration, combined with the exclusion principle of Art. 23(1), means that the remuneration of German seamen on board a Cyprus vessel will not be taxable in Germany. Seamen are taxed at a zero rate in Cyprus and, consequently, tax on the seamen's remuneration can be avoided altogether.

Furthermore, in the case where the provisions of the treaty do not apply in order to exempt dividends received by a resident of Germany from Cyprus (for the reasons mentioned above), a tax sparing credit (common in Germany's treaties with developing countries) of up to 15% is available against tax payable in Germany.

4. Canada

Art. 29(3) of the Cyprus–Canada treaty states that the treaty does not apply to companies entitled to any special benefit under Secs. 8(w) and 28A of the Income Tax Law. Although this effectively excludes "offshore" companies from the benefits of the treaty, there are various benefits that may accrue to other types of companies in respect of income which is not taxable in Cyprus under other sections of the legislation. For example, shipping profits, interest received which is not taxable under Sec. 10 of the Income Tax Law and certain types of capital gains on the sale of shares in a Canadian subsidiary whose assets are not real estate will fall within the provisions of the treaty despite the fact that they are non-taxable in Cyprus.

It is interesting to note that it may be possible to make beneficial use of "offshore" Cyprus companies in connection with Canada without the advantages of the treaty. Cyprus is one of the countries listed in the Canadian Income Tax Regulations from which "exempt surplus" income can be earned by a Canadian foreign affiliate. The Regulations provide that "exempt earnings" can be earned only from an active business carried on by a foreign affiliate in a listed country. Although a Cyprus "offshore" company cannot have earnings from an active business within Cyprus, it may be possible for the Cyprus company to do business in another listed country (assuming that no tax will be payable in that country under a treaty with Cyprus) and still qualify for "exempt surplus" status.

5. United States

Art. 26 of the Cyprus–United States treaty excludes "offshore" companies from treaty benefits.[22] However, a Cyprus "offshore" company can still be of vital importance to U.S. interests without the benefits of the treaty. Cyprus is one of the countries in which a U.S. Foreign Sales Corporation (FSC) may be established, and, in view of Cyprus' geographical position, excellent infrastructure and tax benefits, it appears to be an ideal place for an FSC to be used

[continued on page 202]

21. These sections read as follows:
Sec. 8. There shall be exempt from the tax ...
(w) ninety per centum of the profits or dividends, imported into the Republic, of any business carried on outside the Republic by a Cypriot residing in the Republic or by a company which is controlled by Cypriots having an interest not less than fifteen per centum in such business....
(Sec. 28A.
(1) In the case of a company, incorporated in the Republic, as well as in the case of a company registered under section 347 of the Companies Law and having the management and control of its business in the Republic, the shares of which belong directly or indirectly exclusively to aliens, and which derive income from sources outside the Republic,
(a) From the carrying on of any business the object of which lies outside the Republic; or
(b) from the investment of capital in bonds, shares, debentures of loans of any nature; or
(c) from any royalties; or
(d) from immovable property, tax is imposed on the chargeable income, after deducting tax any tax which is payable outside the Republic, at rates of tax equal to one-tenth of the rates set out in paragraph 4 of the Second Schedule, and the provisions of sections 42 and 43 do not apply.
(2) For the purposes of paragraph (b) of sub-section (1) the income from investment of capital is deemed to emanate from sources outside the Republic if not withstanding the place of investment and the parties to the relevant agreement, such capital is used for activities outside the Republic.
(3) In the case of a dividend which emanates directly or indirectly from the income referred to in sub-section (1) no tax is imposed in addition to the amount deducted by the company by virtue of section 35, and no amount of tax is returned by virtue of section 38 of the Assessment and Collection of Taxes Law.

22. Art. 26 reads as follows:
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 percent of the beneficial interest in such person (or in the case of a corporation, more than 75 percent of the number of shares of each class of the corporation's shares) is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
(b) the gross 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.

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SOMALIA:

Tax Reform in an Unconventional Economy

A Case Study

Dr. Mahesh C. Purohit

Any proposed reform in tax policy is necessarily congruent with the economic and administrative conditions of the country concerned. This is especially important for Somalia, as it has a truly unconventional economy. The macro variables relevant for analyzing economic situations do not strictly apply to this economy, because in most important aspects the economy of Somalia differs from that of other developing economies.

The major economic characteristics attributable to Somalia are listed below.

(1) Labour is primarily concentrated in the rural sector where output is determined independent of activities of the public household and tax policy.
(2) Somalians are primarily a nomadic society, with itinerant communities constituting 40% of the population and having far-flung trade links. These links have a historical past dating back to the advent of settled agriculture in the riverine areas and the growth of close and mutually beneficial relationship among pastoralists, farmers and city traders.
(3) Somali pastoralists owe allegiance to clans, and as the essence of pastoral life is mobility, their outlook conflicts with the raison d'être of the modern state. Hence, here exists a strong and functional tendency in the rural population to avoid all manifestation of government.
(4) Measurement of the output of the overall economy is undeterminable and the pastoral sector in itself is very complex and complicated.
(5) Extended family ties and property transfers are very important. Hence, when one farm family suffers a poor harvest, a more prosperous one can be called upon to tide over the bad time.
(6) As most rural production is for self-consumption, producer prices have a limited role in total production.
(7) Most family units are multi-occupational, and the workers often combine their incomes.
(8) Remittances contribute substantially to domestic cash income. From Gulf countries alone, remittances equal the sum of all non-agricultural components of the GDP. In addition, the manner of the remittances has severe consequences for the economy.[1] This explains not only the consumerism boom in Somalia but also the parallel exchange rate and inflation. These remittances have thus changed the character of the economy to such an extent that there is no correspondence between the measured economy and the functional economy.

OBJECTIVES OF TAX POLICY

The above characteristics suggest that taxation may have a limited although important role to play in the Somalian pre-industrial and unconventional economy. An effective tax policy could accelerate savings and investment, and hence improve the overall economic situation. To achieve these goals, the government should, through its tax system, attempt to:

(a) raise substantial and increasing revenues for necessary allocation for public consumption and investment,
(b) provide fiscal incentives for savings and investment,
(c) help avoid inflation and ensure stability and
(d) help in achieving economic equity.

An attempt at devising a tax system which would achieve the above could help the Somalian economy to attain a higher rate of growth. Taxation would then be the crucial factor in financing planned development, with increasing revenue collections being derived from higher taxation.

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The author is a Professor at the National Institute of Public Finance and Policy, New Delhi. This work, however, was done by the author as U.N. Adviser in Tax Policy and Chief Technical Adviser in Somalia. The author is grateful to the authorities in the Department of Revenue, Ministry of Finance and Government of Somalia for their help. Special thanks are due to Mr. Abdi Khalif Elmi, Director-General, Department of Revenue, and Dr. Ahmed Mohamoud Hersi, Director of Planning and Statistics. Thanks are also due to Messrs. Abdisalam M. Abdille, Director of Excise, Mohd. Hasan Ali, Director of Customs, and Shamun Husein Mohamed, Director of Direct Taxes.

1. The franco valuta system allowed traders to purchase foreign exchange from workers abroad to finance the return flow of consumer goods, payment going to the workers' relatives in Shillings (hereafter referred to as "Shillings" or "Sh.").

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ALLOCATION

Unlike the situation in most developing economies, where the largest part of the total current revenue is derived from taxation, Somalia is heavily and increasingly dependent upon foreign assistance; fiscal revenues have financed a small and declining proportion of ordinary expenditures. This is due to the structural defects in the tax system (e.g. limited tax base and inefficient administration). These factors indicate that the responsiveness of the tax structure in terms of buoyancy of the tax system is very low. Thus, the ability of the tax structure to generate growth in revenue through changes in gross income or output level has been far less than expected. Various studies conducted on different countries indicate that (i) general sales, excise and consumption taxes seem to have elasticities in excess of unity; (ii) income taxes are found to be both elastic as well as inelastic; and (iii) customs and stamp duties seem to be relatively inelastic. In the Somalian context, therefore, there is a need to improve the responsiveness of the tax system.

INCENTIVES

Along with a desired degree of elasticity and buoyancy of the tax system, it is important that attempts to maximize the flow of resources into the exchequer should not be allowed to adversely affect private savings and investment, for savings and investment are equally important objectives of an effective tax policy. Additionally, the flow of resources into the exchequer must be at the expense of private (non-essential) consumption and "unproductive" or non-priority investment. In this context, it is necessary to emphasize that resources are needed in the public sector primarily for capital formation and that increasing tax revenues should be available for this purpose. The trend in the last decade indicates that an increasing proportion of public investment has been financed through foreign aid. This being so, private savings have an important role in the economic development of Somalia.

STABILIZATION AND DISTRIBUTION

The other 2 functions postulated for the tax system of Somalia are the containment of inflation and reduction of economic inequalities. With inflationary pressure estimated at an annual rate of 138% during the second quarter of 1988, the anti-inflationary objectives of tax policy are crucial to the economic development of Somalia. To achieve the 4 tax policy objectives, it would be necessary to adopt a tax structure which has a broad base as well as an harmonious combination of direct and indirect taxes. It should impinge on consumption and be highly income elastic.

With the above objectives in view, we first present the fiscal role of the Somalian taxes. This is followed by an outline of the existing structure of all taxes. We conclude with recommendations for tax reform and related policy imperatives for accelerated and substantial economic development in Somalia.

RELATIVE IMPORTANCE OF TAXES IN FISCAL ARMOURY

The evolution of public finance in the course of economic development reveals that tax revenues are the prime deter-

TABLE 1

TRENDS IN TAX REVENUE

(Figures in million Shillings)

ITEMS.	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988 RE	1989 BE
Total tax revenue	544.7	627.6	751.7	1261.9	1234.5	1169.5	2026.4	2529.3	3240.0	2990.7	5228.6	9165.9	8157.2	12124.0	14356.0
A. Total taxes on income and property	109.1	113.6	136.5	193.4	213.6	211.3	353.4	420.6	528.2	439.9	482.9	1319.5	1702.5	1489.0	1800.0
a. Total taxes on income	98.6	101.3	120.5	148.4	153.1	144.1	211.2	336.1	361.7	303.8	316.4	1014.8	1359.2	1231.0	1500.0
1. Taxes on wages	17.8	21.3	25.3	32.1	38.7	40.6	59.3	78.2	94.4	123.1	141.5	*251.1	*373.8	478.0	550.0
2. Extraordinary tax	23.0	26.1	30.5	35.9	44.3	45.6	53.9	12.3	.3	.4	.2	N.A.	N.A.	N.A.	N.A.
3. Other income tax	4.4	6.6	3.3	6.4	7.8	8.4	32.6	42.8	174.5	179.2	169.7	763.7	@985.4	753.0	950.0
4. Taxes on corporate turnover	53.4	47.3	61.4	74.0	62.3	49.5	65.4	202.8	92.5	1.1	5.0	–	–	–	–
b. Taxes on property	10.5	12.3	16.0	45.0	60.5	67.2	142.2	84.5	166.5	136.1	166.5	305.0	343.3	258.0	300.0
(i) Registration tax	10.5	12.3	16.0	45.0	60.5	67.2	142.2	84.5	166.5	136.1	166.5	305.0	343.3	258.0	300.0
B. Total taxes on goods and services	435.6	462.8	572.1	1034.8	1163.5	1030.8	1713.9	2057.3	2935.3	2540.0	4099.4	7196.6	6436.8	10635.0	12556.0
a. Taxes on production, internal trade & services	48.1	164.8	179.6	227.1	71.0	139.0	312.5	472.0	304.7	458.7	1129.2	1969.3	1720.4	2873.0	4733.0
1. Sugar and spirit	93.2	100.0	78.2	98.5	19.6	51.0	196.7	323.2	106.5	177.6	326.5	530.8	540.6	1284.0	3000.0
2. Fiscal monopolies (tobacco & matches)	49.6	60.0	96.3	118.6	18.1	55.8	55.8	83.7	118.3	93.1	245.4	423.1	100.8	194.0	330.0
3. Motor vehicles tax	1.3	1.3	1.3	2.8	4.8	6.1	6.8	7.4	10.4	7.2	9.1	9.7	11.1	12.0	15.0
4. Sales tax	–	–	–	–	–	–	–	–	–	71.9	181.7	412.4	508.7	933.0	933.0
5. Others	4.0	3.5	3.8	7.2	28.5	26.9	53.2	57.7	69.5	108.9	366.5	593.3	559.2	450.0	455.0
b. Taxes on international trade	287.5	298.0	392.5	807.7	1092.5	891.8	1401.4	1585.3	2630.6	2081.3	2970.2	5227.3	4716.4	7762.0	7823.0
1. Import duties	230.7	241.0	329.4	687.1	927.9	746.8	1156.1	1275.3	2198.3	1816.1	2550.7	4655.7	4307.5	7023.0	7023.0
1.1 Customs duty	177.9	189.7	255.0	572.8	774.6	565.9	922.4	1039.1	1662.0	1333.0	1719.0	3280.7	2811.7	5123.0	5123.0
1.2. Adm./statistical tax	52.8	51.3	74.4	114.3	153.3	180.9	233.7	236.2	536.3	483.1	831.7	1375.0	1495.8	1900.0	1900.0
2. Export duties	16.0	13.2	12.1	17.3	16.1	18.4	50.3	123.2	123.8	37.3	89.4	83.0	65.6	100.0	100.0
3. Stamp taxes	40.8	43.8	51.0	103.3	148.5	126.6	195.0	186.8	308.5	227.9	330.1	488.6	343.3	639.0	700.0

Notes: @ Substantial increase in revenue is due to tax payment by an Italian company on account of construction actitivy. In 1986 alone, tax paid by the Italian company was of the order of 3000 million Shs.
– Indicates abolition of tax in the year and hence no revenue.
N.A. Indicates data not separately available for the year.
* In these years, extraordinary tax on income is merged with tax on wages.

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minant of the magnitude of tax effectiveness in all countries. Higher revenue implies higher taxation. In Somalia, as in other countries, tax revenue over the years has shown an increasing trend. Whereas the total tax revenue was 544.7 million Sh. in 1975, it increased to 1169.8 million Sh. in 1980 and to 8157.2 million Sh. in 1987. It is expected that the yield in 1988 (RE) and 1989 (BE)[2] would be 12,124 and 14,356 million Sh., respectively (see Table 1). However, the growth trend in tax revenue in Somalia has not kept pace with the trend in total revenue during recent years. Consequently, the proportion of tax revenue to total revenue has declined after 1982. It has again increased since 1985.

RESPONSIVENESS

The overall annual growth rate of the total tax revenue from 1975 to 1987 has been approximately 26.44% annually.[3] The growth rate of tax revenue, in relation to the growth of Gross Domestic Product (GDP), does not compare favourably. In fact, the overall responsiveness of tax revenue, measured by the estimated buoyancy of the tax system and indicators of the tax structure to generate growth in revenue through changes in gross income or output level, has been far less than expected.[4] The overall buoyancy, as presented in Table 2, indicates that with a 1% change in income there would be approximately only a 0.65% change in tax revenue.

2. Hereinafter RE stands for revised estimates and BE for budget estimates of the Government.
3. Growth rate refers to trend rate calculated by the relationship $Y_t = ab^t$; where $b = (1+r)$, Y_t is the value of growth character (tax revenue) and t varies from 1 to n.
4. The buoyancy is estimated as: Log Y = Log A + B Log X where Y is tax revenue, and X is Gross Domestic Product. Thus, B shows the percentage change in revenue in response to a percentage change in income.

TABLE 2

BUOYANCY OF SOMALIAN TAX SYSTEM

Serial No.	*Taxes*	*Buoyancy[1] (1975 – 1985)*
1.	Total tax revenue	0.6559
2.	A. Total taxes on income and property	0.5079
3.	a. Total taxes on income	0.4204
4.	i. Taxes on wages	0.6539
5.	ii. Extraordinary tax	–1.7595
6.	iii. Other taxes	–0.8771
7.	iv. Taxes on corporate turnover	0.8404
8.	b. Taxes on property	0.8404
9.	i. Registration tax	0.8404
10.	B. Total taxes on goods & services	0.6692
11.	a. Taxes on production, internal trade and services	0.7145
12.	i. Sugar and spirit	0.4698[2]
13.	ii. Fiscal monopolies (Tobacco and matches)	0.4698[2]
14.	iii. Motor vehicle tax	0.6392
15.	iv. Sales tax	1.3672
16.	v. Others	0.7069

NOTES: 1. Buoyancy with reference to GDP at factor cost.
2. Buoyancy with reference to GDP from manufacturing sector.

FISCAL IMPORTANCE

The yield from income taxes has increased from 109.1 million Sh. in 1975 to 144.1 million in 1980. Thereafter, inflationary conditions caused an upsurge in 1982. However, the increase in the yield in 1986 and 1987 can be attributed to good tax yield on construction activity. The increase in the yield in tax on rental value of property caused by changes

TABLE 3

TRENDS IN PROPORTIONS OF DIFFERENT TAXES
(1975 – 1989)

(Percentage)

ITEMS	1975	1980	1985	1986	1987	1988 RE	1989 BE
Total tax revenue	100	100	100	100	100	100	100
A. Total Taxes on Income & Property	20.02	17.01	10.54	15.50	20.91	12.28	12.54
a. Taxes on Wages	3.26	3.27	3.09	2.95	4.59	3.94	3.83
b. Extraordinary Tax	4.22	3.67	.004	–	–	–	–
c. Other Income Tax	0.80	0.68	3.70	8.97	12.11	6.21	6.62
d. Taxes on Corporation Turnover	9.76	3.98	0.11	–	–	–	–
Total Taxes on Income	18.09	11.60	6.90	11.92	16.70	10.15	10.45
e. Taxes on Property	1.93	5.41	3.63	3.58	4.22	2.12	2.09
i. Registration Tax	1.93	5.41	3.63	3.58	4.22	2.12	2.09
B. Taxes on Production Internal Trade and Services	27.18	11.19	24.64	23.12	21.14	23.96	23.97
a. Excise Duty on Sugar & Spirit	17.10	4.10	7.12	6.23	6.64	10.59	20.90
b. Excise Duty on Tobacco & Metal	9.10	4.43	5.36	4.97	1.24	1.60	2.30
c. Motor Vehicles Tax	0.23	0.49	0.20	0.11	0.14	0.10	0.10
d. Sales Tax	–	–	3.97	4.84	6.25	7.70	6.50
e. Others*	0.73	2.17	8.00	6.97	6.87	3.71	3.71
C. Taxes on International Trade	52.76	71.80	64.82	61.37	57.95	64.02	54.49
a. Import Duties	42.33	60.12	55.64	54.67	52.92	57.93	48.92
i. Customs Duty	32.65	45.56	37.51	38.52	34.34	42.25	35.68
ii. Admin./Statistical Tax	9.69	14.56	18.15	16.14	18.38	15.67	13.23
b. Export Duties	0.29	1.24	1.95	0.97	0.81	0.82	0.70
c. Stamp Taxes	7.49	1.01	7.20	5.74	4.22	5.27	4.88

Source: As for Table 1.

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in the rate structure has been another variable affecting the total yield.

Notwithstanding an absolute increase in the yield of taxes on income and property, its proportion in the total tax revenue has declined from 20% in 1975 to 10.54% in 1985. Although there was an increase in its share in the following years, lately it has again decreased from 20.91% in 1987 to 12.54% in 1989 (BE) (see Table 3). The growth of income and property taxes measured in terms of an index (1975 = 100), as given in Table 4, reads 1560.4 in 1987. However, there was a decline in the 1988 index. In terms of the annual growth rate, taxes on wages have increased by 27.3%; taxes on other income increased by 57.29% per annum during the period 1975 to 1987. The increase in taxes on other income was caused by a spurt in income from rental value of property.[5] This is reflected in the buoyancy estimates of taxes on property with reference to the real estate component of GDP. The buoyancy coefficient in this case turns out to be 0.79.

As in most developing countries, including Somalia, taxes on commodities and services have had an increasing share in the total tax revenue. Excise and customs duties accounted for 389.5 million Sh. in 1975, 872 million Sh. in 1980 and 5692.6 million Sh. in 1986. However, as shown in Table 1, there was a fall in revenue to 5014 million Sh. in 1987, but it rebounded and increased to 8599 million Sh. in 1988 (RE). The budget estimates of 1989 indicate the yield to be 10453 million Sh. Compared to the country's total tax revenue, as presented in Table 2, excise and customs duties constituted about 59% in 1975 and about 51% in 1986. It declined even further in 1987, but gained momentum and increased to 55.27% in 1988. Over a period of 13 years (1975 to 1987), the annual growth rate of excise tax on sugar and spirits was approximately 18.97%. Similarly, the rate of growth for fiscal monopolies (matches and tobacco) was 13.905%. In comparison to excise duties, the growth rate recorded for import duties was 26.73% but only 20.47% for export duties.

The responsiveness of these taxes has been measured with different independent variables. As excise duties are directly affected by the manufacturing component of the GDP, their responsiveness to this variable amounts to .47% for sugar and spirits and .36% for fiscal monopolies. However, the buoyancy of import duties with respect to GDP at factor cost is .68% (see Table 3).

Notwithstanding a decline in the yield from customs and excise duties, the revenue from sales tax has increased ever since its introduction in 1984. The yield from this tax rose from 71.9 million Sh. in 1984 to 93 million Sh. in 1988 (see Table 1). The increase in the yield from sales tax has been witnessed both in absolute and in relative terms. As shown in Table 2, the share of sales tax to total tax revenue increased from 3.97% in 1985 to 7.70% in 1988. The annual growth rate of sales tax during 1984 to 1987 was approximately 95.22%. The responsiveness of the tax with respect to GDP has, however, not been calculated for want of a sufficient number of observations. However, with the recent changes in the rate structure and tax base, it is expected that this tax would yield larger resources.

TABLE 4

INDEX OF GROWTH OF SOMALIAN TAXES
(1975 = 100)

ITEMS	1980	1985	1986	1987	1988 RE
Total Tax Revenue	227.9	840.9	1562.9	1493.7	2225.8
A. Total Taxes on Income & Property	193.7	442.6	1209.7	1560.5	1364.8
a. Taxes on Wages	228.1	794.9	1410.7	2100.0	2685.4
b. Extraordinary Tax	198.3	—	—	—	—
c. Other Income Tax	190.1	3856.8	16750.0	22395.4	17113.6
d. Taxes on Corporation Turnover	90.3	—	—	—	—
Total Taxes on Income	146.1	320.9	1029.2	1378.5	1248.5
e. Taxes on Property	640.0	1585.7	2904.8	3269.5	2457.1
i. Registration Tax	640.0	1585.7	2904.8	3269.5	2457.1
B. Taxes on Production, Internal Trade and Services	93.9	762.5	1329.7	1161.6	5972.9
a. Excise Duty on Sugar & Spirit	54.7	350.3	569.5	580.0	1377.7
b. Excise Duty on Tobacco & Matches	110.9	494.7	853.0	203.2	391.1
c. Motor Vehicles Tax	469.2	700.0	746.1	853.8	923.1
d. Sales Tax	—	252.7	573.6	707.51	1297.6
e. Others*	672.5	9162.5	14832.5	13980.0	11250.0
C. Taxes on International Trade	310.2	1033.0	1818.2	1640.5	2699.8
a. Import Duties	323.7	1105.6	2018.1	1867.1	3044.2
i. Customs Duty	318.1	966.3	1844.1	1580.0	2879.7
ii. Admin./Statistical Tax	342.6	1575.2	2604.2	2832.9	3598.5
b. Export Duties	115.0	558.7	518.7	410.0	625.0
c. Stamp Taxes	310.3	809.1	1197.5	841.4	1566.2

NOTE: For Sales Tax 1984 = 100.

STRUCTURE OF DIFFERENT TAXES

The existing tax structure in Somalia has a mix of taxes on income and property and on commodities and services. Taxes on income and property are designated as: (a) business profits tax, (b) employment tax, (c) property tax and (d) registration fee. Commodities and services taxes include customs and excise duties and sales and motor vehicles taxes.

Tax on income

The general category of taxes on income and profits includes taxes on wages and salaries, profits, interest, rental income and companies. All the taxes are subject to varying rate schedules. Taxes on wages and salaries are levied on monthly earnings, and the tax liability falls on the individual employer. The rate schedule for this category is as follows:

Monthly income (Sh.)	*Tax rate (%)*
201 – 800	6.3
801 – 1,500	12.6
Over 1,500	18.9

Other income (i.e. excluding wage income and rental income) is taxed on the basis of net income. For calculating net income, deductions are allowed for the expenses necessary to produce such incomes. The tax-paying unit is the individual. The exception to this rule is the case where the husband and wife conduct their activities at the same pre-

5. Yield from the rental value of property is reported in budget under the head "3.1.2. – Taxes on other income". Its yield has been recorded as follows:

Years	*Yield (million So.Sh.)*
1984	12.4
1985	29.2
1986	129.4
1987	135.0

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mises, even though they have separate trade licences. In such cases, both incomes are pooled together; the tax rates are as follows:

Annual income (Sh.)	*Rate (%)*
2,401 – 3,600	9
3,601 – 4,800	11
4,801 – 6,000	13
6,001 – 7,200	15
7,201 – 8,400	17
8,401 – 9,600	19
9,601 – 10,800	22
10,801 – 18,000	25
18,001 – 30,000	28
30,001 and over	30

In addition, there is a 17% surcharge on the tax liability. Allowance is made for certain necessary expenses incidental to the production of taxable income. The Minister of Finance has the authority to grant exemption of up to 10 years to new enterprises whose industrial and agricultural activities are considered to be conducive to the development of the country. This is an incentive for promoting economic development.

Companies and corporations are subject to taxation on their net income derived from all sources accruing to or received by domestic companies and enterprises. Foreign companies are taxed only on income derived from Somali sources. The following corporate bodies qualify for tax-exempt status:

(a) state and local administrations;
(b) international organizations;
(c) charitable, educational and cultural organizations; and
(d) holders of special concessionary agreements.

The following deductions are permitted for calculating "net" income:

(a) 40% of undistributed profits or 25% of taxable income, whichever is lower, if the amount is set aside for investments;
(b) ordinary and necessary expenses, interest paid, depreciation, net losses, and contributions to gratuity funds.

The tax rate is 35%.

Tax on property

With effect from 15 August 1988, the rate structure for the rental value of property has been made progressive. The rates are listed below.

Rental income (Sh. per annum)	*Tax rate (%)*
0 – 120,000	22.5
120,001 – 240,000	25.0
240,001 and over	30.0

20% of the rental income is assumed to constitute legitimate expenses and the same is allowed to be deducted. In addition, a 17% surcharge is levied on the tax liability. The total tax liability on property tax is shown in Table 5.

Taxes on property include inheritance tax and registration fee. The former is levied under Law 5 of 20 December 1971, and the tax base is the value of the property being transferred. The tax rate is progressive and varies between 4 and 12%. In addition to inheritance tax, a registration fee is also levied on the transfer of the assets. The rates are as follows:

Property transferred	*Rates (%)*
Real and immovable	11
Movable	4
Tenders and contracts	1
Mortgages	2

Taxes on commodities and services

1. *Import duties*

Import duties are levied on all imports. The rates are categorized in 21 groups and vary according to the nature of the imported goods. In addition, some other taxes, duties and charges are levied: (i) 20% statistical/administrative duty; (ii) 3% harbour charge; (iii) 10% sales tax; (iv) 2% stamp duty; and (v) 1.5% incentive tax for employees.

2. *Excise duties*

As in most pre-industrialized economies, including Somalia, excise duty is likely to become increasingly important in the years to come. As industrialization takes place, the growth in revenue from this tax would accelerate. The tax is levied

TABLE 5

EFFECTIVE RATE OF TAX ON RENTAL VALUE OF PROPERTY

Quarterly Taxable Rental Income	*Property Tax liability*	*Additional property Tax liability*	*Effective Rate of Tax*
30,000	6,750	1,125	26.25
40,000	9,250	1,542	26,98
50,000	11,750	1,958	27.41
60,000	14,250	2,375	27.71
70,000	17,250	2,875	28.75
80,000	20,250	3,375	29,53
90,000	23,250	3,875	30.14
100,000	26,250	4,375	30.63

TABLE 6

RATES OF EXCISE DUTY
(As on 15 December 1988)

GOODS	*PERCENTAGE*
1. Caramels, boiled sweets, chewing gum and the like	15%
2. Syrups for beverages, jams, marmalades and the like	15%
3. Chocolate, candied fruits, halva and the like	15%
4. Liqueurs and other sweetened beverages	12%
5. Fruits in syrup and sweetened fruit juice	10%
6. "Panetooni", cakes and pastries, biscuits and other similar sweetened products	5%
7. Other products containing added sugar	10%
8. Matches	80%
9. Cigarettes	100%
10. Shampoo, soap and hair oil	20%
11. Sugar	60%
12. Mineral water	10%
13. Alcoholic beverages	80%
14. Pure alcohol	100%
15. Tomatoes and Khal	10%
16. Construction materials	15%
17. Leather and materials made of leather	15%
18. Perfumes	20%
19. Foam, etc.	15%
20. Home utensils	10%
21. Clothes	5%
22. Milk and its by-products	5%
23. Carton, plastic and the like	5%
24. Furniture	5%
25. Spare parts	5%
26. Other products manufactured locally and not specifically mentioned	5%

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on all locally manufactured goods, but similar countervailing excise duties are also levied on imported goods. It covers many different commodities, 19 of which are subject to rates varying between 10 and 100%. All items not included in the 19 specified categories are taxed at the rate of 5% (see Table 6).

3. *Sales tax*

Sales tax is levied through Decree-Law 2 of 7 January 1984.[6] According to Art. 1 of the Decree, the tax is levied on (i) imported goods; (ii) wholesale goods; (iii) hotel invoices; and (iv) industry products. The impact of the tax is initially borne, as per Art. 3, by the importer, buyer or hotel residents. It is incumbent upon the wholesale trader, industrialist and hotel owner, according to Art. 9, to make invoices on all goods sold or hotel accommodation provided.

The rate of sales tax was initially prescribed as 5% of the cost of goods imported including customs duties or the value of the hotel invoices. The same rate is applied when the wholesale trader, industrialist and hotel owner make invoices whenever they sell goods or provide services, respectively. However, the rate of tax on goods sold by manufacturers, importers and wholesalers has been increased to 10%, with effect from 15 August 1988.[7] The rate of tax on services continues to be 5%.

The tax extends to all goods, with few exemptions. The exemptions include "food-stuffs (except tinned stuff), medicine, electricity, water, fuel, local agricultural products, livestock and all exported goods". Materials and equipments imported by individuals or institutions which are exempt from import duties are also exempt from sales tax. Also, materials and equipments imported for temporary use (e.g. equipment used for trade fairs, etc.) are exempt.

Although the coverage originally included hotel services, with effect from 15 August 1988 the following have also been brought into the tax net: (i) shipping services; (ii) publicity advertisements; (iii) tickets for sports events, cinema and concerts; (iv) dry cleaning, automobile washing, photography, beautician and grooming services, restaurant and first class café services and video cassette rentals.

The tax due from gate money of cinemas and concerts is to be collected in cash and sent to the Ministry of Finance and Treasury. The tax is collected at the cinemas and concerts by the officers assigned for this purpose. Likewise, tax due from income from sports events, publicity, advertisements and services of shipping agencies is to be collected by the Ministry of Labour and Sports, Ministry of Communication and the concerned shipping agency. The collection and follow-up of these taxes is the responsibility of the Director of Indirect Taxation and the Head of the Sales Tax Service at Headquarters.

4. *Miscellaneous taxes*

Taxes in this category include motor vehicle tax, administrative and statistical fees, harbour fees, transaction registration tax, mortgage tax and insurance tax. The administrative and statistical fee of 20% is levied on all goods imported into Somalia. The exemptions are the same as for customs duties. A harbour fee of 3% is levied on all goods loaded and unloaded at national ports, and is treated as a charge for service rendered.

The motor vehicle tax is levied on all vehicles registered in Somalia. Exemptions from the tax include motor vehicles used for funerals, fire-fighting, medical or surgical care and motor vehicles belonging to State, diplomatic and UN personnel. Tax is levied on the basis of the vehicle's horsepower rating, capacity in quintals and the purpose for which it is used. The rates are as follows:

Motor vehicle	*Rate of tax (Sh.)*
Passenger car for private use or for hire	198 to 1,980
Taxi cabs	137.30 to 1,373.80
Public service vehicles	280.80 to 858
Lorries, vans, trailers used for transporting goods	109.20 to 1,365
Motorcycles	99

Tax is also levied on the registration of specified documents on the basis of the value of the concerned transaction. The rates of tax are as follows:

(a) Deeds for transfer of immovable property or interests in immovable property	10%
(b) Transfer of movable property	4%
(c) Tenders and contracts	3%
(d) Lease and mortgage contracts	1%

Further, tax is levied on all insurance transactions made within Somalia and insurance contracts completed abroad which either relate to property situated in Somalia or used in the national territory. It is payable by national and foreign insurance companies and their agents carrying on insurance activities within Somalia. Generally, such companies and agents are permitted to recover the tax from persons with whom they enter into contracts. Exemptions include insurance for industrial accidents and insurance contracts entered into by mutual aid organizations. The tax is levied on the premium amount. In the case of insurance (other than marine insurance), this includes fees such as commission and policy charges. The applicable tax rates are as follows:

(a) Life and casualty insurance, luggage insurance, crop and livestock insurance	10%
(b) Surface transport insurance	4%
(c) Fire insurance	9%
(d) Third party liability	5%
(e) Marine insurance	2%

Finally, there are some local taxes which are imposed on the sale of animals, consumption of electricity, motor vehicles and public entertainments. Generally, the central government prescribes the maximum rate which may be applied.

REFORMS IN TAX POLICY

In the context of the economic and administrative setting as profiled in the preceding sections, and to indicate the policy imperatives for attaining the objectives of rationalization, presented below are the reforms that are feasible without affecting the inertia of the system.

A. Taxes on income and property

An evaluation of the present levies on income and property suggests that each tax by itself seems suited to the existing level of administrative efficiency. However, in view of the special characteristics inherent in the socio-economic conditions induced by the prevailing multi-occupational pattern, it would be important to attempt a scenario of interaction of these taxes. As the total income of an economic entity

6. This received assent of the President of the Republic on 21 January 1984.
7. Notification number WL/X/J/9-00929 dated 18 August 1988.

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comprises different sources, without cohesing into totality, taxation rates do not impinge upon the real base. Hence, it is necessary to consolidate incomes from different sources (i.e. income from salary, business, rent, etc.) for reporting purposes. Thus, the tax base would be expanded considerably. As a result of that and the current tax rates, tax revenue would certainly spurt. Also, this would make evasion of tax a little more difficult.

TABLE 7

STRUCTURE OF BUSINESS PROFIT TAX PAYING DEALER IN SOMALIA

A Sample Study

Taxable Income Group	Income Sh. So.	No. of Taxpayers	Amount of Tax Paid Sh. So.
5,001 – 10,000	53,504	6	9,130
		(3.02)	(0.13)
10,001 – 20,000	1,013,293	67	224,344
		(33.67)	(3.17)
20.001 – 50,000	2,790,856	93	820,380
		(46.73)	(11.57)
50,001 – 100,000	1,276,576	20	444,332
		(10.05)	(6.27)
100,001 – 200,000	863,576	6	275,035
		(3.02)	(3.88)
200,001 – 500,000	1,516,230	5	303,688
		(2.51)	(4.28)
2,000,001 – above	13,676,599	2	5,010,677
		(1.01)	(70.70)
TOTAL		199	7,087,583

NOTE: Figures within parentheses indicate percentage of total.

SOURCE: Data collected from the tax district of Mogadishu.

TABLE 8

EMPLOYMENT TAXPAYERS IN SOMALIA

A Sample Study

Taxable Income Group	Income of Employee Sh. So.	No. of Taxpayers	Amount of Tax Paid Sh. So.
2,500 – 5,000	158,650	47	22,687
		(12.11)	(0.07)
5,001 – 10,000	129,950	17	18,233
		(4.38)	(0.06)
10,001 – 20,000	587,900	43	64,585
		(11.08)	(0.21)
20.001 – 50,000	1,252,527	36	176,330
		(9.28)	(0.57)
50,001 – 100,000	4,782,830	59	681,988
		(15.21)	(2.22)
100,001 – 200,000	3,538,142	25	592,432
		(6.44)	(1.93)
200,001 – 500,000	23,641,101	73	3,528,105
		(18.81)	(11.47)
500,001 – 1m.	15,863,171	28	2,213,137
		(7.22)	(7.29)
1m. – 2m.	46,565,802	33	8,110,893
		(8.51)	(26.36)
2m. – above	130,463,217	27	15,359,299
		(6.96)	(49.17)
TOTAL		388	30,767,689

NOTE: Figures within parentheses indicate percentage of total.

SOURCE: Data collected from the tax district of Mogadishu.

Except for the amalgamation of the bases, at the present level of administrative efficiency the existing tax rates on income and property do not require any rationalization. In fact, the data on taxpayers' distributions collected on a sample basis (Tables 7, 8 and 9) reveal that the tax base is extremely limited. This is corroborated by the data collected from the Manpower Survey conducted in 1978 (Table 10). It is, therefore, important to presently concentrate only on its improvement as a fiscal measure; no changes in the structure of the taxes on income and property (except for pooling) need be contemplated. The main emphasis has to be on market surveys, assessment, and training of officials as well as taxpayers. The attempted model district approach has sought to train district officials in functions such as proper filing, improved inspection, effective surveys as well as assessment of taxpayers. This would, in the long run, enable the government to sustain increased flows of revenue.

TABLE 9

STRUCTURE OF PROPERTY TAXPAYERS IN SOMALIA

A Sample Study

Taxable Income Group	Rental Income Sh. So.	No. of Taxpayers	Amount of Tax Paid Sh. So.
2,500 – 5,000	10,600	4	2,772
		(0.93)	(0.008)
5,001 – 10,000	72,200	9	15,056
		(2.10)	(0.04)
10,001 – 20,000	396,514	25	89,136
		(5.84)	(0.26)
20.001 – 50,000	2,242,980	67	493,237
		(15.65)	(1.44)
50,001 – 100,000	4,462,567	60	983,760
		(14.02)	(2.87)
100,001 – 200,000	7,738,920	55	172,974
		(12.85)	(5.05)
200,001 – 500,000	30,812,396	96	4,585,016
		(22.43)	(13.37)
500,001 – 1m.	48,072,759	68	5,849,841
		(15.88)	(17.06)
1m. – 2m.	37,026,031	28	8,103,843
		(6.54)	(23.64)
2m. – above	60,891,137	16	12,433,458
		(3.74)	(36.26)
TOTAL		428	34,285,860

TABLE 10

DISTRIBUTION OF ESTABLISHMENTS IN PRIVATE SECTOR IN SOMALIA (1978)

Regions	Size of establishment (No. of workers)					
	1	2	3	4	5+	Total
Mogadishu	9,961	2,581	996	296	551	14,385
	(69.24)	(17.94)	(6.92)	(2.05)	(3.83)	
Hargeisa	2,224	359	181	101	122	2,987
	(74.45)	(12.02)	(6.06)	(3.38)	(4.08)	
Kismayo	436	331	80	35	53	935
	(46.63)	(35.40)	(8.56)	(3.74)	(5.67)	
Other Towns	8,353	2,548	873	344	399	12,517
	(66.73)	(20.35)	(6.97)	(2.75)	(3.19)	

NOTES: Figures within parentheses indicate proportion of establishments in the region.

SOURCE: 1978 Manpower Survey.

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B. Taxes on international trade

The yield from the import duties has been so far quite low, primarily due to undervaluation of imports. As the official exchange rate of shillings has now been adjusted, it is expected that the yield from import duty would substantially increase.

A related aspect is customs valuation at the time of imports. It is felt that presently there is considerable undervaluation which affects the yield of the tax. With a view to improving valuation, it is recommended that (i) an appraising department be formed at the port to integrate valuation with import, exchange control and classification functions; (ii) a valuation branch be created in the Director of Customs' office to ensure correct and constant valuation of goods; and (iii) the GATT valuation agreement be implemented.

Another important aspect related to import duties is the absence of tax on accompanied baggage of air passengers. As there are no specified limitations in the law, the duties from baggage collections at the airport are exceedingly poor. It is required to be increased through legal provisions. It is recommended that the baggage rules be implemented as early as possible.

In addition to improving the administration of import duties, it is important to analyze and, if necessary, to restructure the tax rates to ensure proper and continued protection to the indigenous infant industries. Hence, an estimation of the effective rate of protection (derived by using the input coefficients and value added of an industry) is needed. However, with the present available information, the following recommendations seem to be extremely relevant.

(1) In order to curtail the demand for and encourage domestic production of imported agricultural commodities, such as rice and wheat, import duties on such items should be drastically increased.
(2) Import duties on luxury items also are presently very low with respect to items like airconditioners, refrigerators, washing machines (taxed at 60%) and motor vehicles (taxed from 38 to 123%). Such luxuries need to be put in a higher bracket of at least 150%. The Somalian textile industry is an infant- industry case, and the tax rate on imported textiles must be raised to protect the local industry.

TABLE 11

COMPARATIVE STATISTICAL DATA FROM EXCISE AND STATISTICS DEPARTMENT (1986)

Commodity	Data from Excise Department: No. of Factories	Goods sold	Tax paid	Production Data Ind. Prod. Survey
Soft drinks	5	48,006,106	5,611,329	72,974,574
Pharmaceuticals	1	1,956,000	97,800	45,421,480
Paints	2	3,144,546	458,676	175,670,386
Sweets	1	4,710,000	2,895,060	8,880,000
Plastics	2	11,693,074	589,175	31,450,353
Perfumery/Cosmetics/ Soaps	4	43,106,854	8,792,736	55,037,391
Spare Parts (Metal Products)	1	3,043,544	178,912	12,997,441
Metallurgy	3	7,766,109	498,982	9,495,600
Tanneries and Leather Finishing	5	47,190,257	6,199,188	144,591,273
Stationeries	1	190,000	10,200	129,000,239
Furniture	2	24,565,046	1,476,413	206,239,594

(3) An equally pressing task incumbent upon the government is to check smuggling; the administrative machinery needs to be geared up to ensure that with change in valuation and the implementation of baggage rules, smuggling does not increase.

C. Taxes on commodities and services

Revenue from excise duties has increased in recent times. During the period from March to December 1988, revenue from the following items was as follows:

Items	*Sh. (millions)*
Sugar	1,040
Cigarettes	162
Other excise tax	116
Customs	465

As compared with proceeds in the preceding year, this is a substantial increase. Whereas in 1987 the yield was 1274 million Sh., between March and December 1988 the yield had already reached a level of 1783 million Sh. Also, the Budget Estimates of 1988 were 1412 million Sh., in sharp contrast to the actuals of 1783 million Sh.

Notwithstanding an increase in the yield from excise duties, it needs to be recognized that the present administration is lax. The data compiled from the Excise Department (Table 11) indicate that there is enormous scope for extending coverage, as reflected in the meager yield from the tax. Also, this is corroborated by the yearly data provided by the Industrial Production Surveys of the Central Statistical Department, State Planning Commission. It is important that the excise administrative machinery be strengthened for improving administration.

The structure of sales tax in Somalia is so far not well developed. Most commodities which are subject to sales tax are imported. There are not many transactions which occur before these commodities reach the consumer. Often the importer himself sells directly to the consumer, although in some cases there could be two transactions. In the case of luxury goods and consumer durables, normally there is only one transaction. Thus, the demerits of cascading and inducement to vertical integration[8] would not be quite so serious. At the same time, there is need for a levy which should be administratively easy to enforce. Somalia may therefore consider adopting either the single-point, first-stage levy or the multi-point turnover tax.

Of the two, the first-stage tax would require more sophisticated administration in the sense that a system of declaration would have to be introduced and the accounts of resellers would have to be checked to see if any of their sales happen to be first-stage. Extension of first-stage tax to all commodities is thus likely to be difficult for the tax administrators in Somalia to administrate, who have yet to be trained to enforce the sales tax system. It is recommended that Somalia adopt a combination of a first-stage tax for luxury goods and a multi-point turnover tax for all other taxable goods.

The existing system has two rates, i.e. 10% ad valorem on goods and 5% on services. With the recommended tax sys-

8. *Editor's note.* "Cascading" refers to the phenomenon of sales being levied on a price or value which includes sales tax paid at one or more ealier stages of production. Such a system encourages verticle integration, i.e. the integration of different stages of production, in an attempt to reduce the number of occasions on which tax is levied and thereby also the total amount of tax payable.

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tem, it is advisable to incorporate an element of progressivity. In fact, most countries build progressivity into their indirect tax systems through rate differentials. However, the tax rates in Somalia need to be kept relatively low for the following reasons:

(i) the per capita income of Somalia is very low;
(ii) the monetized sector of the economy is limited;
(iii) there is a parallel economy in existence and as of today it is difficult to discern any administrative attempt to check it; and
(iv) due to the high rate of unofficial foreign exchange prices and inflationary conditions of the economy, even a low rate of tax would lead to collusion between consumers and dealers in order to avoid tax.

For administrative reasons, the rate structure must be kept very simple. For this purpose, there should be only 3 rate categories:

(a) luxury goods to be subjected to 10% first-stage tax;
(b) sales tax on hotel accommodation to be charged at the rate of 5% on the invoice; and
(c) all other commodities (except those exempted) to be subjected to multi-point tax at 2%.

The exempted commodities should include necessities and perishable items such as food (e.g. fresh vegetables, fresh meat, fish and eggs) and educational items, such as books, note-books, slates and slate pencils (but not all stationery items). It is important to note that studies on the consumption pattern indicate that with the above rate structure the sales tax system would be progressive.

With a view to restricting the number of dealers to be administered by the government, it is essential to determine the exemption limit above which all dealers have to be registered with the taxation department. These registered dealers should collect the tax from the consumers and remit it to the government. The lower the exemption limit, the larger the number of registered dealers and hence the heavier the workload for tax administrators.

The experience of most countries suggests that the sum of all tax receipts from a large number of small dealers comprises a small proportion of total revenue. Table 12 indicates a similar situation in almost all the other countries. The information gathered through Manpower Survey indicates similar distribution of dealers in Somalia. The results of the Survey, as presented earlier in Table 10, show that 68% of the establishments have one employee, about 25% of the establishments employ 2 to 3 persons and only 6% of the establishments have 4 or more employees. Likewise, the structure of dealers in Somalia, according to gross turnover and amount of tax paid, would also show a similar trend. It is, therefore, important that an adequately high exemption limit be fixed to avoid an additional workload for the tax department.

In Somalia the exemption limit may thus be fixed at a gross turnover of one million shillings, so that the administration does not have to register small dealers; in effect, it would register only those dealers who may be liable to pay the sales tax as well as the income tax. The proposed exemption limit for turnover need not apply to importers and manufacturers who may be asked to register themselves irrespective of the quantum or value of their imports.

Registration of dealers is the cornerstone of sales tax administration. The dealers collect and pay the tax to the government. However, the existing practice does not require the tax department to register dealers as they obtain their licence from the local government office. Under the sales tax law, retailers are not taxed. Hence, irrespective of the turnover, dealers manage to get their licences changed from the category of wholesaler to retailer. This could be done, and is being done, without any difficulty. Hence, a large number of dealers escape the tax net.

TABLE 12

NUMBER OF DEALERS PAYING SALES TAX IN MOGADISHU REGION
(As on 1 October 1987)

Regions		Number of dealers
1.	Dog. Shanganni	11
2.	" X/Jab-Jab	15
3.	" Karaan	39
4.	" Nodon	20
5.	" Shibis	9
6.	" Yaqnhid	24
7.	" Wardhigley	40
8.	" C/Casis	10
9.	" Bondhere	19
10.	" H/Wadag	66
11.	" X/Weyne	187
12.	" Wadajir	24
13.	" Waberi	13
	TOTAL	477

SOURCE: Ministry of Finance.

As shown in Table 12, the number of dealers in Mogadishu region who pay sales tax is limited to 477 only. By any standards this is a very small number and does not cover even a fraction of the total. It is extremely important that the sales tax law be amended to get dealers registered with the tax department. It is, therefore, recommended that all importers and manufacturers, irrespective of their turnover, and all other dealers having a minimum taxable turnover of one million shillings are registered with the department.

Finally, the structure of motor vehicles tax reveals that the rates are quite outmoded. Given the current income levels and the number of vehicles in the country, it is necessary to revise the rates upwards by a substantial degree.

CONCLUSION

Somalia is among the least developed countries of the world. Unlike most developing countries, it is an unconventional economy characterized by a highly nomad society and a large parallel economy. Somalia has been facing an extremely difficult economic and financial situation. As the government is reviewing its economic and financial policies and trying to adopt a comprehensive programme of adjustment as per the IMF recommendations, it is of paramount importance to analyze its tax policy to enable it to raise requisite resources. In this context, the government has already instituted a Committee to review the tax structure and to recommend further appropriate changes. The Report of the Committee has though been submitted, and no changes have so far been introduced. In this context, we recommend that the changes suggested above would be extremely useful. These changes are estimated to yield at least 80% more revenue than that yielded in 1988.

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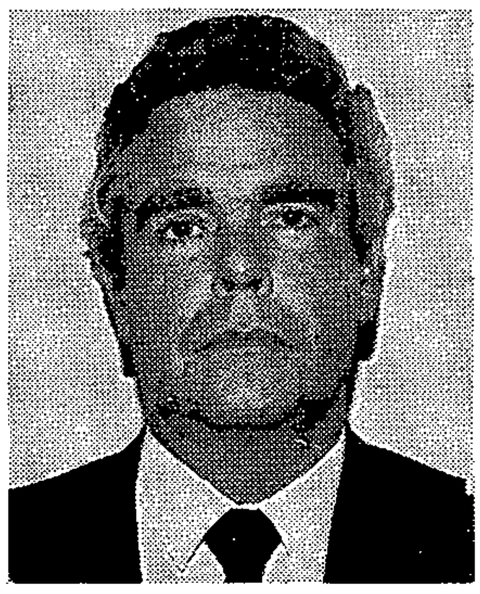

I. W. Harris

HONG KONG:

First Double Taxation Treaty

Mr. Harris is the Group Tax Adviser of the Hong Kong Bank. He is currently Secretary of the Hong Kong Branch of the International Fiscal Association and Chairman of the Taxation Committee of the Hong Kong General Chamber of Commerce.

Mr. Harris speaks frequently at tax conferences in Hong Kong, Singapore and elsewhere. He also contributes to various tax journals.

Although Sec. 49 of the Hong Kong Inland Revenue Ordinance makes provision for the Government of Hong Kong to enter into tax treaties with other jurisdictions it has steadfastly refused to do so and has made this attitude clear frequently in the past few years. Although few specific reasons have ever been given for this refusal, the Hong Kong Government has generally been understood to have received no evidence of double taxation of Hong Kong income elsewhere because Hong Kong tax generally relates only to income or profits arising in or derived from Hong Kong. Another reason why the Government may not consider entering into any double tax treaties is that given the provisions of OECD model and Hong Kong's low rate of taxation, the Hong Kong Government would be likely to give up more revenue than it would gain. Despite the Government policy there is a body of opinion which considers that further examination of this topic is required, even given the problems of exchanges of information which most treaties require and which many in Hong Kong consider would be unacceptable to the public in general.

However, a chink has appeared in the Government's armour, as in August 1989 an exchange of notes took place between the Consul General of the United States of America in Hong Kong and the Hong Kong Commissioner of Inland Revenue setting forth the terms of the "Double Taxation Relief (Income from Shipping Operations) (United States of America) Order 1989".

Under the U.S. Tax Reform Act 1986, foreign shipowners are assessed to U.S. tax on the uplift of freight from the United States unless there is a reciprocal arrangement with the country of residence of the shipowner which grants a similar exemption to U.S. resident shipowners. After a considerable lobbying effort by the shipping industry in Hong Kong, it persuaded the Government to enter into this limited treaty. It should be noted, however, that although the relevant U.S. Tax Reform Act provisions also include income from operating aircraft, the Hong Kong-U.S. treaty is limited to shipping only. It is also perhaps not surprising in these special circumstances that there is no exchange of information clause.

As is to be expected, the treaty is very short and the exemption granted to Hong Kong corporations by the United States applies only when either:

(a) the corporation's stock is primarily and regularly traded on an established stock market in Hong Kong, the United States or another country which grants an equivalent exemption to U.S. corporations; or

(b) more than 50% of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Hong Kong or of a country which grants an equivalent exemption to U.S. corporations or by a corporation organized in a country which grants an equivalent exemption to U.S. corporations and whose stock is primarily and regularly traded on an established stock market in that country, the United States or a country that grants an equivalent exemption to U.S. corporations.

Gross income under the treaty is defined as all income derived from the international operation of ships and includes:

1. Income from the rental of ships used in international transport and income from containers and related equipment used in international transport which is incidental to income from the international operation of ships.

2. Income from participation in marine transport pools which engage in the international operation of ships.

3. Gains from the sale, disposal or other alienation of ships by a person primarily engaged in the international operation, leasing or rental of ships.

Although, as stated above, there is no exchange of information clause in the treaty, Clause 7 states that if there is any difficulty or doubt as to the interpretation or application of the treaty, the competent authorities of the two governments must seek to resolve the difficulty. In announcing the treaty, the Financial Secretary of Hong Kong, Sir Piers Jacobs, stated categorically that this particular treaty was unique and he strongly indicated that the Government was not prepared to consider any other treaties, limited or otherwise.

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INTERNATIONAL:

TAX OBSTACLES TO INTERNATIONAL FLOWS OF CAPITAL

BIAC

I. INTRODUCTION

1. This paper presents the views expressed by members of the BIAC Committee on Taxation and Fiscal Policy to the OECD with respect to 8 topics concerning the taxation of multinational enterprises (MNEs). The topics are:

- Nominal vs. effective rate of tax
- Corporate tax systems/dividend flows
- Equal treatment – investment and/or investor
- Financing cross-border investments
- Location of headquarters offices
- Cross-border mergers
- Procedures and formalities
- Business secrecy.

2. The basic premise underlying our expressions of views on all the above listed topics is that taxation is just one of a number of factors of importance and potential importance to an MNE in allocating resources across geographic borders and among nations. But taxation is nonetheless a significant factor since it can affect, sometimes drastically, an MNE's rate of return in a given jurisdiction and, in some cases, may well be a marginally decisive cost factor.

3. BIAC would urge the OECD to concentrate its efforts in the taxation area more toward the goal of eliminating international double taxation rather than on the subject of tax evasion. As BIAC has stated on many occasions in meetings with the OECD, the typical MNE follows the principles of good corporate citizenship and does not engage in tax evasion. Thus, we do not feel that OECD's concern in this area is commensurate with the reality.

4. Stability of tax legislation is another area of concern to BIAC. During the decade of the 1980s, frequent changes in tax laws in many of the capital importing countries, in particular the U.S.A., have made the planning of cross-border investment quite hazardous. When the tax rules which were considered in planning an inbound investment in a target country are substantially altered, it can just as substantially alter the economics of the investment.

5. The concept of tax legislation stability merits some clarification. First of all, for BIAC, stability is *not* synonymous with immobility, which would be neither realistic nor desirable; after all, BIAC itself has suggested modifications. But these elements should be considered:

– enterprises need some stability in order to make serious long and medium-term forecasts; and

– as noted, stability does not equate to immobility but rather it means the introduction of changes within certain guidelines, namely:

- avoid, if possible, sudden significant changes of major taxes;
- if these changes are necessary, make every effort to spread them over a long period (e.g. 5 years);
- reduce the number of changes which are made more on the basis of administrative needs rather than on legal, economic or budgetary necessities;
- avoid changes which do not sufficiently take account of the realities and complexities of business life, and may hamper international transactions or investments.

II. NOMINAL vs. EFFECTIVE RATE OF TAX

(a) Overall tax structures

6. Variations in overall tax levels and tax structures may affect international investment patterns in several important ways.

7. Besides the traditional corporate income tax, which is the main focus of this paper, BIAC would like to stress the adverse impact, in particular, of high marginal tax rates. These contribute to the creation of disadvantages in the international competition for the location of production activities. Of specific importance is the impact on the supply of strategic groups of labour. BIAC recommends that such high marginal income tax rates should be reduced.

8. Capital taxes on business wealth and business property increase the cost of capital to companies. This has a particularly stifling effect on the supply of much needed venture capital, and on young, growing companies or companies in difficulty, both of which may not be earning strong profits. BIAC holds the view that such additional burdens, since unrelated to profits (as is partly the case with the Gewerbesteuer in Germany and the Taxe Professionnelle in France), are not compatible with modern business taxation. The governments of countries where such additional taxes exist should therefore consider their elimination.

9. Excise taxes on financial transactions are an additional example of taxes that cause distortions to international flows of capital. Such taxes, which in many OECD countries are levied on transactions in shares, options and convertibles, should therefore be abolished. Similar taxes on debt instruments (used in Germany, Japan, Sweden and Switzerland, for example) should also be eliminated.

10. With respect to the potential effects on investment patterns of differences between countries in their tax structures, in BIAC's opinion, countries with a heavy emphasis on taxes on profits and capital at the corporate level create a disadvantageous situation regarding business investment. As a consequence of high capital cost, investment activities in such countries tend to decrease compared to such activities in countries with higher reliance on, for example, payroll or value added taxes.

11. Concerning indirect taxes (payroll tax and value added tax), the long run effects are often considered as being very similar but the timing is very different. It is BIAC's view that the significant differences in the short run are very relevant, in particular for countries which rely heavily on exports. This is further complicated by the fact that governments tend to change tax rates rather frequently. A change of VAT is immediately shifted to consumers. A change of a payroll tax will typically be shifted only slowly through an indirect process affecting profitability and wage formation. Therefore the potential distortions in the allocation of capital resources resulting from some countries' reliance on payroll taxes as opposed to others' reliance on VAT may be large in the short run.

(b) The corporate tax system

12. Studies, some of which are referred to in the OECD report on Structural Adjustment and Economic Performance published in 1987, have shown that, in the early 1980s, the corporate tax systems had potentially very strong distortive effects on the allocation of capital within as well as be-

The Business and Industry Advisory Committee to the OECD (BIAC) was constituted in March 1962 as an independent organisation officially recognised by the OECD as being representative of business and industry. Therefore, BIAC, an organisation whose members include the industrial and employers' organisations of the 24 OECD Member Countries, is representative of the private sector in the industrialised world.

The BIAC Committee on Taxation and Fiscal Policy, a multinational group of private sector tax specialists, has met with the OECD Committee on Fiscal Affairs and its Working Groups to discuss various issues in the tax field.

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tween countries. The marginal effective tax rates, and various cost of capital measures, including so-called tax wedges, which generally reflect the impact of taxation on the structure of investments, showed a wide spread. For example, remarkable differences could be observed in the tax burden on different kinds of capital goods and on various sources of finance. The absence of a level playing field within and between nations was striking. The average effective tax rates were also very often significantly different from the statutory rates. In many cases, the degree of understanding of the corporate tax systems was not satisfactory.

13. While, during recent years, some OECD countries have undertaken significant tax reforms, including rate reductions and base broadening, much remains to be done by other governments. Deregulation of capital markets has generally reduced the dispersion of interest rates between countries, though there are still some important differences, e.g. the currently high rates in the U.K. But the remaining differences between effective tax rates continue to have an impact on costs of capital and to influence the international allocation of highly mobile capital resources. As shown, for example, by Fukao and Hanazaki in the OECD Economic Studies (Spring 1987), this generates negative welfare effects in a global context. Appendix 1 to this paper illustrates the remaining wide variation between countries in tax incentives to new investments. The existence of these differences has clear implications for the international allocation of scarce capital resources.

14. A more neutral business tax environment *within as well as between* countries (i.e. lack of differences) would yield many advantages. The allocation of capital resources would become much more efficient than today. There would be reductions in:
- intersectoral differences in effective tax rates that prevail today in many countries;
- intercountry differences in tax burdens;
- locking-in of capital in companies with good historic profits;
- inflation sensitivity;
- relative discrimination against newly established firms.

15. Potentially large welfare gains could be achieved in the OECD countries if many of the remaining tax distortions were reduced.

16. In BIAC's view, however, it would be inappropriate to seek the complete elimination of differences in nominal and/or effective tax rates between countries. Basic imperfections of markets or particular institutional arrangements may make it sensible, from a national as well as an international perspective, to allow some differences.

III. CORPORATE TAX SYSTEMS/ DIVIDEND FLOWS

General

17. With the growth in the number of imputation systems, concern has increased about the implications for international capital flows of the co-existence of these systems with the classical systems still existent in a number of countries.

18. Imputation systems are designed to mitigate economic double taxation of corporate profits by imputing corporate tax to shareholders. BIAC has long been concerned about promoting its objective of minimising the overall tax burden on distributed income by use of such systems. BIAC also seeks neutral treatment in both investment and residence countries, so that, in the former, there is no discrimination between domestic and foreign (inbound) investors and, in the latter, there is no discrimination between domestic and foreign (outbound) investment.

19. We recognise that minimisation of the overall tax burden depends on a number of factors acting in combination, in particular the level of effective tax rates and the extent to which relief is provided for double taxation, whether juridical or economic, domestic or international.

20. For these reasons, the influence of imputation systems on international income flows, and hence on capital investment, cannot be considered in isolation from the impact of the effective tax rates at corporate and shareholder level, and of the systems in place to relieve international double taxation (exemption, credit or other means). It is, therefore, a highly complex area. It is further complicated by the wide disparities of treatment from country to country, creating a range of possible permutations, and by the reluctance of countries generally to extend imputation benefits across national borders at the cost of their domestic exchequer.

21. BIAC's particular concern in relation to the growing spread of imputation systems is the harm they may do to foreign direct investment; where, in a country of investment (i.e. host country), domestic and non-resident direct investors are treated unequally; and where, in the residence country of the foreign investor (i.e. the home country), discrimination exists against outbound foreign investment.

22. We do not believe that the co-existence of imputation systems with classical systems is necessarily the genesis of problems, although this is obviously an important factor. Our main concern arises from the fact that existing imputation systems, generally speaking, either do not deal at all with the problem of economic double taxation at the international level or may indeed add to the problem, since:
- in the host countries, the imputation credit is not normally extended to non-resident direct investors (the United Kingdom, and France, to a lesser extent, seem to be the only significant exceptions); and
- in home countries, foreign direct and underlying taxes are not normally recognised for imputation purposes when foreign-source income is distributed to shareholders.

23. As was pointed out in a BIAC paper submitted to the OECD in 1982, imputation systems are designed and implemented with domestic investment and resident shareholders in mind. The further spread of imputation systems since 1982 confirms the points.

Equal treatment – foreign investors

24. Imputation systems take various forms, but the general principle is to impute to shareholders part or all of the tax paid at the corporate level, and, in almost all cases, to provide a mechanism to ensure that no tax is imputed to shareholders which has not been actually paid at the corporate level (e.g. by means of the précompte in France and the advance corporation tax in the U.K.). In some systems, the shareholder may only take the imputed tax as a credit against his/her tax liability. In other systems, the imputation credit is paid in cash to the extent that it exceeds the tax liability or cannot be credited, as for example, by exempt institutions such as pension funds.

25. The main purpose of an imputation system is to remove or reduce the economic double taxation which arises where corporate profits are twice taxed, first at the corporate level when earned and second at the shareholder level when distributed.

26. In practice, however, imputation systems have confined their benefits to purely domestic dividend flows, with very few exceptions. Most existing or proposed systems deliberately refrain from mitigating *international* economic double taxation and do not extend the benefit of imputation to non-resident direct investors.

27. From the standpoint of the host country, therefore, domestic and foreign investors *do not* receive *equal* treatment.

28. The concept of extending imputation across national borders within a corporate chain, through the direct shareholder and, in turn, to the ultimate shareholders, should be a simple one. But, in the real world, this is a highly complex matter for the reasons we have outlined. We recognise, of course, that there are no simple answers, and we further recognise that bilateral or multilateral solutions are more likely to be achievable than are unilateral domestically legislated solutions.

29. Presumably, host countries would be less prepared to provide equal treatment if the benefit they grant to the non-resident investor will be taxed away in the investor's home country, as for example by excluding an amount corresponding to the imputation credit from the investor's deemed-paid (indirect) foreign tax credit.

30. The total picture will, of course, differ from case to case, depending how the home country taxes the income flow first in the hands of the recipient company and then to its shareholders. This is part of the difficulty.

31. Again, to grant equal treatment on the basis of full imputation to the non-resident shareholder may unfairly advantage the non-resident shareholder (in comparison with domestic enterprises) since full imputation assumes onward distribution whereas, in practice, profits may be re-

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tained. It may, therefore, be necessary to introduce mechanisms designed to produce a broad measure of neutrality between realisation of the benefit by foreign direct investors at corporate level and by domestic investors only at ultimate shareholder level. This is attempted, for example, in the U.K. treaties by limiting the amount of the imputation payment.

32. BIAC believes nevertheless that, in principle, the imputation credit should be given to direct investment by non-residents, with whatever modifications may be necessary to take account of these complexities.

33. This should be more readily achievable between countries having imputation systems, on a basis of treaty reciprocity, or within multi-country economic units such as the European Community (see the 1975 Directive on harmonisation of systems of company taxation).

Equal treatment – foreign investment

34. The concern here is with the serious problems which can arise under imputation systems where distributions are made out of foreign-source income.

35. Imputation systems generally insist that tax at the corporate level cannot be imputed to shareholders unless it has actually been paid by the company to its home exchequer. Various mechanisms are used to achieve this: equalisation tax, précompte, advance corporation tax, etc. Foreign underlying and withholding taxes cannot normally be either imputed to the shareholder or credited against the equalisation tax, etc.

36. Where distributions are made out of foreign-source income these restrictions may well have the discriminatory result of imposing a substantial net additional charge, compared with distributions out of domestic-source income, effectively cancelling out the benefit of double taxation relief. The impact on companies varies widely, depending essentially on the relative weight of foreign investment in the total portfolio. It will tend to be most severe where the foreign investment weighs most heavily.

37. It may be argued that the impact on the corporation is washed out at the shareholder level, or at least partly. First, domestic shareholders will receive the full imputation credit. Second, in addition to those few cases where imputation credits are paid to non-resident investors under treaties, certain countries (e.g. France, Germany) refund the précompte itself in these circumstances to foreign shareholders either unilaterally or by treaty, although after deduction of the dividend withholding tax. This argument, however, ignores the fact that, since the cost of the equalisation charge falls on the company, it will be taken into account as a cost in making the investment decision, e.g. in making the project evaluation, and this may critically influence that decision (to go ahead or not to go ahead). There is no doubt that, in practice, this acts as a deterrent to foreign investment, and has also led on occasion to domestic acquisitions designed to produce a larger domestic taxable income base from which to source distributions without net additional tax cost.

38. In our view, this equalisation charge is a distortive factor which presents a significant obstacle to international investment. Residence (home) countries which have imputation systems should, therefore, be prepared to take foreign corporation and withholding taxes into account in imputing tax to shareholders (e.g. grant a foreign tax credit against the equalisation tax on the distribution of foreign-source income). France, for instance, does it to a certain extent as it imputes foreign withholding taxes on received dividends (a) on the précompte mobilier, and (b) on the withholding tax on dividends paid to foreign shareholders.

Credit versus exemption system

39. It is felt that a brief indication of the distinctive features of the two systems and of their present application provides a useful framework for discussion.

40. Under the principle of exemption, the State of residence does not tax income which is taxed or taxable in another State. The main method in use is the so-called exemption with progression method: the residence State retains the right to take the exempted income into consideration when determining the tax to be imposed on the rest of the income. Under the principle of credit, the State of residence calculates its tax on the taxpayer's total income, including the income from any other State. It then allows a deduction from its own tax for the tax paid in the other State.

41. In many countries, a combination of the two methods is used: the exemption method for some foreign-source income (e.g. dividends from a substantial participation or branch profits) and a credit system for some other foreign-source income (e.g. royalties and interest).

42. In a few countries, only the credit system is used to avoid double taxation on foreign-source system.

43. A large majority of BIAC members have a clear preference for the aforementioned combination of exemption and credit methods. A minority of BIAC members are in favour of an overall credit system.

44. The majority bases its preference on these factors:
– When a company has subsidiaries or branches in another country, the latter have to compete with local companies. The overall tax burden should be the same so as not to disturb competition.
– The exemption method recognises that taxation in a host country is part of an overall economic environment, and it avoids distortion between the various components of that environment, composed of multiple tax and non-tax factors.
– The exemption system allows business to take advantage of tax incentives and other incentives provided by some countries.
– The exemption system is not affected by disparities between the tax systems of two countries regarding the (timing of) recognition of gains and losses, and it therefore provides a better protection against double taxation.
– The exemption system is simple and has limited compliance costs. There is no need for complex anti-deferral provisions.
– The credit system for royalties and interest is favoured because BIAC members are of the opinion that the resident country of the recipient of royalties and interest should have the primary right to tax those items of income. Only in that case will it be possible to ensure that the costs of developing new products and the costs of borrowing are adequately taken into account in determining net income.

45. As mentioned, a minority of BIAC members prefer the credit system. These members stress, however, that when a credit system is used, the overall approach should be systematically applied. Also, tax sparing arrangements should be included in tax treaties.

46. In these circumstances, the preference is based on the facts that:
– The credit system provides neutrality (and stability) in terms of choice of investment country. This is true both in a comparison between investment in the home country and in any foreign country, as well as in comparing investment potential in two foreign countries.
– Depending on the financial flows involved, the credit system can lead to a lower overall tax burden.
– The credit system makes no distinctions on the basis of nature of the financial flows.

47. As a tentative conclusion, BIAC would like to offer the following:
– Many corporations in BIAC are in countries which have a mixed system of exemption and credit. They wish to stay under this system. Some corporations in BIAC are in countries which have a credit system and would like to switch to an exemption system for dividends and branch profits (e.g. many U.K. companies). This preference is strongly influenced by the failure, or relative failure, of existing credit systems to apply an overall approach and to allow tax sparing. Particular targets of criticism are the U.K., as regards the former, and the U.S.A., as regards the latter.
– Some corporations in BIAC are in countries which have a credit system and wish to stay under this system. It should be noted, however, that such a desire is largely premised on the fact that in their particular home countries the credit system is applied on an overall basis rather than on a country-by-country basis. Otherwise the credit system loses most of its advantages as, without an overall approach, it will always result in a higher tax burden than the exemption system.
– Corporations have structured their foreign investments taking into account the home country legislation that has been in existence for years. Switching from one system to the other may result in significant tax increases, a factor which cannot be disregarded.

48. Overall, therefore, a large majority take the view that it is more important to have a neutral competitive position in the

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country of investment (as under the exemption system) than to have a neutral choice as between different possible countries of investment (as under the credit method). And all are agreed that existing credit systems should move as far as possible towards the elimination of distortions in investment countries by permitting averaging – both between different income sources and over time by carryforward and carryback – and by providing tax sparing relief.

IV. FINANCING CROSS-BORDER INVESTMENT

49. The experience of BIAC's member companies supports the conclusion that tax factors *do have* an important influence on both the method of financing, and the structure used therefor, of foreign subsidiaries and on the composition of the portfolios of MNEs. It should be reiterated, however, that taxation is only one of many factors to be considered, and other factors will also have an important – and sometimes even primary – influence (for example macroeconomic factors, business economics factors, and government regulations in the home and host countries).

50. Withholding taxes represent a potential obstacle to international capital flows. In the case of interest and royalties, the main problem is that the amount of withholding taxes is often higher than the profit on the transaction, so that full credit of the withholding tax against domestic liability is often difficult. In the case of related company dividends, withholding taxes are frequently an absolute addition to the total tax burden for the concern as a whole.

51. As far as interest is concerned, BIAC would like to draw attention to a study by a Dutch bank which pointed out that, in the case of adoption of a 10% withholding tax on interest in the Netherlands, the total interest charges for Dutch borrowers under foreign loans could be expected to increase by a significant amount. Another example is the implementation of the so-called Kupon-Steuer in the Federal Republic of Germany in 1964. The Kupon-Steuer was levied only on interest paid to non-residents. The announcement-effect of the Kupon-Steuer was that Germany, up to then a net capital-importing country, became a net capital-exporting country. In 1975, the OECD Financial Markets Committee concluded that a general system of withholding taxes on interest was not favourable because of the high costs of the distortions caused by such a levy.

52. BIAC therefore recommends the adoption of a zero rate of withholding for cross-border interest payments. BIAC also recommends that the OECD continue its efforts to encourage adoption of the Model Treaty provision for a zero rate of withholding on cross-border royalties. This translates into taxation only in the home country. BIAC also calls for reconsideration of the proposal that tax treaties provide for zero withholding in the case of related company (direct investment) dividends. This has already been recommended by BIAC in its 1986 position paper on the 1977 OECD Model Double Taxation Convention.

53. Greater harmonisation of withholding tax rates and improved withholding procedures alone are not a satisfactory substitute for exemption and would not facilitate speedy recovery (in the case of complete or partial reduction), nor would harmonisation enhance the possibility for offsetting the unrelieved taxes.

54. BIAC knows that, in the context of liberalisation of capital movements within the EC, there are plans to establish a uniform withholding tax at source as a means of combatting anticipated tax evasion (e.g. by transfers of funds from France to Luxembourg). This would be a retrogressive move. It should be rejected in the interest of minimising investment obstacles and zero withholding rates put in place.

55. Furthermore, BIAC would welcome receiving from the OECD an analysis and justification for the existence of unrelieved withholding taxes. In our view a withholding tax originally has the character of a pre-tax which should ultimately be offset. (For numerical examples of unrelieved withholding taxes and some explanatory comments, reference is made to Appendix 2 of this paper).

56. Where, nevertheless, the home country has agreed to source basis taxation in the host country by way of a withholding tax on gross income, it would be appropriate for the residence country to grant full credit for this tax, taking into account the OECD's own perception that withholding taxes should always be fully credited. In this way, double taxation relief could be facilitated at least to the extent of the amount of taxes due in the country of residence.

57. BIAC sees absolutely no justification for withholding taxes on cost recovery items like service fees, etc.

58. There should be no obstacles and delays in implementing a reduction of withholding taxes under a tax treaty. Although BIAC understands that, in practice, the reduction or removal of withholding taxes is generally a treaty matter, this principle should fundamentally be considered as a matter of high priority in national legislation.

59. Interest, royalties and services fees which are paid on an arm's length basis by a resident company to a non-resident company should be fully deductible. Restrictions on the deductibility of interest paid by a resident company to its non-resident parent company or to a resident of a third country would influence (and undoubtedly distort) international capital flows, probably resulting in an encouragement to domestically sourced lending.

60. BIAC has taken a very strong position against provisions such as Article 16 of the U.S.A.-Model Treaty 1981 which excludes cross-border streams of dividends, interest and royalties from treaty-protection in the case of "treaty shopping". In any case, at a minimum, treaty-protection should always be given to corporations whose shares are quoted on a bona fide stock exchange, and to their subsidiaries.

61. MNEs cannot artificially change the character of income flows (e.g. characterising royalties as interest). Interest is payment for the use of money whereas royalties are generally paid for the transfer of technology and know-how. In this regard, the two are indeed quite different. Artificial constructions solely intended to avoid taxes, should (and can) be challenged by means of normal anti-avoidance provisions.

V. LOCATION OF HEADQUARTERS OFFICES

62. Headquarters offices, usually established on a regional basis, serve as "administrative" outposts for MNEs. Generally, the activities which could be assigned to such an office range from management and supervision (sometimes including determination of regional corporate strategy) to specific technical support and assistance (including general advice and guidance). Accordingly, such offices are not generally expected to be profit centers, since they do not engage in direct income generative activities, but rather they are expected to operate as cost centers, engaging solely in corporate support activities. Corporate taxation should not therefore be a factor.

63. Some countries, however, do attempt to tax such operations as if the activities were income producing, with the result that such a country would not be chosen as the situs for a headquarters office. Other countries, notably Belgium, France, the Netherlands and the United Kingdom have made conscious efforts to attract headquarters operations by providing specific, benign tax regimes. For the most part, these efforts have been successful, although it sometimes happens that the authorities in these three countries disagree with MNEs seeking to establish headquarters offices over the scope of activities which may be carried on by a headquarters office hoping to qualify for the applicable special tax regime. BIAC would recommend that the carrying on of *any* of the aforementioned activities by a headquarters office should qualify for the special tax regime and *only direct* income generative activities should be precluded thereunder.

64. With regard to the executives who are transferred from the home country to staff these headquarters operations, it is very important that they not be overly burdened by local income tax. The corporate employers generally will be forced to absorb the excess tax costs that their overseas transferees may incur under the many and varied "tax equalisation" schemes in effect today. Thus, an MNE will also be interested in finding a location for its headquarters activity that applies a benign tax regime to the expatriate employees as well. Again, Belgium, France, the Netherlands and the United Kingdom have established rules, either by specific legislation or by concession, which offer favourable tax provisions to expatriates temporarily residing in their jurisdictions, although we understand that the rules in the U.K. are now under review.

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65. On the question of time limits for favourable tax treatment of both the headquarters operation itself and its expatriate personnel, BIAC believes that, with respect to the headquarters operations, favourable treatment should be indefinite. Our reasoning stems from the fact that headquarters facilities cannot be moved easily, and therefore cannot readily adjust to shifting relative tax advantages among various countries.

66. For expatriate personnel, although BIAC believes that different companies may have varying views on time limits depending on their own unique assignment policies, we generally feel that less than 5 years of favourable tax treatment would be counterproductive.

VI. INTERNATIONAL MERGERS, ACQUISITIONS AND REORGANISATIONS

67. Before commenting on the tax implications of international mergers, it is worth pointing out that international mergers face legal obstacles (jurisdiction, rules applicable to employee participation, etc.), for which solutions must be found before dealing with the fiscal difficulties. In this respect, the debate on taxation is, for the time being, very theoretical and BIAC considers that the OECD should exert its influence in the area of competition law and policy to try to solve these legal problems. Additionally, the reorganisation or the restructuring of international groups may be achieved through means other than mergers. These, too, frequently meet with serious fiscal obstacles.

68. In general, however, mergers constitute a vehicle to achieve certain corporate objectives. The business motivations which underlie formal corporate mergers may differ considerably from case to case, with these items representing some of the typical motivations:

- reduction of administrative and manufacturing costs;
- increase of credit facilities;
- effecting a more efficient distribution structure;
- reduction of purchasing costs for services and raw materials.

69. These goals cannot always be reached through an outright cash acquisition of assets or shares of a target company.

70. In some instances, the acquisition would require financial liquidity which may not be available to the acquiring company. Therefore, the acquiring company prefers to pay the shareholder of the absorbed company by means of its shares. For this purpose, a merger could be useful. In other instances, the shareholders of the target company may simply refuse an outright sale, for whatever reason, preferring to receive shares of the absorbing company after absorption. It may be that reduction of administrative costs cannot be achieved if two distinct legal entities continue to exist.

71. The motivations which induce business entities to use the legal technique of a merger may well apply to cross-border mergers which have a great potential with the increase in globalisation of business activities. It should be possible to have tax-free reorganisations regardless of the countries of residence of the companies, or the countries of residence of the shareholders involved in the exchange of shares.

72. As has already been noted, tax factors are rarely a leading factor in making a business decision, such as a merger decision. Furthermore, in this area, it should be noted that most tax legislations contain anti-avoidance provisions which neutralise the tax benefits which may be gained through a tax-motivated merger. In particular, the use by an acquiring company of losses realised by the target company is generally not permitted or very restricted.

73. While tax laws of most countries provide for tax neutrality of *domestic* reorganisations, international mergers are heavily penalised by the tax cost applicable to them. The most important obstacle is constituted by the fact that the home country of the acquired company very often treats the merger as a deemed liquidation of the company so that latent capital gains become taxable to the shareholders of the target company. Such taxation jeopardises tax neutrality and imposes an undesirable influence on the business decision involved.

74. Another related issue involves the important problem of reorganisation within an international group of companies incident to an acquisition. An example would involve the acquisition of a group of companies located in a country other than that of the acquirer. For sound business and organisational reasons, it is generally appropriate that the acquirers' and the acquirees' subsidiaries in third countries should be combined by merger or that the acquirees' subsidiaries in other countries should at least be directly linked to the acquirer, i.e. to the new parent company, rather than being owned through the acquired company. This has become increasingly impossible because of the tax costs involved.

75. If, in addition, anti-treaty shopping provisions, along the lines of Art. 16 of the U.S.-Model Treaty, were to be inserted into double taxation agreements, the difficulty of effecting cross-border reorganisations and mergers would become even more acute.

76. Corporations should be free to choose that legal form which is more advantageous from the operational standpoint without fiscal constraints. This freedom and flexibility is important if rapid structural changes and innovations are required, particularly as MNEs grow in size and scope.

77. Tax neutrality of international mergers could contribute greatly to eliminating obstacles to international investment. Within the context of the European Communities (EC), the issue has been carefully examined and a proposed directive concerning international mergers was submitted by the Commission to the Council in 1969 (doc. com. 69,5 final). Acknowledging that there are many non-tax considerations which are impeding the EC's efforts in this area, BIAC nevertheless strongly suggests that initiatives to eliminate tax obstacles to international mergers should now be recommended at the OECD level.

78. Measures to eliminate tax distortions to international mergers might include a new article to be added to the Model treaty on income and capital. Such an article would apply in the case of a merger between a company which is a resident of one contracting state and a company which is a resident of another contracting state. Such an article could provide that any gains realised by the absorbed company or its shareholders shall be exempted from tax in the other contracting state until actual realisation of a gain takes place (i.e. the shares of the acquiring company are disposed of in a taxable transaction).

79. The recommendation of a similar measure is already contained in the resolution adopted by the XXIV I.F.A. Congress in 1970, which, for international mergers, proposed that "a model bilateral agreement be formulated to provide for the neutral tax treatment of liquidation profits arising from mergers across frontiers; it is recommended that this problem be submitted to the Fiscal Committee of the OECD".

VII. BURDENSOME PROCEDURES AND FORMALITIES

80. The cost of compliance with tax laws and regulations is becoming increasingly burdensome. There are, in particular, two reasons for this phenomenon. First, compliance burdens increase in direct proportion to the input of needless complexities into tax legislation and regulations. Increasing complexity has indeed become the hallmark of our times in most of the world. Second, legislation and regulations are more and more directed towards every possible aspect of tax avoidance rather than towards the formulation of a tax regime with which honest taxpayers can cope.

81. There is a tendency towards oversophisticated, labyrinthine tax laws and regulations. The excessive compliance burden caused by this tendency could be mitigated by a reasonable and pragmatic approach taken by the revenue agents in the field and by their upgrading their level of understanding of the relevant economic facts and circumstances.

82. In the context of the burden of compliance, BIAC would like to offer two additional comments:

- Treaties which provide for an application and refund of withholding taxes instead of an up-front exemption procedure create an unnecessary compliance burden in terms of the extra effort to effect the reduction of the tax, not to mention the time value of the loss of use of the funds until a refund is forthcoming.
- The ever increasing amount of information requested of taxpayers adds to the excessive compliance burden.

83. Information has certainly to be supplied but only for specific purposes, and

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it should also be made clear exactly what use will be made of the information so gathered.

84. The reservation that many taxpayers have is that too much non-essential information has to be supplied. Moreover, the protection of the taxpayer is not adequately addressed in domestic legislation mandating information submission as well as in discussions concerning the supply and exchange of information between governments (pursuant to treaty obligations). In particular, the necessity of the protection of business secrets has not been taken fully into account, and the risks of fishing expeditions are obvious.

VIII. BUSINESS SECRECY

85. In light of the growing interdependence of national economies, the number of taxable events with international implications is steadily increasing. As a result, more and more taxpayers are experiencing relationships with foreign tax authorities, generally consisting of the filing of tax returns and the subjection to tax inspection. Under these circumstances, the foreign tax authorities obtain data, the confidentiality of which is of the utmost importance to business activities of the taxpayer concerned.

86. In most countries, the information obtained by the tax authorities in the course of tax examinations can only be used for fiscal purposes. In particular, such data must not be disclosed to third parties and, in this regard, is granted special protection. Yet this protection varies greatly from country to country.

87. BIAC holds the view that governments, in their own interest, should ensure confidentiality of all trade and commercial secrets made available to them in the course of tax examinations. This applies especially to information concerning a foreign taxpayer. Governments risk prompting foreign investors to cut back on, or totally abandon, local investment if the confidentiality of trade and commercial secrets is not safeguarded.

88. BIAC is of the opinion that it is a taxpayer's fundamental right to be confident that information about his business that has come to the knowledge of the tax authority in the process of an examination, should *not* be used other than for fiscal purposes, and must not be disclosed to anyone outside of the tax administration.

89. The almost uncontrolled expansion, over the past few years, of the exchange of tax information between tax administrations involves additional risks for the confidentiality of taxpayers' trade and commercial secrets. In this context, mention must be made of the Multilateral Convention on Mutual Assistance in Tax Matters. BIAC has previously expressed its opposition to the Convention and we would like to summarise our arguments, which we set forth in 1987, below:

Taxpayer's rights are *not* adequately *protected:*

– increased exchange of information among more participants will enhance the risks for breach of confidentiality and improper use of data obtained; and
– the potential for sharing information without the knowledge of affected taxpayers will be considerably increased.

This type of *administrative cooperation between* fiscal authorities *more aptly* belongs in a *bilateral arrangement:*

– providing information not available in the tax files of a participating country, automatic exchanges of information, simultaneous examinations and providing relevant yet unrequested information will be complex, time consuming and expensive to the national governments involved.

Even if the Convention were to be duly signed, as is required for it to enter into force, we question the use of a coordinating body, as such a body has the potential of expanding its mandate beyond its originally intended purpose.

90. The international business community, through BIAC in the course of numerous consultations with the OECD over the years, has always stood ready to endorse any proposal put forth by the OECD as a legitimate means to attack tax evasion, and this view has been expressed to OECD representatives on countless occasions. However, the Convention is not an appropriate vehicle toward that end since it has the potential of taking insufficient account of taxpayers' rights.

91. Any program or tool devised to fight tax evasion must be a balanced program that weighs the potential benefits to the fiscal authorities against the potential detriments to the affected taxpayers so as to find the appropriate compromise. The Convention does not achieve that necessary balance, and for this reason BIAC opposes it.

IX. CONCLUSION

92. In conclusion, BIAC would like to reiterate that taxation is a significant consideration for international investors, affecting multinational corporate decisions on such important matters as financial structure and portfolio composition.

93. For this reason, BIAC would like to emphasise certain areas which we deem of particular importance when discussing tax obstacles to international investment. Our primary message on this subject is that measures which result in international double taxation and effective discrimination against foreign investors act as considerable impediments to international capital flows. BIAC has noted the emphasis which has been placed on tax evasion in recent years. Since international companies generally do not engage in tax evasion, we strongly urge that this effort be redirected towards reducing double taxation of multinational taxpayers.

94. Our specific priorities in this context begin with withholding taxes. As we have stated earlier in this paper, and repeatedly on other occasions, unrelieved withholding taxes are a major source of double taxation. We therefore urge the OECD to work towards zero rates of withholding on interest, royalties and related company dividends.

95. Other priority concerns of BIAC in this area are taxation of multinational personnel and, in particular, provisions which apply to pensions of internationally transient employees. Additionally, we urge that the OECD address the issues we have raised under burdensome procedures and business secrecy. Finally, we note that imputation systems are very confusing from an international point of view, and we encourage the OECD to work towards simplifying procedures in this area.

APPENDIX 1

The international heterogeneity of tax wedges in 1986 is illustrated by table 1 and table 2. Both tables deal with the tax situation on new investments and the calculations are based on neoclassical investment theory under which the cost of capital (or alternatively the post-tax real rate of return) is derived. The cost of capital in this context expresses the minimum pre-tax rate of return necessary for a new investment project to satisfy the real post-tax return requirement on part of the owners. A tax wedge can be defined as the difference between the rates of return before and after taxes. In table 1 a comparison is made between countries as well as between old and new tax systems in each country. The calculations are for each country based on average interest and inflation rates during the 70s and the 80s respectively. By applying the tax rules of corporations and owners the cost of capital as well as the post-tax return is calculated. The table illustrates that in all countries except West Germany the cost of capital as well as the real return after taxes increased between the two periods. This is partly a result of higher real interest rates but, as shown by the increased tax wedges, it is also a consequence of tax changes. An important observation from the table is that there were in 1986 substantial international differences with respect to costs of capital and tax wedges.

The calculations behind table 2 represent a slight variation of those behind table 1 in the sense that here the percentage tax wedges are compared on investments all yielding a 10 percent pre-tax return. In the economics literature these measures are called marginal effective tax rates. If for example in the case of Belgium corporate and owner tax rules are applied to an investment yielding a 10 percent pre-tax return the post-tax real rate of return will be 7.4 percent under the assumption of zero inflation. The tax wedge is therefore 2.6 percentage units in this case and the marginal effective tax rate 26 percent as table 2 says. A comparison of the marginal rates again shows that the tax wedges differ substantially between countries. Observe that in the case of table 2 the tax rules on companies and individuals is the sole reason for the variation between countries since differences in interest rates are neglected in this calculation. For comparative reason a line illustrating the much smaller variation in statutory corporate tax rates has been added to the table.

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TABLE 1

International cost of capital comparisons; percentages

	United States		United Kingdom		Germany (Fed.Rep.)		Japan	
	1980 rules 70s	1986 rules 80s	1980 rules 70s	1985 rules 80s	1980 rules 70s	1985 rules 80s	1980 rules 70s	1985 rules 80s
Cost of capital	2.4	7.2	–1.0	3.6	5.0	4.4	–1.6	2.8
Post tax real rate of return	–0.6	3.1	–2.6	1.3	1.0	0.7	–0.7	1.8
Tax wedge for capital (percentage units)	3.1	4.1	1.6	2.3	4.0	3.7	–0.9	1.0

Calculations based on average interest and inflation rates during respective time periods.
Source: Bernheim & Shoven, 1986.

TABLE 2

Marginal effective tax rates (end of 1986 tax systems; percentages)

Rate of inflation (percent)	Belgium	France	Germany	Italy	Netherlands	United Kingdom
0	26	41	37	2	19	27
10	34	89	31	9	24	63
Statutory tax rate	43	45	61	46	42	35

The calculations are based on new investments with a pre-tax real rate of return of 10 percent.
Source: Alworth & Fritz, 1988.

Source: OECD, 1988

References:

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APPENDIX 2

Numerical examples of unrelieved withholding taxes

Note: In the examples the corporation tax rate is assumed to be 50% and the withholding tax rates 10%.

A.1. *Dividends*

A parent company A has as its sole asset a 100% shareholding in a foreign subsidiary B.

B's profit of 100 is taxed at 50% in country B. On the dividend of the remaining 50 B levies a withholding tax of 5. It is clear that:
– under the exemption system there is no corporation tax in country A against which the withholding tax could be set off;
– under a tax credit system A's corporation tax on the dividend at 50 is fully eliminated by B's corporation tax of 50; the withholding tax of 5 remains an additional and unabsorbed burden.

See further comment B. 2.

A.2. *Interest*

A parent company A has borrowed 100 mln. at the cheap rate of 6% and lends that money on to its foreign subsidiary B at a market rate of 6.5%. A receives 6.5 mln. interest and has to pay 6 mln. A's corporation tax amounts to 50% of the difference, i.e. 50% of 500,000 = 250,000 (disregarding A's borrowing costs).

If country B is levying a withholding tax of 10%, that amount (10% of 6.5 mln. = 650,000) is much higher than A's corporation tax and for that part remains unrelieved.

The example assumes that both loans are in the same currency: in such case a margin of 0.5% is already often the maximum or even more than arm's length dealing will allow. If the borrowing by A is done in hard currency and the lending on to B in weaker currency, A's margin may be higher, but then its corporation tax tends to be reduced by currency losses.

A.3. *Royalties*

A parent company A has research and service centres costing 200 mln. and uses a cost-sharing system for its domestic and foreign subsidiaries. Foreign subsidiary B uses half of the facilities and pays its share of 100 mln.

A withholding tax in country B of 10% would reduce this share to 90 mln., so that parent A has a shortfall of 10 mln. In order to cover this shortfall, parent A would have to increase its charge to B from 100 mln. to 125 mln.

Calculation

Corporation tax A 50% mln.	=	12.5 mln.
Withholding tax in B 10% of 125 mln.	=	12.5 mln.
		0

Consequence
Country B receives 12.5 mln. withholding tax, but loses 12.5 mln. corporation tax (50% of the difference between a charge of 100 mln. and a charge of 125 mln.).

If country B would disallow part of the 125 mln. because a mark-up of 25% is too high, then part of the withholding tax remains unrelieved.

B. *Comments*

1. In BIAC's opinion withholding taxes have two main domestic functions and one main international function. The *domestic* functions are:
(a) to control that the main tax will be paid;
(b) to advance the tax payment (pay as you go).

The international function is:
(c) to allocate part of the main tax accruing to the country of residence to the source country.

In all these cases, however, it is essential that the withholding tax is a prelevy on and can be absorbed by the main tax, and not an independent tax.

2. In the case of a dividend withholding tax the prelevy is on the final income tax for the (portfolio) shareholder. A withholding tax on intercompany dividends tends to be an unrelieved and therefore independent and additional tax, unless it could be set off against the final income tax of the portfolio shareholder or against the dividend withholding tax due by the parent company on its own dividends. This, however, is not the practice and it is doubtful whether there is a theoretical foundation for such a system.

In some countries the withholding tax might be set off against other income – if any – of the parent company, but this means that domestic-source income is eroded for this purpose.

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3. In the case of interest and royalty withholding taxes, the examples prove that in many normal situations withholding taxes remain unrelieved. They presuppose unrealistically high profit mark-ups, which are impossible, not only from tax points of view but also for other reasons. This puts an additional burden on international business operations as compared to domestic operations.

4. The question of whether developing countries should be allowed to maintain higher withholding tax rates under treaties has been answered by the foregoing. At first sight this looks simply as a question of dividing taxing rights between developed and developing countries, an issue on which BIAC could remain neutral. But in fact it would lead either to a similar or greater tax loss for the developing country (see example A.3.), or to a higher amount of unrelieved tax. This would not be favourable to investments in the developing country concerned.

5. In this context, BIAC would like to point out that the fight against "treaty shopping" by some countries is mainly a fight for retaining the very high withholding tax rates under domestic legislation for situations where a treaty is considered to be too liberal. BIAC thinks it has shown that even in treaty situations unrelieved withholding taxes may be an impediment to international investment.

6. The above comments concern the pure tax principles and consequences of withholding taxes. These taxes may have other practical and economic drawbacks, for which BIAC refers to its paper.

CYPRUS: DOUBLE TAX TREATIES

[continued from page 184]

as a base for doing business in the Middle East, the Gulf States and Europe. Although no treaty benefits will apply, the FSC rules and the low tax in Cyprus make this an attractive possibility.

I. Elimination of double taxation

If a resident of one Contracting State derives income which, under the treaty, may be taxed in the other Contracting State, double taxation is eliminated in the Cyprus treaties by the exemption method or the credit method.

1. Exemption method

Under the treaties with Bulgaria, the German Democratic Republic, Hungary, Norway, the U.S.S.R. and Yugoslavia, the income will be exempt from tax. The same applies in the case of the Federal Republic of Germany (except that Germany relieves the double taxation of certain income by the credit method), and in the case of Sweden, in respect of certain types of income.[23]

2. Credit method

In all other cases the credit method applies, i.e. the tax payable in one State is allowable as a deduction against tax payable in the other State. However, if under the laws of Cyprus certain types of income are subject to a very low or zero rate of tax (e.g. income of an "offshore" entity), in many cases tax payable in the other State is completely or partially eliminated through the use of tax sparing credits (see above).

J. Treaty shopping

The term "treaty shopping" is practically unknown in Cyprus and Cypriot legislation does not contain any references to it or any provisions dealing with "misuse" or "improper use" of tax treaties. However, this is becoming, internationally, a very important issue and legislation is being introduced in other countries to combat tax avoidance through the use of treaties.

In addition to the "Limitation of Benefits Article" contained in some of Cyprus' treaties, a number of countries are "looking through" various transactions involving tax treaties to ensure that a treaty is not being "misused". It is therefore important, when setting up a structure designed to take advantage of the treaties, to ensure that the proposed set-up has the substance and commercial justification that will allow it to pass a more thorough examination by the authorities of the other country.

IV. CONCLUSION

Despite the limitations and continuing restrictive legislation from various countries, Cyprus still has much to offer in connection with international tax planning. The present policy of the Cyprus Government is to encourage even further foreign investment in Cyprus, and its aim is to turn Cyprus into a very modern business centre with many facilities and incentives for both offshore and local investors. To this end, new legislation is expected soon which will offer more incentives and attract more business to Cyprus. As far as new treaties are concerned, the authorities are very eager to expand the double tax treaty network to include all of Cyprus' major trading partners and as many other countries as possible.

In this article, the writer attempted to list, in general terms, the main benefits and advantages that may accrue by utilizing Cyprus' double taxation treaties. The list is by no means exhaustive; further possibilities can be found. Cyprus has in the past offered some of the best solutions to problems facing international tax advisers and will continue to do so in the future.

23. No tax will be due on business profits, however, if the resident of the other country carries on an "offshore" business through a permanent establishment in Cyprus, rather than a company. Profits will be taxed in Cyprus at a zero rate but will be exempt from tax in the other country.

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Resolutions 43rd IFA Congress Rio de Janeiro 1989

SUBJECT I

The Disregard of a Legal Entity for Tax Purposes

Resolution (original version)

The 43rd IFA Congress:

RECALLING its Resolutions of the 19th Congress in London, 1965, on the interpretation of tax laws with special reference to form and substance, and the 37th Congress in Venice, 1983, on tax avoidance/tax evasion;

TAKING NOTE of 29 National Reports and the General Report as published in Cahier de Droits Fiscal International, Volume LXXIVa, and

TAKING FURTHER NOTE of the discussion held during the Congress on the 11th of September 1989,

CONSIDERING THAT:

1) the concept of the separate existence of a duly created legal entity is generally recognised and is essential in domestic and international commerce;

2) it is also generally recognised that the taxpayer has the clear and free choice to adopt the structure that meets his needs, whether or not it involves the utilisation of a legal entity;

3) a taxing authority has a legitimate interest in protecting the integrity of its tax system where the legal entity may be utilised for fraudulent or abusive purposes;

4) in addition, the rules of general law are also applicable to determine the tax treatment of legal entities;

5) the manner and circumstances in which the separate existence of an entity is disregarded will differ from jurisdiction to jurisdiction; and

6) although there is no uniform approach to the concept of disregard and to the conditions for its application, it is generally regarded to be a more drastic remedial measure than the reallocation of income, the recharacterisation of transactions, the arm's length rule, etc.

RECOMMENDS:

1) the disregard for tax purposes of the legal entity or of its intervention in transactions should be limited to exceptional cases and accordingly interpreted and applied in a restricted manner;

2) in addition to cases where the entity is not recognised under general law or where in exceptional cases the tax legislation so expressly provides (consolidated returns, etc.), the remedy of disregard should be confined to circumstances where there is fraud or abuse;

3) while each taxing jurisdiction may determine for itself how it will formulate rules concerning the disregard of the legal entity, their application should be in conformity with the above recommendations and should offer the taxpayer adequate protection against arbitrary application and uncertainty of result; and

4) special problems (such as international economic double taxation and treaty shopping) which result from or could lead to the application of rules concerning the disregard of the legal entity to international situations should be dealt with in the domestic tax law or in the applicable tax treaty by appropriate remedial measures (including the possibility of the non-application of such disregard rules).

Review of the Resolution on Subject I by Prof. S.O. Lodin (Sweden), Chairman of the Resolutions Committee

The general questions concerning form versus substance and tax avoidance have been discussed by IFA at earlier congresses. The issue under what circumstances it could be permissible to disregard a duly created legal entity is of a more limited nature which is important to have in mind when studying the resolution. Accordingly it does not deal with general tax avoidance questions.

From the national reports on the subject it is evident that there is no general agreement on the exact concept of disregard with regard to neither content nor application. However, there is a general agreement that disregard of a legal entity is an exceptional measure more drastic and farreaching than the disregard of individual acts and other measures against tax avoidance. The resolution underlines the exceptional nature of disregarding a legal entity.

There is a general agreement that duly created legal entities are generally recognized and that this recognition is essential for the functioning of business and commerce and must be protected.

In order to stress that this principle is not only advisable and desirable but already generally applied and accepted the general recognition of the legal entity is stated in the preamble of the resolution as a fact instead of being included in the recommendation.

For the same reason the preamble also states as a generally recognized fact that a taxpayer has the clear and free choice of establishing a legal structure that meets his needs. Tax effects are only one of all circumstances that a person has to consider when choosing legal form for his business.

There was a long discussion whether a government or other taxing authority should have the right to disregard a legal entity without expressive provisions not only where abuse or fraud was involved but also under special circumstances in other cases where the integrity of the tax system could be jeopardized. The Congress rejected in its recommendation this possibility.

During the discussion the view was brought forward that the need for disregarding legal entities in most cases were caused by disparities in the tax systems. With lower tax rates and broader tax bases the tax systems will become more neutral and the treatment of alternative possibilities will be

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more equal. Hereby the need for such remedies as disregarding a legal entity will be reduced. This may be true with regard to domestic legislation. International disparities will, however, still remain and cause problems.

Although the resolution recognizes that rules for disregarding legal entities can be formulated in different ways it also underlines that the rules must be clear in order to protect the taxpayers from arbitrary application and uncertainty. Moreover the resolution stresses the need for adjustment mechanisms in order to avoid that the act of disregarding a legal entity leads to double taxation or excessive taxburdens for the taxpayers involved. Such measures are of special importance in international situations, as disregarding a foreign legal entity for tax purposes in most cases leads to double taxation unless special rules in order to avoid an excessive tax burden are introduced.

SUBJECT II

Administrative and Compliance Costs of Taxation

Resolution (original version)

The 43rd IFA Congress:

TAKING NOTE of the 23 National Reports and the General Report as published in the "Cahiers de Droit Fiscal International", Volume LXXIVb, Subject II, and

TAKING FURTHER NOTE of the discussions held during the Congress on 12th September 1989, in which it was generally recognised that:

1) The running or "tax operating costs" of taxation systems pertaining to personal income tax (including capital gains tax), corporation tax and general sales tax are substantial.

2) The private sector – compliance cost component of tax operating costs, consisting both of the costs to taxpayer and third parties, is invariably significantly higher than the public sector-administrative costs component.

3) The level and burden of compliance costs is regressive and falls with disproportionate severity on smaller firms and in some cases on special taxpayer groups.

4) There is a pronounced tendency for States to transfer the burden of tax operating costs from the public sector to the private sector, thus increasing compliance costs and decreasing administrative costs by imposing more duties respecting the collection of tax (and, in general, enforcement of the tax system) on the private sector.

5) Notwithstanding (1)-(4), there is, in fact, little comprehensive data respecting the amount of tax operating costs, and that which is available relates predominantly to administrative costs, not compliance costs.

6) Available data rarely provide the basis to comprehensively evaluate the efficiency of tax operations and the manner in which the costs are distributed between the public and private sectors.

7) The high level of tax operating costs results, in part, from frequent change in and complexity of tax law (although the latter is sometimes unavoidable in light of the complexity of modern business practices), and multiplicity of, and lack of harmonisation among, taxing jurisdictions in federal States.

8) Tax operating costs are a necessary consequence of fiscal policy, but States directly influence the level of such costs by the manner in which they formulate and effect substantive or procedural tax law.

CONSIDERING THAT:

1) Notwithstanding (1) to (4) above and in view of (5) and (6) above:
   (a) although tax operating costs are substantial, it is not known whether they are, in fact, excessive in relation to the proper administration of taxation and the tax revenues collected by States;
   (b) although compliance costs exceed administrative costs, and there is tendency for a transfer from the latter to the former, it is not known when such is an appropriate result; one of the causes of such transfers is the requirements – seen by States as ensuring the maximum compliance with tax law – respecting the withholding of taxes at the source and/or reporting information respecting items of income.

2) The high level of compliance costs associated with 1) (b) relates to the tax liability of taxpayers other than the withholding agent or provider of the information, thus raising the question of whether compensation should be paid by States in such cases; in some instances in some countries cashflow benefits arising from tax collections or withholding may constitute such compensation.

3) The high level of compliance costs apparently is caused in some instances by:
   (a) unnecessary demands for information;
   (b) unduly complex tax legislation;
   (c) legislation that sometimes is repealed before it is brought into force, but only after substantial compliance costs (of the "temporary" nature) have been incurred;
   (d) legislation which is disproportionate or inappropriate to the tax policy objective;
   (e) legislation which does not adequately distinguish between the situation of large corporations and smaller firms;
   (f) tax assessments which are proved to be unfounded;
   (g) errors by tax administrations which the taxpayer has to correct; or
   (h) unduly complex appeal and litigation procedures; and

   some of these raise the question of whether compensation should be paid.

4) There have been, to date, initiatives undertaken by certain States to deal with and/or ameliorate one or more of the causes of high tax operating costs.

5) Tax administrations may be constrained by laws respecting confidentiality of taxpayer information in respect of studies which would provide relevant data concerning compliance costs; but by appropriate methods tax administrations can assist research without breaching obligations respecting confidentiality or anonymity.

6) The high level of tax operating costs, constituting a significant proportion of a country's GNP, renders vital a consideration and evaluation of such costs in implementing fiscal policy.

7) The relative effectiveness of administrative or compliance procedures and consequently the relative incidence of tax operating costs may vary as between personal income tax, corporation income tax or general sales tax, or as between different categories such as, for example, methods of procuring compliance with taxation of portfolio income – dividends and interest.

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8) Ineffective, inefficient or insufficient administrative or compliance procedures jeopardise maximum collection of tax properly due and consequently raise the risk of increasing the tax burden for all taxpayers.

9) High rates of inflation have a tendency to generate exceptional compliance costs, but may also generate offsetting cashflow benefits.

10) The importance of psychological costs as an element of compliance costs should be clearly recognised, although their measurement is particularly difficult.

RECOMMENDS:

1) States should explicitly acknowledge the importance of administrative and compliance costs and take them fully into account in establishing fiscal policy.

2) States in cooperation with business, the professional and academic communities and inter-governmental organisations such as OECD should, as quickly as possible, pursue studies to determine the tax operating costs of existing tax laws.

3) The determination referred to in (2) should entail an evaluation of the effectiveness of the underlying administrative and compliance procedures.

4) As part of any significant proposed change of tax law States should assess and disclose the associated administrative and compliance costs.

5) As part of the implementation of (1)-(4), States should:
   (a) seek to eliminate unnecessary administrative and compliance costs;
   (b) especially address the regressive nature of compliance costs in relation to smaller firms and seek to ameliorate this problem;
   (c) consider and evaluate the extent to which compensation should be paid to relevant categories of taxpayers in respect of compliance costs;
   (d) address the causes of excessive tax operating costs in federal States with multiplicity of taxing jurisdictions and, in particular, consider the establishment of incentives to harmonise their tax systems;
   (e) address the special cases of high inflation;
   (f) optimise the opportunities afforded by modern technology to (i) collect data and (ii) simplify and standardise reporting, tax returns and audits/assessments.

6) Because compliance costs are often regressive and also generate psychological costs, where, with equal efficiency for the same total costs, there is a choice between administrative and compliance costs, the balance should be tilted in the direction of more administrative cost and less compliance costs.

Review of the Resolutions on Subject II by Nathan Boidman, Esq. (Canada), Chairman of the Resolutions Committee

The final Resolutions for Subject II, dealing with the "tax operating cost" of taxation systems, comprise an unusually comprehensive statement of both (1) the many factors and tendencies explicitly or implicitly suggested by Professor Cedric Sanford's excellent and incisive General Report and the stimulating panel discussion led by Mr. Guy Delorme and (2) much of the nuances and underlying uncertainty relevant to the topic. This was for three reasons:

1. First, the subject did not deal with the normal issue of tax imposed by government on taxpayers and the resulting, inherent adversarial position between the two groups, which has characterized most if not all other matters dealt with by IFA.
2. Second, there is decided paucity of comprehensive information available respecting the topic.
3. Third, there are very few who are familiar, experienced or knowledgeable on the topic.

Because of the comprehensive nature of the Resolutions, it would be largely redundant to review herein much of the substantive aspects of the considerations underlying their drafting and finalization. Nonetheless, a number of points may be noted.

It was evident that there is a general concern that the administrative and compliance costs comprise a substantial burden, both for government and taxpayer alike. But it was also clear that it will take a great deal of cooperative and coordinated study by governments, taxpayers (and related government or taxpayer groups) to determine the true magnitude of the costs, whether they reflect the most effective and efficient manner in which tax laws should be enforced and taxes collected, whether there can be ameliorated the apparent disproportionately high burden imposed on small businesses and whether it is feasible to implement a number of programs to reduce the burdens, and other relevant concerns.

Neither the panel discussion nor the resolution making process (in committee and general session) had much difficulty in reaching a consensus on the matters reflected in the Resolutions. However, the following areas of (moderate) debate, not necessarily reflected or fully analyzed by the Resolutions, may be noted at this juncture:

1. There is little if any expectation that psychological costs either can be measured, reduced or compensated for.
2. It is much easier to (1) measure administrative costs than compliance costs and (2) forecast and plan for the administrative costs of new or revised tax legislation than for the compliance costs which will arise therefrom. Accordingly, there was some suggestion, not amounting to a consensus, that governments should design tax law to tilt costs to the administrative side, and not the compliance side. However, the Resolutions do reflect agreement, reflected in the final paragraph, that where there is choice between administrative and compliance costs, the balance should be tilted in the direction of more administrative costs and less compliance costs. Also not agreed to was the thesis that there should be compensation for taxpayers in respect of compliance costs resulting from ill designed tax law (particularly where its defect is acknowledged by subsequent repeal or drastic modification of the particular law involved).
3. The Resolutions do not reflect specific suggestions, which would be designed to ameliorate the burden on small business, that tax law be formulated to differentiate between the position or requirements of small and large business nor the possibility of compensating individual taxpayer or taxpayer groups who are utilized by government in developing compliance procedures and who, accordingly, are subject to unusually high costs of compliance.
4. There was also substantial but indecisive discussion respecting the various methods which could be employed in simply identifying and measuring compliance or administrative costs, particularly as between those which are direct and those which are indirect.

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5. The panel discussions also reflected varying and uncertain views respecting the relationship between compliance costs and the incidence of tax evasion and appropriate steps, if any, which would be taken to deal therewith.

6. Although the first resolution proposed that "the State should explicitly acknowledge the importance of administrative and compliance costs and take them fully into account in establishing fiscal policy", there appeared not to be a consensus respecting the manner in which governments should inform the business community and the taxpayers of the specific nature of the costs which are incurred. It must be determined whether with better knowledge taxpayers would be better positioned to contribute to a dialogue which could lead to a reduction of either administrative or compliance costs or both. In other words, more facts and better management of both administrative and compliance procedures and better allocation of costs as between taxpayers and governments may be possible.

In summary, Subject II raised very important concerns for government, business and the tax community and the Congress's deliberation in respect thereof provided the basis for lengthy and comprehensive Resolutions, without the divisiveness which often accompanies the study of difficult issues of taxation.

Conference Diary

MAY 1990

9th National Convention of The Taxation Institute of Australia. Adelaide, 4 May (English):
Ann Ewer, Convention Co-ordinator, 9th National Convention of the Taxation Institute of Australia, P.O. Box 232, Kensington Park, S.A. 5068, Australia.

Leasing – Flexible Off-balance Sheet Financing, Achieving Fiscal Advantages, Effective Sales Aid. Brussels, 8-11 May (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

Successful Structuring of Cross-border and Multinational Operations and Investment in Europe for the 90's. Frankfurt, 8 May (English); Amsterdam, 9 May (English); Milan, 21 May (English):
OM Conferences, Fideal, Chemin Taverney 13, CH 1218 Grand-Saconnex, Geneva, Switzerland.

Harmonisatie van Belastingen in de Europese Gemeenschap. Bussum, 10 May (Dutch):
Studiecentrum voor Internationaal Management, World Trade Center, Strawinskylaan 331, 1077 XX Amsterdam, The Netherlands.

Fundamental Elements of U.S. Federal Taxation. 14-16 May; Introduction to U.S./International Taxation, 14-16 May; U.S. Taxation of Corporate reorganizations, 17-18 May; U.S. Taxation of International Joint Ventures. 17-18 May (English). Venue to be selected near London:
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

ITPA 1990 Annual Conference. Venice Lido, 17-18 May (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

Fourth Annual Salzburg Spring Conference: Mergers and Acquisitions; Meeting the Challenges in Europe and North America After 1992. Salzburg, 18-21 May (English):
McGeorge School of Law, Box 150, A5021 Salzburg, Austria.

U.S./International Taxation of Oil & Gas. London, 21-23 May (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Debt/Equity funding and leveraged buy-outs. London, 23 May (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touch Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

How to prepare now for the coming Goods & Services Tax. Toronto, 23-24 May (English):
Equinet Publishing Ltd., 88 Prince Arthur Avenue, Toronto, Ontario, M5R 1B6, Canada.

Internationaal Ondernemen en de Fiscus. Rotterdam, 30-31 May (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

International Tax Aspects of Cross-border Financing. Amsterdam, 31 May (English):
International Tax Academy, c/o International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

JUNE 1990

Een Nieuw Fiscaal Regime voor Beleggingsinstellingen. Amsterdam, 7 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Offshore Tax Planning – the Uses of IOFCs and Tax Havens. Geneva, 11-12 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Successful Structuring of Cross-border and Multinational Operations and Investment in Europe for the 90's. Paris, 12 June (French); Brussels, 20 June (English); Stockholm, 21 June (English):
OM Conferences, Fideal, Chemin Taverney 13, CH 1218 Grand-Saconnex, Geneva, Switzerland.

The Valuation of Intangible Assets including Accounting Treatment of Goodwill & Brands. London, 15 June (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Planning through Transcontinental Trusts – The Fourth Annual Conference on the Use of Trusts and their Underlying Companies in International Planning. London, 25-26 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Taxation of Branches and Subsidiaries. Brussels, 25-26 June (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands.

AUGUST 1990

44th Congress of the International Fiscal Association: I. Taxation of Cross-border Leasing; II. International mutual assistance and exchange of information. Seminars: 1. The Nordic multilateral tax treaty; 2. Double tax treaties between industrialized and developing countries, the OECD and U.S. models – a comparison; 3. The extension of tax sovereignty – especially in connection with emigration; 4. Tax reform in Scandinavia. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125, 3001 DE Rotterdam, The Netherlands.

SEPTEMBER 1990

Monte-Carlo Workshop: Entertainers and Athletes (inbound transactions); Taxation of international shipping. Monte-Carlo, 17-18 September (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

NOVEMBER 1990

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

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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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1990 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ASIA & THE PACIFIC

DIRECT AND INDIRECT TAXATION
in selected countries in Asia and the Pacific. A project of the Study Group on Asian Tax Administration and Research (SGATAR).
Prepared by the National Tax Research Center, Philippines, November 1988.
Manila, National Tax Research Center, 1988, pp. 553.
Country-wise structure of major taxes including the tax base, the tax rates and the system for their administration in comparable form set out for purposes of the Study Group on Asian Tax Administration and Research (SGATAR) research project at the occasion of the meeting in Manila. The selected countries are: Australia, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand.
(B. 57.391)

Australia

AUSTRALIAN TAX REFORM IN
retrospect and prospect. Papers presented at a conference organised by the Centre of Policy Studies, Monash University. Edited by John G. Head.
Clayton, Monash University, Centre of Policy Studies, Clayton, Vic. 3168, Australia; Sydney, Australian Tax Research Foundation, 1989, p. 531, Aus$ 29.95.
Conference papers contributed by various authors. Topics include: Overview and international perspectives; Income tax reform; Consumption taxes, sales tax reform and tax mix change; Tax incidence and economic effects: estimates and methodology. Some of the delivered articles: "Taxation of fringe benefits" by D.J. Collins; "International aspects of tax reform in Australia" by Richard M. Bird; "U.S. tax reform" by Charles E. McLure; "New Zealand tax reform" by R.J. Stephens; "A value added tax for Australia" by G.M. Bascand; "Changes in Australian tax incidence between 1975-76 and 1984-85" by N.A. Warren.
(B. 57.381)

Japan

ISHI, Hiromitsu.
The Japanese tax system.
Oxford, Oxford University Press, Walton Street, Oxford OX2 6DP, England, 1989, pp. 347.
£ 35.0.
A survey of the theory and principles of the important Japanese taxes and their economic effects, written too early to include detailed consideration of the consumption tax.
(B. 57.399)

EUROPE

CORPORATE TAX STRATEGY IN
Europe and the United States and intercompany pricing.
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Amaresh Bagchi:

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Der Autor versucht in diesem Artikel die relevanten Probleme und Folgerungen bezüglich Alternativen für die Besteuerung von Dividenden zu skizzieren.

G.K. Kwatra:

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Dieser Artikel beschreibt die Hintergründe des „ATA Carnet" Systems, die Weise, in der es funktioniert und die Auswirkung auf indische Unternehmen, welche auf dem internationalen Markt tätig sind.

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UNITED STATES:

Earnings Stripping*

David R. Hardy and Paul D. Wigg-Maxwell

Of all the revisions to U.S. tax law enacted as the Revenue Reconciliation Act of 1989 (the "1989 Act"), the provision of greatest relevance to inbound investments is the limitation on earnings stripping.

"Earnings stripping" refers to reducing the U.S. taxable earnings of corporations by capitalizing the corporations in part with shareholder loans. The interest payments on the loan portion of the capital is generally deductible to the borrower and, if paid to a foreign shareholder benefiting from a treaty, is exempt from U.S. withholding tax.

The earnings stripping provision is derived from a provision included in the version of the 1989 Act first passed by the House of Representatives. It defers the deductibility of certain interest expense on loans from related entities, unless such interest is subject to U.S. tax in the hands of the related entity. Loans incurred or modified after 10 July 1989 are subject to the earnings stripping provision, if the interest expense on such loans, when combined with other interest income and expense, exceeds in the aggregate 50% of the net operating income of the borrower. In principle, the 1989 Act limits earnings stripping so that the borrower's earnings subject to U.S. taxation cannot be reduced by this technique by more than 50% of what its net operating income would otherwise be.

BASIC OPERATION

The 1989 Act enacts a new Sec. 163(j) to the Internal Revenue Code of 1986, as amended,[1] which provides, "....no deduction shall be allowed... for disqualified interest .... The amount disallowed shall not exceed the corporation's excess interest expense for the taxable year."

Only disqualified interest is subject to the limitation on deductibility. "Disqualified interest" means interest paid or accrued directly or indirectly to a related person (more than 50% commonly owned) if the related person is not subject to U.S. income tax on receipt of that interest income. If unrelated party interest is also present, it is fully deductible, subject to the general rules under current law. The interest is not disqualified interest if the related party lender is subject to U.S. tax on the interest income.[2] Any interest deduction disallowed is suspended and treated as a disqualified interest expense in the succeeding tax year.

Only that portion of disqualified interest which is "excess interest expense" is disallowed. "Excess interest expense" means "the excess of the corporation's net interest expense over ... 50% of the adjusted taxable income .." Any excess limitation (the amount by which 50% of adjusted taxable income exceeds net interest expense) carries forward to increase the limitation for the 1st, 2nd or 3rd succeeding years.[3]

"Net interest expense" means interest paid or accrued over interest income. If the deduction of interest expense is deferred and disallowed under any other provisions, e.g. Secs. 163(e)(3) (O.I.D. re a foreign lender); 263 (capitalized interest); 267(a)(3) (accrued but unpaid interest), Sec. 163(j)'s operation is deferred until the interest expense is otherwise allowable.

* This article appeared in the March 1990 issue of *Taxation for Accountants*.

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1. Hereinafter, all sectional references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
2. If any treaty with a foreign country reduces the tax imposed on interest paid or accrued, such interest shall be treated as interest on which no tax is imposed in proportion to the treaty withholding rate over the statutory 30% withholding rate.
3. A carry-over may arise from years when the 1.5 safe harbor applies. While a close reading of the statute suggests that excess limitation cannot arise from years prior to the effective date, some assert that the purpose and intent of the limitation carry-over should permit such carry-overs.

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"Adjusted taxable income" means taxable income calculated without reduction for net interest expense, net operating losses or non-cash deductions such as depreciation. Thus, somewhat like existing net operating losses, disqualified interest is simply deferred. However, unlike similar provisions, the deferred expense is not ultimately deductible in all events. The statute gives Treasury the authority to promulgate regulations that would alter the definition of "adjusted taxable income". The Conference Agreement states "adjusted taxable income" will add back non-cash items "but would *disregard .... the proceeds of certain capital asset dispositions*". Could this mean that, in the context of the traditional real estate investment, the disposition gain would not absorb any of the deferred disqualified interest?

Four short examples may help to clarify the operation of this earnings stripping provision. For purposes of these examples, all related party interest is considered paid to an entity in whose hands the interest is exempt from U.S. tax.

Example 1 – Related party interest is less than 50% of NOI

Net operating income		100
Net interest expense		
Total	45	
3rd party interest	0	
Related person interest	45	
Allowable interest		(45)
Depreciation		(40)
Taxable income		15

Example 2 – 3rd party interest exceeds 50% of NOI

Net operating income		100
Net interest expense		
Total	65	
3rd party interest	55	
Related person interest	10	
Allowable interest		(55)
Depreciation		(40)
Taxable income		5

Example 3 – Related party interest exceeds 50% of NOI

Net operating income		100
Net interest expense		
Total	65	
3rd party interest	0	
Related person interest	65	
Allowable interest		(50)
Depreciation		(40)
Taxable income		10

Example 4 – Related party plus 3rd party interest exceeds 50% of NOI

Net operating income		100
Net interest expense		
Total	65	
3rd party interest	40	
Related person interest	25	
Allowable interest		(50)
Depreciation		(40)
Taxable income		10

All members of a U.S. affiliated group shall be treated as a single taxpayer for the purpose of this calculation.

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The refinancing of other loans, third party construction loans or term loans will not trigger the earnings stripping limitation because they are not related party loans. However, if a property is financed partially with related party debt and partially with unrelated debt, increasing the amount of unrelated party debt by refinancing the debt could cause interest on related party debt to exceed the earnings stripping limitation.

DEBT/EQUITY SAFE HARBOR

In response to concerns over the scope of any new earnings stripping rules, the Conference Committee on the 1989 Act ("Conference Committee") added a debt/equity safe harbor to the original provisions adopted by the House of Representatives. However, unlike the old Sec. 385 Regulations[4] which established a basic 3 to 1 safe harbor, the new earnings stripping safe harbor is set at 1.5 to 1.[5] Unfortunately, this safe harbor is not likely to be of wide utility. Common real estate transactions where third party banks' lending policies typically permit loans in amounts up to 80 to 85% of value, create a 1 to 4 or 1 to 5 debt/equity ratio. Unlike the old Sec. 385 Regulations which had separate, more generous, ratios for particular industries (i.e. finance and real estate), the earnings stripping rules provide only the single ratio.

The method of determining debt/equity is specifically set out in the statute in a manner which may cause unexpected problems. The debt/equity ratio is defined as the excess of all liabilities over the taxpayer's total assets less liabilities. This methodology effectively tests the debt/equity ratio on a continuous basis, ignoring the normal rules of evaluating characteristics of capital at the time the capital is invested. For example, an industrial company may be capitalized originally with $ 50 of equity and $ 50 of debt; at first, the debt would clearly be respected as debt and the new earnings stripping safe harbor would be satisfied. However, if payables during the initial operating period grow to $ 50 and everything else remains constant, the company would cease to satisfy the safe harbor and begin having to calculate the earnings stripping limitation.

In addition, the statute requires that assets be evaluated by reference to their adjusted basis for determining gain rather than by reference to their fair market values. For example, if the industrial company described above had previously purchased real estate for $ 100, and depreciation has since reduced the asset's adjusted basis to $ 70, and the principal amount of debt has not been amortized, then equity would be reduced to $ 20 while debt would still be $ 50 and the debt/equity safe harbor would be available. This result occurs in spite of the fact that the real estate may actually have increased in value. This rule would similarly restrict an investor's ability to refinance appreciated real estate in situations where any related party indebtedness exists. The debt/equity safe harbor is thus a small cove which offers protection to very few taxpayers. Perhaps due to time constraints it does not seem to have been given the consideration that went into similar safe harbors under the old Sec. 385 Regulations.

4. See T.D. 7747, 1981-1 C.B. 141; 1981-1 C.B. 168; T.D. 7801, 1982-1 C.B. 60; and T.D. 7822, 1982-2 C.B.84; withdrawn T.D. 7920, 1983-2 C.B. 69.

5. Supposedly, the 1.5 to 1 rule was supported by the OECD Thin Capitalization Study (1987) and represents the median debt/equity ratio of U.S. corporations.

TAX-EXEMPT ENTITIES

Two features must be present for interest on a loan to be disqualified interest. The interest must be paid to a related party and paid to a party which is exempt from U.S. tax. Unlike relatedness which is basically tested at the entity level, tax exemption may be tested at the partner level.

The simplest application of this rule is interest paid by a borrower corporation to a tax-exempt pension plan, church, educational institution or other public charity owing 100% of its stock. Interest paid or accrued to such tax-exempt entities would be disqualified interest because the 50% control relationship exists and the interest received should be exempt in the recipient's hands. However, in the case of a loan by such an entity to its wholly-owned subsidiary corporation, the interest would, in fact, be taxable as unrelated business taxable income under Sec. 512(b). Similarly, a loan from a pension plan to a closely held corporation which sponsors the plan would probably represent a prohibited transaction and be subject to penalty taxes.[6] Therefore, there will be few applications of the earnings stripping provisions to tax-exempt entities.

The trust of the statute, although apparently broadly written to try to avoid discrimination issues (see below), is to reach foreign lenders to related U.S. entities. Such lenders are treated as tax-exempt to the extent of any treaty reduction in withholding tax rate. The provision states that if any treaty with a foreign country reduces the tax imposed on interest paid or accrued, such interest shall be treated as interest on which no tax is imposed in proportion to the treaty withholding rate over the statutory 30% withholding rate. Thus, interest paid to a Netherlands corporation, generally exempt from withholding under the current Netherlands–U.S. treaty, would be treated as interest on which no tax is imposed; interest paid to a related Japanese lender subject to a 10% withholding rate under the Japan–U.S. treaty, would be treated as ⅔ exempt.

A refinement in the treaty rule is set forth for interest paid to foreign partnerships or pass-through entities. In such cases the determination of whether the interest is tax-exempt is required to be made at the partner level. The Conference Committee Report does not clearly explain how a determination is to be made as to whether a foreign entity is a pass-through entity.

The House Ways and Means Committee Report states that interest received by an otherwise exempt controlled foreign corporation, passive foreign investment company, foreign personal holding company, or the like will be treated as non-exempt to the extent that such interest is currently taxed to a U.S. shareholder. That Report further states that interest on a back-to-back loan through a related tax-exempt entity may be treated under regulations as a direct loan to an ultimate unrelated lender.

The fact that a lending corporation has a net operating loss would not result in its receipt of interest being considered interest on which no tax is imposed. Accordingly, loss companies acting as lenders would not cause the interest they receive to be treated as disqualified.

RELATED PERSONS

The central concept governing the scope of the disqualified debt concept is the relatedness of the lender to the borrower. In general, the statute adopts the standards set forth in Secs. 267(b) and 707(b)(1). This means that taxpayers who are more than 50% commonly controlled will be treated as related persons. The House Bill's provision included a reference to the more subjective Sec. 482 standard which was dropped by the Conference.

The statutory language is fairly vague in providing how the relatedness is tested. The relatedness of a borrower that is a 100%-owned subsidiary of the lender corporation is clear. In the case of a borrower that is a partnership, the determination of who is related, and to what degree, is less simple. General Code principles[7] as well as the House Report require that interest expense be allocated first to each partner and that each partner in turn would determine whether its distributive share of interest expense is considered related party interest or not. This leads to a potentially anomalous circumstance. For example, consider a situation in which 3 investors A, B and C form a U.S. partnership. A and B, who are foreign corporations, each have a 25% interest in the partnership. C is a domestic corporation and has the remaining 50% interest. A and B also form a foreign corporation which they own 50/50. The corporation makes a loan to the partnership. When A and B's distributive shares of partnership interest expense are tested, each has a 50% direct interest in the foreign corporation. Without more, the interest expense of A and B should not be subject to the Sec. 163(j) limitation. The House Committee Report states, however, that the relationship is to be tested "applying, where necessary, appropriate ancillary provisions such as the constructive ownership rules of section 267(c)". Sec. 267(c)(3) contains a rule providing for the constructive ownership by an *individual* of stock owned by his partner. Question whether Regulations will provide that a rule causing corporations to constructively own the stock in a foreign corporation held by their partners is an "appropriate ancillary provision" under these facts.

On the other hand, consider the following variation of the above example. Now A, B and C form a foreign partnership. A loan is made from the partnership to a corporation owned by A and B 50/50. In determining whether the interest expense of the corporation is on a loan between related parties, relatedness is tested at the entity level. It is clear that A and B do not own more than 50% of the outstanding stock of the corporation. Thus, the corporation and the partnership should not be treated as related entities and the interest expenses would not be disqualified interest.

An additional complexity was added by the Conference Committee Report to the rules for determining whether interest is paid to a related person in the case of payment of interest to a partnership. Related partnerships are ignored where less than 10% of the profits and capital interests are owned by entities in whose hands such interests are taxable in the United States (except that interest continues to be subject to the rules to the extent allocable to related partners.

The House Report contemplates that arrangements to defeat related ownership[8] will be disregarded under rules similar to Reg. Sec. 1.957-1(b)(2).

EFFECTIVE DATES

The earnings stripping limitation is effective for interest paid or accrued in taxable years beginning after 10 July 1989. A grandfathering provision exempts loans with a fixed

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6. See Sec. 4975(c)(1)B.
7. Sec. 702.
8. See *Garlock v. Commissioner,* 489 F,2d 197 (2d Cir. 1973).

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term which were issued on or before 10 July 1989 or which were issued after 10 July 1989 pursuant to a written binding contract in effect on 10 July 1989 and continuing through the date the loan was made. The House Committee report states that "debt instruments which are renegotiated, assumed, reissued, extended, modified, or otherwise revised after July 10, 1989, shall be treated (as of the effective date of such new terms) as new debt instruments that were not outstanding on July 10, 1989".

The "assumed" and "modified" terms are potentially broader in scope that the Sec. 1001 standards used to evaluate re-issuance in the tax-exempt bond area.[9] On the other hand, the language does not specifically include property acquired "subject to" existing indebtedness, a common real estate situation which other sections of the Code have found it necessary to specifically identify[10].

Typically the earnings stripping loans will have been put in place at the time of the initial investment and will therefore qualify for grandfathering. Subsequent modifications of the term, amount, interest rate, collateral, or lending party of these loans may cause them to be treated as new loans no longer qualifying for the grandfathering provision. Earnings stripping loans made as demand loans will not qualify for the grandfathering provision. It may also be difficult in some cases to produce adequate documentation that a related party loan was for a fixed term rather than payable on demand. The House Report adds that a written contract between related parties will be treated as binding only if it could have been enforced by reliance or otherwise by an unrelated party.[11]

Loans pursuant to lending facilities recorded in written binding agreements in effect on 10 July 1989 may qualify for the grandfathering provision if they are limited as to the total amount which can be drawn and fixed as to the term the facility will be available. The fact that the borrower has no binding commitment to draw any funds under the facility should not jeopardize the loan's qualification for the grandfathering provision. Provisions in the loan facility giving the lender the right to call the loan on demand or alter significant terms of the facility, make it less likely that the facility will qualify for the grandfathering provision.

TREATY NONDISCRIMINATION

During the consideration of the legislation, many commentators, including several foreign governments, strongly opposed the earnings stripping provision on the grounds that it was contrary to the nondiscrimination provisions of our existing treaties. Generally, such nondiscriminatory provisions make inapplicable to treaty beneficiaries any provisions of U.S. tax law imposing a tax on them more burdensome than that imposed on other U.S. taxpayers. Economically, it appears relatively clear that the revenue estimates from the provision are justified only by its application to inbound investors in U.S. assets.

In the case of related party loans between domestic or foreign taxpayers, normal debt/equity rules apply to permit the Internal Revenue Service (the "Service") to disallow interest in whole or in part. An additional disallowance provision applicable principally to taxpayers with foreign owners appears discriminatory.

The Conference Report goes to great lengths to refute this opposition with arguments resembling those made in the Sec. 482 White Paper. For example, the Conference Report states that our treaties give Treasury the power to force related parties to adhere to arm's length dealings. To the extent that the earnings stripping rules are reasonably designed to accomplish that, they are permissible under the treaties. It is also asserted that the 1.5 to 1 debt/equity safe harbor is consistent with the capitalization of many companies. The weakness of these arguments is that statistical averages upon which the 1.5 safe harbor and 50% of net operating income rule are based have not fared well in the courts as a means for determining arm's length dealings.[12] Implicit in the notion of a median is that half of the sampled cases fall below the median number.

The more satisfying argument of the Congress is that a substantial portion of U.S. taxpayers (i.e. tax-exempt entities) are also subject to similar provisions or are made subject to this new provision; therefore, the provision is non-discriminatory.[13] Some assert that a foreign corporation taxable in its home country is not comparable to a U.S. tax-exempt entity.

INDIRECT LOANS

Because the earnings stripping provision does not apply to loans from third-party banks, the substitution of bank credit for related party leverage may strike many as a technique for avoiding its imposition. However, it is not clear that bank credit substitution in the form of back-to-back, collateralized or guaranteed loans works. Back-to-back loans have been a principal technique in treaty shopping. The foreign investors deposited or loaned money to an intermediary in a favorable treaty country who then on-lent to a U.S. affiliate of the investor at a slight spread in interest rates. The Service has taken the position that so-called "back-to-back" loans are to be treated as loans directly between the related parties rather than as loans from the unrelated bank.[14] The House Report clarifies that the power to recharacterize back-to-back loans will also be used in the enforcement of the earnings stripping provision. The application of this principle to earnings stripping situations, however, will frequently result in treating a loan from a tax-exempt treaty lender as a loan to a non-treaty beneficiary, fully subject to withholding. Because the withholding tax will apply to the lender, the earnings stripping provision will not be imposed on the borrower.

There is additional uncertainty as to the application of the earnings stripping provision to banking arrangements which do not fit the traditional back-to-back loan pattern (i.e. collateralized guarantees). The Service may assert that the arrangement is also a related party loan. However, borrowers frequently incur loans from unrelated banks primarily on the strength of a guarantee or security offered by a party related to the borrower rather than on the borrower's own credit. If the Service prevailed in asserting that such support was in effect a back-to-back loan, interest expense on the collateralized or guaranteed loan would be subject to the earnings stripping limitations to the extent that the arrangement could not qualify for grandfathering. The final Conference Report added the following language on this point:

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9. See Rev. Rul. 87-19, 1987-1 C.B. 249.
10. Compare Sec. 357(c) and 752.
11. See also Announcement 90-6, I.R.B. 1990-3 (10 January 1990).
12. *E.I. Dupont v. Comm'r,* 608 F. 2d 445 (Ct. Cl. 1979), cert den., 100 S. Ct. 1648 (1980); *Nissho Iwai American Corp. v. Comm'r,* 89 T.C. 765 (1987); and *Cadillac Textiles Inc. v. Comm'r,* T.C. Memo 1975-46.
13. Sec. 163(e); 512(b), etc.
14. See *Aiken Industries,* 56 T.C. 925 (1972); Rev. Rul. 76-192; 76-1 C.B. 205; Rev. Rul. 84-152, 84-2 C.B. 381; and Rev. Rul. 84- 153, 1984-2 C.B. 383; and see Reg. Sec. 1.956-2(c); Rev. Rul. 87- 89, 1987-2 C.B. 195.

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Some have argued that the House report's discussion of parent-guaranteed debt would potentially have made ordinary third-party financing transactions subject to the disallowance rule, in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings. The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course. On the other hand, the conferees do not intend to preclude Treasury from disallowing interest on a guaranteed third-party debt, in appropriate circumstances where the use of guaranteed third-party debt is a device for avoiding the operation of the earnings stripping rules, just as Treasury is not precluded from disallowing interest on a back-to-back loan. In the event that Treasury issues regulations that would treat as related party interest the interest paid on debt of a U.S. corporation to an unrelated third party, which debt is guaranteed (or otherwise supported) by a related person, the conferees expect that any such regulations would not apply to debt outstanding prior to notice of the rule if and to the extent that the regulations depart from positions the Service and Treasury might properly take under analogous principles of present law that would recharacterize guaranteed debt as equity. However, this grant of authority is not intended to restrict Treasury's ability under current law to recharacterize certain guaranteed loans as equity. Cf. *Plantations Patterns, Inc. v. Commissioner,* 462 F. 2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972).

The possibility that a collateralized guaranteed loan will be recharacterized as a related party loan is a risk to investment structures relying upon such loans under present law. In *Plantation Patterns,* the court recharacterized a loan to a thinly capitalized corporation guaranteed by its shareholder as a loan to the shareholder and a capital contribution to the nominal borrower. If the Service had *Plantation Patterns* available, why would it use the authority to create a disqualified loan for earning stripping purposes where the same authority could be used to recharacterize the debt as equity, denying the interest deduction altogether. Under this interpretation, new regulations on guaranteed loans will not have much impact until they expand *Plantation Patterns.*

Some commentators have suggested that guaranteed or back-to-back loans should not be recharacterized if the intermediary is a U.S. bank. Interest on such loans, it is argued, would be taxed in the United States. Robert Colbertson, Assistant Chief Counsel (International) of the Service was unwilling to accept this interpretation on 19 January 1990, in his remarks to the Tax Section of the New York State Bar Association. Perhaps the high leverage of banks resulting in offsetting interest deduction is thought to make this structure a potential tax conduit.[15]

The Conference Committee Report discusses the possibility of new information disclosure in the form of a requirement for return statements that outbound interest payments are not "part of a back-to-back loan or device". This provision may exceed the current requirements of Form 5472 as modified by new Sec. 6038A.

CONTINUED USE OF EARNINGS STRIPPING LOANS

The earnings stripping provision will certainly make some financing of U.S. assets more complicated and more expensive. Notwithstanding the detrimental effect of the new rule, some taxpayers may continue to use earnings stripping loans. This is because debt continues to be less expensive than equity. Without the earnings stripping interest expense, operating income is subject to a U.S. tax of 34% plus a dividend withholding tax of 30% to the extent distributed out of earnings – unless a treaty reduction in rate is available. With an earnings stripping loan, up to 50% of net operating income may be sheltered from U.S. tax resulting in an effective rate of tax of 17%. The interest payments may also be shielded from withholding tax as a result of an applicable treaty.

15. See House Report at 102.

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Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

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CARIBBEAN:

Social Security, Saving and Investment in the OECS Countries

Wendell A. Samuel

INTRODUCTION

The Organization of Eastern Caribbean States (OECS) comprises 7 small islands having a joint population of approximately 570,000 people, with an average GDP per capita in 1986 of US$ 1,400 and land area of less than 3,000 sq. km scattered over many islands and cays. These states are Antigua & Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, St. Lucia and St. Vincent & the Grenadines.

The OECS treaty which established the organization in June 1981 covers Foreign Affairs, Defence and Security, and Economic Affairs very broadly defined. It has an administrative and institutional structure which comprises as the supreme body the authority of the Heads of Government, a Foreign Affairs committee, an Economic Affairs committee, and a Central Secretariat. The major objectives and activities are the promotion of economic integration, the issuance and management of a common currency through the East Caribbean Central Bank, the coordination of judicial activities through a joint supreme court, coordination of civil aviation activities, and the establishment of joint overseas missions. Discussions are currently underway to create a unified state.

This article discusses the development of Social Security in these states and its effect on saving and investment. The article can, therefore, be seen as a contribution to the discussions on the fiscal integration of the OECS sub-region.

One of the major developments in the fiscal system of the OECS sub-region during the last 2 decades is the emergence of the National Insurance/Social Security Schemes, hereafter called National Insurance Schemes (NIS). Some of the islands established Provident Funds initially, which offered limited benefits, but during the period these were developed into full-blown NIS.

The National Provident Funds in the OECS region were introduced to provide a greater measure of security for the aged in these countries. The establishment of the National Provident Funds was only an interim step and they were subsequently upgraded into full-fledged social security schemes.

Although the social security/national insurance schemes are first and foremost schemes to provide security for the aged, in the context of less developed countries, there is another dimension to them which is not always recognized. They are powerful instruments for mobilizing domestic saving which can be used to finance domestic investment. The social security schemes in the region have mobilized in excess of EC$ 300 million worth of resources and maintain an investment portfolio of about EC$ 284 million.[1]

However, these resources, by and large have not been channelled into the productive sectors. The main reason for this is the portfolio mix selected by the people charged with investing these funds is heavily skewed towards commercial bank fixed deposits (approximately 68%) and statutory bodies and government debt (approximately 25%). Neither of these are very efficient ways to utilize the hard earned saving of the working population.

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1. These figures do not include Antigua & Barbuda, for which no data is available.

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Although this situation results from a dearth of high grade private sector securities in the region, with a little thought, more imaginative use can be made of these resources to increase private investment and foster economic growth in these countries.

In section I of this article a historical development of the schemes is given, section II describes a typical NIS programme and section III analyses the effects of the schemes on saving and investment behaviour in the OECS countries. The final section offers some suggestions for the efficient use of these funds in productive enterprises and some conclusions.

HISTORICAL DEVELOPMENT

With the attainment of associated statehood by most of the territories in the late 1960s, and the consequent reduction of British grants in aid, the countries took on greater fiscal responsibilities. It became quite clear that the provision of support for the elderly could no longer be financed out of the general budgetary resources. Thus, Provident Funds were established with technical support from the British government to force people to save for their retirement. The earliest of these funds were established in St. Kitts-Nevis in 1968. Table I gives the dates for the establishment of Provident Funds in the other countries.

Contributions to the Provident Funds were made by both employers and workers. In most cases employers and employees paid the same percentage, which was set initially at 5% in all countries. Membership was usually extended to agricultural workers and self-employed persons. The coverage of the schemes is uncertain due to the paucity of labour force data in the countries. St. Rose (1982) found that registrations exceeded the labour force. However, in Dominica, where reasonably accurate estimates of the labour force exist, the NIS covers about 90% of the labour force.

The benefits from these funds were limited. At retirement the participant would receive his accumulated contributions plus accrued interest. If the participant died before retirement the benefits would go to the next of kin. There were no unemployment benefits or disability compensation.

Table I

Dates of establishment of provident funds and national insurance schemes in the OECS

Country	Provident Fund	NIS
Antigua	1970	1972
Dominica	1970	1976
Grenada	1978*	1983
Montserrat	1972	1986
St. Kitts-Nevis	1968	1977
St. Lucia	1970	1978
St. Vincent	1970	1980

* This was a non-contributory fund for agricultural workers only.

The continuing disintegration of the extended family meant that government was called upon to provide more services for the elderly and other disadvantaged groups. This put greater pressure on the limited government resources. Thus, one logical solution was to provide these services under an extended NIS program. The New NIS manages 2 sets of resources: the resources which participants had in the old Provident Funds, in addition to the contributions under the extended NIS. Table I also traces the extension of the various Provident Funds into NIS.

A TYPICAL NATIONAL INSURANCE SCHEME

A typical NIS scheme consists of 4 components: a retirement fund, a sickness and disability fund, a maternity fund and an unemployment fund.[2] The Retirement Fund provides a source of income for retired people and for approved surviving relatives, i.e. spouses and children under a specified age.

The Sickness and Disability Fund provides reduced income to qualifying members of the scheme in the event of illness and disability. In some cases the Maternity Fund is subsumed under the Sickness and Disability Fund. Some of the schemes also provide a funeral grant when a participant dies.

Unemployment benefits are provided to qualifying individuals so that they receive temporary remuneration during periods of unemployment. None of the countries in the OECS have started the unemployment fund. However some countries are considering its introduction.

The NIS programs are financed by payroll taxes in all the islands. They are operated on a part capitalization basis. That is, part of the current revenue is used to pay current claims on the fund and the rest to augment the reserves of the schemes. An upper limit is imposed on the insurable income of the members. Thus, no tax is paid on income in excess of a specified threshold.

All of the countries require that employers pay a part of the tax. In some cases, a distinction is made between the sickness and the retirement fund. In some cases the employer is required to pay a greater percentage into the sickness fund than the employee, the argument being that some illnesses may arise out of the working conditions of the employees. Income from capital is not included in this tax base.

The tax is withheld at the source by the employers and paid over to the scheme. Self-employed people and agricultural workers are included in the scheme. The tax brings in a large amount of revenue with relatively low administrative and compliance costs. The percentage of administrative cost to contributions for the year 1985 are given in Table II. Although these percentages are higher than those reported by St. Rose (1982), the schemes are still relatively cost efficient in their mobilization of savings.

Self-employed people have an incentive to remit their contributions for their benefits depend on it, and employees would take steps to ensure that the deducted amounts are remitted to the scheme. However, this is not always the case if individuals prefer current consumption to future consumption or people have greater confidence in their own ability to provide for retirement. This feeling may arise because, in some cases, an inordinate amount of government paper is acquired by the National Insurance Schemes. In effect most of the governments use the schemes as a source of low cost funds to finance government deficits.

2. There is a Caribbean Community (CARICOM) sponsored initiative to coordinate the various practices in the NIS programs. Thus, the representatives of the NIS programs meet periodically to exchange information.

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Table II

Administrative cost as a percentage of contributions for social security schemes in the OECS countries

	St. Rose	1985
Antigua	5.6	NA*
Dominica	6.7	13.1
Grenada	NA	9.1
Montserrat	13.9	12.2
St. Kitts	3.1	17.3
St. Lucia	9.8	16.2
St. Vincent	4.2	6.0

Source: St. Rose (1982) and Annual Reports of the Various Schemes
* Not applicable

There is some debate over whether the payroll tax should be viewed as straight tax or viewed as premiums paid to an insurance scheme. If the benefits individuals receive from the scheme are determined by a quid pro quo formula based on their contributions, there is some justification for viewing it as insurance premium.

However, as most schemes are operated there are significant redistributive effects. Such redistributive effects suggest that payroll tax should be viewed as a pure tax and the benefits seen as part of the overall government expenditure program.

If the tax and benefits of the National Insurance Schemes are separated, the payroll tax receives very low rating on the grounds of equity. It exempts income from capital and sources other than labour. Although the tax is proportional up to the ceiling, the existence of the ceiling makes the tax very regressive since it ensures that the people in the lower income bracket pay a higher proportion of their income in payroll taxes. However, if the benefits are figured in along with the tax payments, the tax may be neutral or mildly progressive.

To avoid the regressiveness of the tax, it has been suggested that a low income allowance should be given and the abolition of the ceiling. However, (Musgrave and Musgrave (1973)) suggested that, rather than doing this, it might be better to scrap the payroll tax entirely and rely more heavily on income tax which is less objectionable on grounds of equity and efficiency.

The payroll tax, however, will not be scrapped for it reinforces the myth of the insurance scheme. Making social insurance a part of general expenditure programs would make the program appear as if the government was simply giving hand-outs to retirees, rather than the current feeling, that they have earned these benefits. The present system safeguards the self-respect of the aged.

Another myth that is reinforced by practice is the incidence of the tax. The insistence by most schemes that firms pay a fair share of tax seems to suggest that the statutory and economic incidence are the same. Firms can pass the tax on to the consumer or back to the worker. It can be demonstrated (Musgrave & Musgrave (1973), p. 507-509) that in a competitive market the incidence of the tax is the same whether it is paid by the employer or by the employees.

In an imperfect market the competitive result may not hold, for unions may not accept wage cuts because the employers' contribution has increased. However, to the extent that the firms can pass this tax on to consumers in the form of higher administered prices, it affects the uses rather than the sources side of the consumer budget. The distribution of the burden in this case will be similar since general consumption taxes are usually regressive.

THE EFFECTS OF NIS ON SAVING AND INVESTMENT

In addition to providing social security for the aged and disabled, the NIS programs have implications for saving and capital formation in the country. It is argued that NIS may lead to a reduction in saving. If people's retirement benefits are provided for by the state, there will be less incentive for private retirement funds. They save by paying their payroll tax but the funds are not retained by the system, for the pay-as-you-go method of finance requires that the funds be used to pay out current benefits. This will result in a net reduction in saving. A fall in saving implies a reduction in capital formation.

This argument, however, does not stand up in face of further scrutiny. First, the NIS are operated on a part capitalization basis. Thus, all current revenue is not used to pay current benefits. The accounts for the significant accumulation of assets in the schemes. Second, there is no presumption that people will save less if social security benefits increase people's taste for a better life after retirement, or recognize that their children will reduce support if they know that the aged will receive social security.

The alleged reduction in saving will only be a one shot event at the inception of the system. Assuming that the age distribution of the population is roughly constant, benefits which are paid to the retired will be matched exactly by the tax payments of the young, hence there will be no net saving nor dissaving. The same as in the case of private funds. However, there will be marginal reductions in saving if the population is growing, which is the case in all of the OECS countries. Under a private system, the young will save more than the aged dissave. However, under social schemes the contributions only replace old age benefits, thus a fall in saving. A similar result holds if productivity is growing, prompting the young to save more than the old generation did at lower levels of income.

In the open economy the assumed link between capital formation and saving is not as tight as is usually suggested. Capital formation can be financed out of saving as well as foreign borrowing. In all of the OECS countries, most of government capital expenditure is financed from external sources. Table III illustrates the extreme dependence of the

Table III

Consolidated public sector deficit financing sources for the OECS countries
(EC$ Millions)

	1981	1982	1983	1984	1985	1986
Overall deficit	–243.90	–247.50	–213.90	–155.50	–164.90	–370.60
financing	243.90	247.50	213.90	155.50	164.90	370.60
External	212.60	187.30	175.30	186.30	173.80	374.00
Grants	87.30	96.00	95.60	154.70	157.30	152.50
Net external loans	125.30	91.30	79.70	31.60	16.50	221.50
Domestic (net)	31.30	60.20	38.60	– 30.80	– 8.90	– 3.40

Source: Eastern Caribbean Central Bank.

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OECS countries for government capital expenditure. Foreign grants and loans constitute more than 75% of the governments' deficit financing in most years.

Private investment is also heavily dependent on foreign sources as many of the hotels in the tourism sector are foreign-owned and the pattern of ownership in the enclave manufacturing sector is the same. At the same time domestic saving can be invested abroad if the returns are greater.

There is no doubt that the existence of the NIS has had a positive impact on saving in the region. However, with respect to investment, the evidence is inconclusive. St. Rose (1982) estimated that the schemes in the OECS have over EC$ 100 million in assets and mobilize EC$ 16 million per annum. He concluded, "The schemes have not had a deleterious effect on the growth of savings deposits . . . and during the period estimated balances of the various schemes amount to 37% of savings deposit balances which means an increase in financial flows".

By 1986 the total resources mobilized by the schemes in the OECS was EC$ 302.7 million and the schemes had a total investment portfolio of EC$ 284.7 million.[3] This means that over the 20 years of their existence they have increased their assets by EC$ 15 million annually.

However, an increasing in savings deposits is simply an increase in financial assets and is not tantamount to an increase in domestic saving. It may simply reflect a reallocation of wealth-holders portfolios, or in the case of less developed countries, increased monetization. The effect on domestic saving is seen in the ratio of saving to GDP. This ratio was negative for all the OECS countries in 1971 and was – 6.9% for the group as a whole (see Table IV). High consumption was financed by foreign transfers. In 1985 the ratio of saving to GDP for the group was 6.6%, with only St. Kitts and Montserrat having negative saving to GDP ratios.

The effect on investment is not as encouraging. Table IV shows that although the investment ratio increased for 3 countries for the OECS as a whole, the ratio of investment to GDP has declined between the years 1971 and 1986. This observation, along with the observed trends in the saving ratios, highlights the absence of strong linkages between saving and investment in small dependent economies. One explanation for this observation is the portfolio mix chosen by the NIS. About 68% of the funds are held in commercial banks, 18% in government paper (treasury bills, bonds, debentures, etc.), and statutory corporations account for another 5% (see Table V). The figure for government does not include government arrears.

Table IV

Saving and investment ratios of the various OECS countries

	Saving/GDP ratio		Investment/GDP ratio	
	1971	1985	1971	1985
Antigua	–15.0	28.8	19.3	26.9
Dominica	– 6.8	4.0	29.1	38.5
Grenada	– 3.8	14.2	26.4	48.2
Montserrat	–11.3	–10.4	29.4	26.4
St. Kitts	– 0.8	–15.1	46.7	31.8
St. Lucia	– 0.3	13.5	49.3	30.3
St. Vincent	–17.7	11.2	38.4	31.3
Total OECS	– 6.9	6.6	34.2	32.9

Source: St. Rose (1982), OECS *National Accounts Digest.*

Table V

Consolidated balance sheet of various NIS schemes in the OECS for the year 1985

	EC$ '000	% of Investments
Cash	2,848.70	NA
Accounts receivable	6,716.70	NA
Investments	243,263.40	100
Bank (fixed deposits)	165,388.60	68.0
Treasury Bills	29,394.80	12.2
Statutory bodies	13,869.20	5.7
Private sector	11,560.00	4.8
Government bonds	13,649.40	5.6
Property	2,517.20	1.0
Credit unions	2,900.00	1.2
Foreign assets	1,120.80	0.5
Other	2,863.40	1.0
Other assets	8,489.70	NA
Fixed assets	8,850.60	NA
Total assets	270,169.10	NA
Accounts payable	2,173.90	NA
Reserves	267,985.20	NA
Total liabilities	270,159.00	NA

Source: Reports of the Various NIS schemes.

The social security schemes need to invest their funds in such a way that the best return is achieved without assuming excessive risk in the portfolio. They also must maintain a certain degree of liquidity. Thus, the social security schemes need to hold some proportion of their reserves with the commercial banks in the form of fixed deposits for prudential reasons, just in case current payments outstrip current contributions for a prolonged period. However, there is no necessity for them to hold this inordinate amount in the form of low interest bearing fixed deposits whose maturity rarely exceed one year.

The funds so deposited with the commercial banks are not always channelled into the productive sectors. Commercial banks prefer to lend short-term mainly to the distributive and personal sectors. That way their portfolio keeps turning over and the goods can be used for collateral. They prefer not to make long-term risky loans, which is the type of loan most frequently demanded by the productive sectors.

Thus, as custodians of about EC$ 177 million of NIS funds they have been unable to channel much of these funds into productive enterprises. Even in the face of excess liquidity they prefer to keep the funds idle. Thus, the suggestion here is that the government ought to make a conscious effort to channel these funds into institutions which can utilize these funds more efficiently.

A large proportion of the resources is also appropriated by the government to finance capital expenditure and sometimes current expenditure. When private saving is used to finance current account deficits, it defeats the whole purpose of saving. Current expenditure ought to be financed out of current revenues, not saving.

3. These figures do not include the Antigua & Barbuda scheme, for which data is unavailable.

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Capital expenditure improves the infrastructure of the country and is not directly productive although it increases the efficiency of private investment. Thus, it can be argued that to the extent that the NIS funds are used by the governments to upgrade the country's infrastructure it is being used efficiently. The efficiency argument advanced here is slightly more sophisticated. The government is more efficient than the private sector at obtaining finance, both in terms of the quantity and the terms which can be negotiated. Therefore, the government ought not to deprive private enterprise of the limited amount of captive domestic saving.

It may be argued that in small countries like the ones under consideration there is not a great deal of high grade, domestic financial assets other than government paper and that government debt may be safer than private debt. The case may also be strengthened by arguing that domestically generated savings should be used for local development rather than invested abroad. However, the acquisition of government debt carries a contingent future liability which will be liquidated by higher taxes in the future, some of which may have to be paid by retired people in the form of consumption taxes when they spend their pensions.

The foregoing discussion suggests that there is a need to channel the resources marshalled by the NIS into long-term private investment. The following section offers some suggestions.

SUGGESTED SOLUTIONS

One of the reasons given for banks not using the current excess liquidity in the banking system for long-term lending is that they are afraid the current liquidity position may prove to be ephemeral. Crops can fail and people will withdraw the excess funds. To get around this sudden withdrawal of funds the commercial banks can offer longer-term instruments to ensure the stability of their deposit base.

At present, very few banks offer any instruments in excess of one year. Given this state of affairs the NIS are forced to roll over one-year fixed deposits. If longer-term instruments were available, the NIS could invest in these, for the funds they have in the commercial banks are essentially long-term funds. The longer maturity deposits can be staggered in such a way that the deposits are continuously maturing to ensure liquidity of the schemes.

If the commercial banks are unwilling to take the first step to issue longer-term instruments, the governments, who make the ultimate decision on the use of the NIS reserves can make a long-term commitment of the NIS funds for loans to the productive sectors. The government of St. Vincent and the Grenadines has committed a pool of NIS funds in the National Commercial Bank for home mortgages. There is no reason why this facility cannot, in theory, be extended to loans to agriculture, manufacturing and tourism.

This facility need not to be placed exclusively in the commercial banks, it can also be housed in the national development banks. This would reduce their dependence on the Caribbean Development Bank for funds for on lending. The Caribbean Development Bank has been trying to encourage the development banks in the various countries to increase the amount of local funds they have available for lending. To some extent the development banks have utilized some of the resources available in the National Insurance Schemes, but this is a minuscule part of the resources harnessed by the NIS and an even smaller fraction of the loan funds of the national development banks. It is quite possible that there will be some trepidation in investing NIS funds in the development banks because they do not have a very good track record. This is a result of the poor management that is characteristic of the development banks in the individual countries.

The use of NIS funds was forced on the development banks in some cases by the Caribbean Development Bank's requirement to provide domestic matching funds for some of their loans. In a few cases it was a deliberate effort on the part of the development banks to acquire their own funds. The acquisition of local funds allows the development banks to make some of their loans without the restrictions which are placed on the use of funds provided by the Caribbean Development Bank and the donor agencies. Such restrictions include the inability to use the funds to finance working capital.

As part of their efforts to diversify the sources of their loan funds the individual development banks should be encouraged to issue their own bonds. This would provide an alternative to government paper and commercial banks' deposits for investing the resources of the NIS. The issue of these bonds must be well organized and coordinated to ensure efficient financial intermediation.

It can be argued that bonds issued by the development banks do not provide an adequate alternative to government paper since they are also guaranteed by the government. However, the bonds issued by the development banks have as a first line of security the assets of the firms to which the development banks have given loans. Whereas in the case of straight government paper, taxes will have to be levied.

There is some concern that placing an excessively large amount of NIS resources in local assets may over-expose the pensioners to the vagaries of domestic economic conditions. Given the exposed nature of these economies and their susceptibility to natural disasters and adverse external influences, this concern may be well placed. Thus, it is necessary for the NIS to diversify their portfolios. However, this concern must be balanced against the need to use domestically generated savings for domestic investment. The prudent NIS investment specialist must be able to strike that delicate balance.

A look at the investment portfolio of the various NIS reveals that the overwhelming concern has been the need to use domestic saving for domestic investment and very little attention paid to diversification to reduce risk. Foreign assets account for less than 1% of the total resources in the NIS in the OECS.

The establishment of a regional development fund can ensure that the locally generated resources can be made available to local enterprises and at the same time reduce the excessive exposure of a portfolio consisting of purely local assets. An OECS regional development fund can provide a pool of resources which can be used for projects in the OECS. Some of the resources in the fund can be raised by issuing bonds regionally.

The regional focus of the fund would increase its ability to attract funds. The bonds issued by the regional development fund could prove attractive for NIS investment, for the economies of the OECS countries are sufficiently diverse to spread the risk around. In addition a regional fund is likely to attract better management than is available to each of the individual territories.

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CONCLUSION

In this article we have looked at the Social Security schemes in the Organization of Eastern Caribbean States, paying attention to their role of mobilizing saving in less developed countries, where the nature of the financial markets do not encourage private saving. It was noted that the Social Security Schemes have indeed succeeded in mobilizing a significant amount of resources which can be utilized in the development of these economies. During the period of their existence, an increase in the ratio of saving to GDP has also been observed.

However, the impact of the increase in saving on investment has not been very significant. This is due to the portfolio mix chosen by the investment committees of the various schemes. Almost 70% of the funds are held in one-year, fixed deposits in commercial banks and another 25% is appropriated by the governments. Due to data limitations related to the availability of data and the disclosure policies of the various governments, the analysis only covers the period 1971 to 1985. However, indications are that there has been little change in the pattern with a slight move to the acquisition of more government paper.

The analysis concludes by offering some suggestions for increasing the efficiency of the use of the NIS funds. These include the designing of longer-term financial instruments and the establishment of an OECS development fund.

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COLOMBIA:

Colombian Adjustment of Income for Inflation

Pedro Massone

I. INTRODUCTION

A. Historical survey

The Colombian inflation rate, which until the beginning of 1970 did not reach 10% on the average, was by the middle of 1974 higher than 25% per year. Accordingly, the first adjustments for inflation in the Colombian tax system were introduced only in 1974; a partial adjustment (limited to 8% in that year) was introduced in the tariff brackets of the individual income tax and in the cost of fixed assets (in this case optional) for purposes of capital gains taxation. This adjustment was extended to any pesos-denominated sum appearing in the national tax laws.

Regulations with regard to inflation were later governed by Law 54 of 23 December 1977. On 16 April 1979, Law 20 replaced most provisions of the old law; law 20 was subsequently replaced by Law 9 of 15 June 1983, which repeats the provisions of Law 20 with minor changes. Law 9 was later replaced by Law 75 of 15 December 1986.

These laws provided for the periodic adjustment of the cost of fixed assets and of amounts denominated in Colombian currency included in the main tax laws. Law 75 of 1986 also provided for the gradual introduction of the adjustment of interest income and interest payments for inflation.

In addition to the periodic adjustments, special adjustments were authorized in 1974, 1977, 1982, 1984 and 1986, to increase the registered cost of fixed assets up to their market value, free of income tax.

Finally, Decree 2,687 of 26 December 1988[1] introduced an integral system of adjustment of income for inflation which is applicable as from taxable year 1992 and is the main subject of this article.

B. Units linked to inflation

Decree 1,229 of 1972 established the unit of constant acquisition power (unidad de poder adquisitivo constante or UPAC), the peso value of which is periodically adjusted for inflation and which is principally used to measure debts of the housing system.

Decree 1,319 of 7 July 1988 limited the annual increase of debt units (UPACs) to 24%.

C. Correction of amounts included in tax legislation

Amounts denominated in Colombian currency included in legislation referring to income tax, complementary taxes and sales taxes are annually augmented by the full increase in the "consumer" price index for employees, as registered between 1 October of the second year preceding the taxable year and 1 October of the year preceding the taxable year. Before 1 August of every year, the Government issues a decree specifying the new adjusted amounts.

The sums shown in the tariffs approved by Law 75, now included in the Tax Code, are adjusted in accordance with the procedure specified by the Government. New brackets can be added to the higher levels without exceeding the highest rates established in the law.

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1. A revised text of Decree 2,687 was included in the Tax Code (Estatuto Tributario). enacted with Decree 624 of 30 March 1989, issued under the powers granted to the Executive Branch by Laws 75 of 1986 and 43 of 1987.

II. PARTIAL ADJUSTMENTS

A. Periodic adjustment of fixed assets

1. Entities

Law 54 of 23 December 1977 introduced several rules which took inflation into account, some of which provided for the following measures:

(i) the cost of real property and shares, if registered at the end of taxable year 1977, could be increased under special rules which offered several alternatives, the most significant of which considered the cadastral value of real property, the value of real property as assessed by the taxpayer, and the price of shares on the stock exchange based on that of the last transfer prior to 1 July 1977; and

(ii) as from the taxable year 1978, the cost of personal and real property representing fixed assets could be augmented annually by 60% of the increase in the consumer price index for employees as registered between 1 September of the year preceding the taxable year and 1 September of the taxable year.[2]

Law 20 of 16 April 1979, which replaced Law 54, established new rules which take inflation into account. Law 20 includes the following provisions:

(i) the cost of real and personal property representing fixed assets can be augmented annually by the full increase in the "consumer" price index for employees, as registered between 1 September of the year preceding the taxable year and 1 September of the taxable year. The possibility of restating the value of eligible assets must be exercised during the pertinent year and cannot be deferred to subsequent years. If the taxpayer does not take advantage of this right in due time, the right is lost; and

(ii) amounts received as a consequence of the adjustment of debt-claims for inflation are exempt from income tax for that part which does not exceed 8 percentage points per year; taxpayers are subject to capital gains tax on the excess.

Law 75 of 1986 provides that taxpayers other than individuals can adjust every year the cost of fixed assets in accordance with the full increase in the consumer price index for employees, as registered between 1 October of the second year preceding the taxable year and 1 October of the year preceding the taxable year.

Under Decree 2,595 of 26 October 1979, which contains Regulations (which are still in force) to Law 20 and Law 75 of 1986, the adjustment of the cost of fixed assets is calculated on the book value thereof as registered on the last day of the year or period preceding that which is being adjusted, as augmented by previous adjustments. For property acquired during the period which is being adjusted, the adjustment is calculated on the acquisition cost. The cost subject to adjustment is increased by the value of improvements introduced during the year and reduced by depreciation allowances.

The cost of property acquired or transferred during the year is adjusted proportionally to the holding period. Likewise, if the tax return covers only part of the year, the adjustment is calculated on a proportional basis. For immovable property included in fixed assets, the value resulting from the adjustment cannot be less than the cadastral value.[3]

All the rules mentioned above, however, have limited consequences in that they only affect the calculation of capital gains derived from the transfer of fixed assets held by the taxpayer for at least 2 years; presumed income;[4] taxable net worth;[5] and the value of estates, for purposes of the inheritance and gift tax.[6]

This means that the above rules have no effect on the calculation of amortization, depreciation allowances, losses of goods or losses resulting from the transfer of assets, all of which are calculated on the basis of historical costs. As to shares, the rules apply only in the calculation of capital gains arising from their transfer. Note, however, that depreciation allowances on goods acquired as from taxable year 1989 can be calculated on cost as adjusted for inflation, and as from taxable year 1992, the taxpayers subject to the integral adjustment will calculate depreciation allowances under rules discussed in III. below.

2. Individuals

In computing income or occasional gains derived by individuals from the transfer of immovable property, shares or contributions included in fixed assets, the cost of the asset can be adjusted in accordance, respectively, with the percentage of appreciation of immovable property or with the increase in the consumer price index for employees between 1 January of the year in which the asset was acquired and 1 January of the year in which the asset is transferred. The cost of immovable property can be further adjusted with the value of improvements and betterment contributions.

As from taxable year 1989, taxpayers with net wealth below 20 million pesos on 31 December of the preceding year may, in calculating their income or capital gains, adjust the cost of shares in open stock corporations for inflation, up to the market price on the sale date, without exceeding the sale price. To be eligible, the taxpayer's net wealth on 31 December of the year preceding the sale must be below 20 million pesos and the shares must be purchased on a stock exchange or through the direct subscription of a first issue of shares (emision primaria) and be sold on the stock exchange.

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2. For taxable year 1977, the augmentation in the cost of personal property was established at 14%.

3. Editor's note: Most Latin American countries utilize the term "cadastral value" to designate the official minimum value of real estate determined according to the public record (cadaster) within a district for tax purposes.

4. Colombian legislation has established a presumption of income based on the taxpayer's net worth or on the taxpayer's net receipts. This presumption only applies when the regular reported net income is less than the presumptive amount established by law.
Accordingly, taxpayers are presumed to realize during a taxable year an annual income of not less than the greater of a percentage of their net worth on the last day of the preceding taxable year or a percentage of net receipts derived during the taxable period, i.e. 8% of net worth or 2% of net receipts for taxable years 1985 through 1988, 8% of net worth or 1% of net receipts for taxable year 1989 and 7% of net worth (the percentage of net receipts is revoked) for taxable year 1990 and subsequent years.

5. A "complementary" net wealth is levied together with the individual income tax on taxpayer's net wealth held on 31 December of any calendar year.
Law 84 of 29 December 1988 (now included in the Tax Code) vested the President of the Republic with extraordinary power to eliminate or reduce the complementary net wealth tax. Accordingly, Decree 1,321 of 20 June 1989, issued under such power, revokes the net wealth tax as from the entry into force of the integral adjustment of income for inflation, i.e. as from taxable year 1992.

6. As from 7 February 1983, inheritances, bequests and gifts are treated as capital gains and are subject to a special income tax. This tax is assessed together with the income tax.

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B. Extraordinary adjustments of fixed assets

As explained above, special adjustments were authorized in 1974, 1977, 1982, 1984 and 1986, to increase the registered cost of fixed assets up to their market value, free of income tax.

The most recent adjustment was established by Law 75 of 15 December 1986. Under this law, taxpayers could, in their income and net wealth tax returns for taxable year 1986, adjust the cost of fixed assets held on 31 December of that year to their commercial value. The adjustment does not change cadastral values. The adjustment of shares representing fixed assets held on 31 December 1986 and quoted on the stock exchange cannot exceed the average quotation for December 1986. For other shares, the adjustment cannot exceed the value resulting from the division of the company's net worth by the number of shares.

The adjustment is taken into account in establishing the fiscal cost of transfers.

C. Adjustment of interest income

1. Entities

To establish the taxable interest derived by taxpayers other than individuals and undivided inheritances, a percentage of the inflationary component of financial income must be deducted. The deductible percentage is gradually being increased to 100% for taxable year 1998.

The rule is not applicable to construction loans granted by savings and housing corporations, and financial brokers controlled by the Banking Superintendency. Moreover, as from taxable year 1992, financial income obtained by taxpayers subject to the integral adjustment of income for inflation discussed in III. below, must be treated as taxable income, without deducting a percentage of the inflationary component.

The inflationary component of interest is calculated by multiplying the gross amount of interest by the ratio of the rate of monetary correction in force on 31 December of the year before the taxable year to the most representative rate paid to savers on that date, as certified by the Banking Superintendency.

The deductible percentage of the inflationary component referred to is:

– 10% for taxable year	1986
– 20% for taxable years	1987 and 1988
– 30% for taxable years	1989, 1990 and 1991
– 40% for taxable year	1992
– 50% for taxable year	1993
– 60% for taxable year	1994
– 70% for taxable year	1995
– 80% for taxable year	1996
– 90% for taxable year	1997
– 100% as from taxable year	1998

The deductible percentage has been fixed at:
- for taxable year 1987: 12.92% of financial income (Decree 370 of 29 February 1988);
- for taxable year 1988: 20% of financial income (Decree 2,670 of 26 December 1988); and
- for taxable year 1989: 20.73% of financial income (Decree 408 of 27 February 1989).

2. Individuals

To establish the taxable interest and financial income derived by individuals and undivided inheritances it is necessary, in certain cases, to deduct the inflationary component, which is calculated by dividing the rate of monetary correction in force on 31 December of the taxable year (21% on 31 December 1987 and 22.7% on 31 December 1988) by the annual rate corresponding to the interest obtained by the taxpayer.

The rule applies to financial income derived from:
- entities subject to the control of the Banking Superintendency, the purpose of which is brokerage in the financial market;
- treasury bonds; and
- bonds and commercial documents issued by stock corporations under the authorization of the National Securities Commission.

For purposes of withholding taxes, the rates that may be specified by the Government can be applied on gross payments.

3. Interest paid by savings and housing corporations

In the case of financial income paid or credited by savings and housing corporations on debts denominated in units linked to inflation or UPACs (see I.B. above), the inflationary component to be excluded from income or capital gains is equal to the monetary correction paid or credited in the respective taxable year.

D. Adjustment of interest payments

1. Entities

Due to the fact that the tax system in force before Law 75 of 1976 was very favourable to debt financing, most enterprises showed, and still show, a high degree of indebtedness and face high financial costs. To correct this situation, Law 75 makes the inflationary component of debts non-deductible but, so as to avoid the impact of this change, provides for the gradual elimination of the deduction.

Accordingly, the deductibility of that part of interest corresponding to the "inflationary component" is gradually being eliminated over a period of 10 years. In computing deductible interest or financial expenses, including exchange differences incurred by taxpayers other than individuals or undivided inheritances, a percentage of their inflationary component which is not deductible must be excluded. The non-deductible percentage is gradually being increased to 100% in taxable year 1998.

The rule does not apply to construction loans granted by savings and housing corporations and financial brokers controlled by the Banking Superintendency. Moreover, as from taxable year 1992, interest and other financial expenses incurred by the taxpayers subject to the integral adjustment of income for inflation discussed in III. below, including the entire inflationary component, are deductible, provided there are credits registered in the "monetary correction account" (see III. below).

The inflationary component of interest and financial expenses is calculated by multiplying the gross amount of interest by the ratio of the rate of monetary correction in force on 31 December of the year before the taxable year to the most representative rate for term deposits on that date, as certified by the Banking Superintendency.

In the case of debts denominated in foreign currency, the inflationary component of interest and financial expenses is calculated by multiplying the gross amount of interest and financial costs and expenses by the ratio of the rate of monetary correction in force on 31 December of the year

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before the taxable year to the most representative rate of interest and other costs of foreign debts on that date, as certified by the Central Bank (Banco de la República).

The non-deductible percentage of the inflationary component in all the cases referred to is:

– 10% for taxable year	1986
– 20% for taxable years	1987 and 1988
– 30% for taxable years	1989, 1990 and 1991
– 40% for taxable year	1992
– 50% for taxable year	1993
– 60% for taxable year	1994
– 70% for taxable year	1995
– 80% for taxable year	1996
– 90% for taxable year	1997
– 100% for taxable year	1998

The non-deductible percentage of interest and financial expenses incurred by the taxpayer has been fixed at:
- for taxable year 1987: 9.75% for debts denominated in pesos and 9.94% for debts denominated in foreign currency;[7]
- for taxable year 1988: 14.84% for debt denominated in pesos and 18.89% for debts denominated in foreign currency;[8] and
- for taxable year 1989: 16.37% for debts denominated in pesos and 15.77% for debts denominated in foreign currency[9].

2. Individuals

To establish deductible interest or financial expenses incurred by individuals or undivided inheritances, it is necessary to deduct their inflationary component, which is calculated by dividing the rate of monetary correction in force on 31 December of the taxable year by the annual rate corresponding to the interest obtained by the taxpayer.

III. INTEGRAL ADJUSTMENT

A. Basic information

Law 75 of 1986 granted the Executive Branch power to issue rules aimed at making the assessment of the income tax independent of the effects of inflation. Under such power, the government could establish the total or partial adjustment of the taxpayer's financial statement, permit computation of the annual depreciation allowances on revalued assets and amend the provisions on income, costs, deductions, presumptive income, assets and liabilities, so that income tax would not be levied on the taxpayers' nominal income.

Accordingly, Decree 2,687 of 26 December 1988, enacted under faculties granted to the government by Law 75 of 15 December 1986, introduced an integral system of adjustment of income for inflation which is applicable as from taxable year 1992. The taxpayer, however, can choose to anticipate the use of the system. A revised text of Decree 2,687 has been included in the Tax Code.

In general, the adjustment corrects assets, liabilities and net worth and is reflected in taxable results.

Some special accounts are used for correction purposes, i.e. an equity account called "net worth revalorization account" (or NWRA) and a result account called "monetary correction account" (or MCA).

B. Persons subject to the adjustment

The adjustment is compulsory for taxpayers of the income and net wealth taxes who are required to keep accounting records. The following are free from the requirement:
- individuals and undivided inheritances eligible for the simplified regime of sales tax,[10] even if they are not actually taxpayers of such tax;
- non-profit entities, cooperatives and, in general, "new" taxpayers introduced by Law 75 of 1986;[11]
- agriculturists and cattle raisers; and
- employees and self-employed individuals.

Taxpayers that are not compulsorily required to adjust their income for inflation can opt to use the scheme, but they must keep duly registered accounting records. Likewise, taxpayers can decide to use the system before it becomes compulsory.

Taxpayers of the income and net wealth taxes can apply to the tax administration (Administración de Impuestos) to be exempt from the adjustment provided they demonstrate that the market value of their assets does not exceed 50% of the cost that would result from the adjustment. The application must be filed at least 4 months before the end of the period for filing the income tax return and is deemed to be accepted if it is not decided within one month.

C. Adjustment base

The adjustment applies to "non-monetary" assets, liabilities denominated in foreign currency or with an adjustment clause and opening net worth.

For adjustment purposes, "non-monetary" assets are goods or rights whose nominal value increases as a consequence of the depreciation of the purchasing power of money. Non-monetary assets include fixed assets, inventory, interest-producing bonds and securities, foreign exchange, debt claims, securities or rights denominated in foreign currency, assets located abroad, advance payments and intangibles, shares and contributions to companies and other non-monetary assets.

Assets acquired before 1992 (i.e. before the entry into force of the new adjustment scheme) are adjusted under the new rules taking the equity value they have on 31 December 1991 as the adjustment basis. If the fiscal cost of such assets is higher, the taxpayer can elect to go on separately adjusting such fiscal cost in order to assess the profit or loss upon their transfer.

Monetary assets, which maintain the same value because they do not have an adjustment clause, nor increase their nominal value as a consequence of the depreciation of the purchasing power of money, cannot be adjusted for inflation. Consequently, the adjustment does not cover Colombian cash, deposits in saving or current accounts and debt claims when they do not include an indexation clause.

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7. Decree 370 of 29 February 1988.
8. Decree 2,670 of 1988.
9. Decree 408 of 2 February 1989.
10. Retailers whose taxable sales are subject to the ordinary 10% rate and persons rendering certain specified services can choose to be taxed under a simplified regime.
11. The "new" taxpayers introduced by Law 75 are:
- non-profit corporations, foundations and associations;
- non-profit legal entities which receive deposits for investment and are subject to supervision of the Superintendency of Banks;
- family subsidy entities, mutual investment funds, employee funds, retirement and disability pension funds, and professional (guild-type) associations, in respect of income derived from industrial and marketing activities.

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The beginning net worth subject to the adjustment cannot include the net equity value (valor patrimonial neto) of goodwill, know-how and other intangibles whose value is estimated by the taxpayer or which were not acquired for consideration. Also excluded from the beginning net worth is the net value of shares in open stock corporations whose adjustment must be directly registered as a credit to the NWRA.

D. Adjustment computation (in general)

As a rule, the adjustment is made by using the "adjustment percentage of the taxable year" or PAAG, i.e. the percentage of change in the consumer price index for employees, registered between 1 October of the second year preceding the taxable year and 1 October of the year preceding the taxable year. Before 31 December of each year, the government must publish the percentage to be used for the following taxable year. The system for computation of PAAG index has been criticised because it involves a time lag of 15 months.

The law provides specific rules for each item involved, and it is therefore necessary to consider separately the adjustment of different types of assets, liabilities, net worth and result accounts.

E. Adjustment of assets

1. Adjustment of fixed assets

The cost of fixed assets held on the last day of the taxable period is adjusted according to the following rules:

(i) the value of fixed assets held during the whole taxable year, as per the last day of the preceding year, is multiplied by PAAG;

(ii) the acquisition cost of fixed assets acquired during the taxable year is adjusted in proportion to the annual PAAG which belongs to the number of months in which the asset was held during the taxable year;

(iii) additions and improvements to fixed assets are adjusted in that proportion to the annual PAAG which belongs to the number of months elapsed between the addition or improvement and the last day of the taxable year. The result is added to the cost of the asset calculated under (i) or (ii). The same rule applies to betterment contributions paid in respect of immovable property; and

(iv) the value of immovable property is adjusted to the highest of either the value resulting from the foregoing rules or the cadastral value.

For the foregoing purposes, the cost of assets includes interest, indexation, exchange differences and other financial expenses originating from the acquisition or construction of the asset, while the asset is not put into use and is not ready for use or transfer. Expenses incurred after the asset is put into use or is ready for use or transfer must be treated as a deduction or, in the case of exchange differences, registered in the MCA.

The value of the assets, as adjusted for inflation, and accumulated depreciation allowances and amortization must be shown separately in financial statements. Depreciation allowances and amortization corresponding to the taxable year are calculated on the value of assets as adjusted in accordance with PAAG. Accumulated depreciation allowances and amortization are also adjusted in accordance with PAAG.

In calculating gains or losses from transfers, the cost includes its adjustment for inflation but is reduced by accumulated depreciation allowances and amortization. The sale cost of fixed assets transferred during the year can be adjusted proportionally to that part of PAAG which corresponds to the number of months the asset was held during the year.

2. Adjustment of inventory

Inventory held on the last day of the taxable period is adjusted up to the replacement cost, established under the following rules:

for goods not processed by the taxpayer:

- if goods similar to those to be restated were acquired during the second quarter, the replacement cost cannot be below the highest acquisition price of that quarter;
- if no such acquisition took place during the second quarter, but during the first quarter, goods are valued at the highest acquisition price for similar goods purchased in the first quarter, as adjusted with 50% of PAAG. In the case of imports, however, merchandise is adjusted by 50% of the devaluation of the Colombian peso occurred in the period used for the calculation of PAAG;[12]
- if no such acquisition took place during the entire taxable period, goods are valued at the final value for similar goods in the last year, as adjusted in accordance with PAAG or, in the case of imported merchandise, with the devaluation rate of the Colombian currency;

for goods processed by the taxpayer:

- the replacement cost of inventory processed or transformed by the taxpayer cannot be below the highest sale price set by him for the same type of goods in the second quarter of the taxable year, as reduced by the gross profit margin on the sale price for similar goods sold in the same year;
- in the case of inventory in process, the highest sale price referred to is multiplied by the percentage of finished (acabado) goods. The replacement cost, however, cannot be below the aggregate of material, production cost and work involved in the inventory in process; and
- interest, indexation, exchange differences and other financial expenses originating from the acquisition of current assets must be registered as an increase in the value of inventory while it is not ready for use or sale and are treated thereafter as deductions in the corresponding taxable year. When deductible, exchange differences must be charged to the MCA.

When the cost of sales of current assets is established by the system of play of inventories[13], the value of the ending inventory used to calculate that cost is the value obtained before the adjustment. However, the value of the ending inventory used to calculated gross assets (patrimonio bruto) is that value obtained after the adjustment, which is also taken as beginning inventory of the following period.

3. Adjustment of shares

Shares and contributions to companies held on the last day of the taxable period are adjusted according to the following rules:

- shares in stock corporations quoted on the stock exchange are adjusted to the average quotation of the last month in which transactions were made;
- contributions to limited liability companies and shares in stock corporations not quoted on the stock exchange

12. Between 1 October of the second year preceding the taxable year and 1 October of the year preceding the taxable year.

13. Difference between opening inventory plus purchases, and closing inventories.

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are adjusted to the book value (valor intrínseco) as certified by the company after the adjustment of its own assets.

4. Adjustment of securities and debt claims

Bonds, securities and other assets producing interest or financial income are adjusted according to the following rules:

- that part of financial income accrued but not collected on the last day of the taxable year increases the value of the asset and is therefore charged to the account representing the asset and credited to an account representing income (de ingreso);
- the cost of bonds, securities and other documents producing financial income, quoted on the stock exchange and held on the last day of the taxable year, is not adjusted for inflation but must be reported in accordance with the average quotation on the stock exchange during the last month of the taxable year;
- if the securities, bonds and other documents are not quoted on the stock exchange, they are not adjusted for inflation, but must be reported in accordance with the acquisition cost in the taxable year or cost of the preceding year, as the case may be, as increased by financial income accrued but not collected.

Foreign currency, debt claims, claims or rights denominated in foreign currency or assets located abroad, held on the last day of the taxable period, are adjusted in accordance with the official exchange rate of that day. Debt claims, whether indexed or denominated in units linked to inflation (UPACs), are adjusted under the corresponding indexation clause or under the value of the debt unit on the last day of the taxable year, as the case may be.

5. Adjustment of intangibles

The value of expenses paid in advance (deferred charges), patents, trade marks and other intangibles, for which consideration has been paid, is adjusted in accordance with PAAG under the same rules applicable to fixed assets.

6. Adjustment of other non-monetary assets

In general, all "non-monetary" assets for which no special adjustment method has been provided, must be adjusted in accordance with PAAG.

F. Adjustment of liabilities

Debts or obligations in foreign currency, outstanding on the last day of the taxable year, are adjusted in accordance with the quotation of the relevant currency.

Debts or obligations indexed or denominated in units linked to inflation (UPACs) are adjusted in accordance with the adjustment clause or the value of the unit on the last day of the taxable year, as the case may be.

G. Adjustment of net worth

The taxpayer's beginning net worth (i.e. the difference between total assets and liabilities as per commencement of the taxable period) is adjusted in accordance with PAAG. However, if the net worth is negative, no adjustment is made to net worth, other adjustments being still required.

If net worth increases or decreases, the following additional adjustments are effected at the end of the taxable year:

(i) capital increases made during the taxable year by means of the issue of new shares or ownership interests (partes de interés), not corresponding to the capitalization of profits or reserves from previous years, are adjusted in accordance with PAAG, in that proportional part which corresponds to the number of months elapsed between the capital increase and 31 December of the same year;

(ii) the distribution of dividends or profits from previous years, and distributions made in the taxable year out of reserves or capital forming part of net worth at the beginning of the taxable period, are adjusted through the multiplication of such equity reductions by PAAG, in that proportional part which corresponds to the number of months elapsed between the equity reduction and 31 December of the same year.

For adjustment purposes, profits or losses of the period are not treated as an increase or reduction of net worth until the period following the period to which they belong.

H. Adjustment of results

As explained above, taxpayers subject to the adjustment of income for inflation must keep a result account called "monetary correction account" (MCA) which must be cancelled at the end of the period with the profit and loss account. The MCA is charged or credited with the following entries:

(i) the following items are charged to the MCA, provided the account is credited with some of the items referred to in (ii) below:
   - the adjustment of the beginning net worth and the adjustment of increases thereof;
   - the adjustment of liabilities with indexation clause and exchange differences other than those that must be charged to assets;
   - the adjustment of accumulated depreciation allowances of the preceding year;

(ii) the following items are credited to the MCA:
   - the adjustment of inventory;
   - the adjustment of fixed assets;
   - the adjustment of other assets subject to the scheme; and
   - the adjustment of reductions of net worth.

The profit and loss account reflects the adjustments of balance sheet accounts (assets, liabilities and net worth) but is not itself subject to direct correction.

Losses registered at the end of the taxable period can be carried over to be set off against profits of the following 5 years. For that purpose, the losses are adjusted for inflation in accordance with PAAG. Moreover, it is necessary to make the corresponding adjustments to the NWRA.

I. Registration

The adjustment made to non-monetary assets is registered as an appreciation of such assets by means of a charge to the account representing them, equal to the amount of the adjustment. The counter-entry is a credit to the MCA for the same sum.

The adjustment of shares in open stock corporations is registered by debiting the account representing the shares and crediting the NWRA.

The adjustment of liabilities, including exchange differences, are registered as an increase of the debt by means of a credit to the account representing the liability and a charge for the same amount to the MCA, or to the value of the goods when it must be charged to them.

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The adjustment of net worth is registered by means of the recognition of an expense originating from its exposure to inflation, which is charged to the MCA for the value of the adjustment and, as a counter-entry, is credited to an equity account called "net worth revaluation account" (NWRA). This account is shown separately among equity accounts and is considered part of net worth in the following years, for the purposes of the adjustment of net worth.

The adjustment of capital increases is registered by means of a charge to the MCA and a credit to the NWRA and the adjustment of equity reductions is registered by means of a charge to the NWRA and a credit to the MCA.

III. FINAL REMARKS

A. Effects of the integral adjustment

The adjustment for inflation must be reflected in the taxpayer's financial statements and taken into account for the assessment of commercial profits and the taxable base of the income and net wealth taxes.

For income tax purposes, the difference between sums credited and sums debited to the MCA represents, as the case may be, a profit or loss originating from exposure to inflation, which must be reflected in the profit and loss statement.

If the taxpayer's non-monetary assets exceed net worth (as in the case of taxpayers who have financed their fixed assets or inventory with debt), the result of the adjustment may be a profit originating from inflation. On the contrary, if the taxpayer's net worth exceeds his non-monetary assets (this is frequently the case of the financial and service sectors), the adjustment result is a loss from exposure to inflation. This simply means that the adjustment scheme favours taxpayers with substantial equity and low liabilities and prejudices those taxpayers with reduced or no equity.

The equity appreciation reflected in the NWRA cannot be distributed as a profit to partners or shareholders except when the enterprise is liquidated or such value is capitalized; in this case, it is distributed as a receipt not representing income or capital gain.

The full interest and other financial income obtained by taxpayers subject to the adjustment of income for inflation (without deducting a percentage of the inflationary component) must be treated as taxable income. On the other hand, the full amount of interest and other financial expenses incurred during the taxable year by the taxpayers referred to (including the entire inflationary component) are deductible, provided there are credits registered in the MCA.

In the case of taxpayers subject to the adjustment of income for inflation, capital gains (other than those originating from raffles, lotteries, wagers (apuestas) and similar sources) are treated as ordinary taxable income. Accordingly, capital losses incurred in the transfer of fixed assets are deductible from the taxpayer's gross income even if the assets are held for 2 years or more.

B. Temporary rules

Assets acquired before 1992 (i.e. before the entry into force of the new adjustment scheme) are adjusted under the new rules the book value they have on 31 December 1991 as the adjustment basis. If the fiscal cost of such assets is higher, the taxpayer can opt to continue adjusting such fiscal cost separately in order to assess the profit or loss upon their transfer.

Due to the fact that the tax system in force before Law 75 of 1976 was very favourable to debt financing, most enterprises show a high degree of indebtedness and face high financial costs. To correct the situation, Law 75 made the inflationary component of debts non-deductible but, to avoid the impact of the change, provided for the gradual elimination of the deduction.

For the same reasons, Decree 2,687 of 1988 grants a theoretical deduction to debtor enterprises. Thus, in taxable years 1992 through 2002, taxpayers who adjust their non-monetary assets under the new scheme and whose non-monetary assets in the relevant year exceed their net worth in the same period can take against taxable income a deduction calculated under the following formula:
(i91 × 70%) × (mc91 / pr91) × (1 × nw / ea), where:
i91 = interest paid or incurred in taxable year 1991;
mc91 = monetary correction rate in force on 31 December 1991;
pr91 = the most representative placing rate on the market on 31 December 1991;
nw = net worth at the beginning of the corresponding year;
ea = non-monetary assets eligible for adjustment, at values opening the corresponding year.

For tax purposes, the deduction is treated as an increase of charges to the MCA. In the case of companies, dividends distributed out of the deduction are exempt from income tax in addition to the exemption for dividends not exceeding the ordinary exemption limits.[14]

In taxable years 1992 through 2002, a percentage of the difference between the final inventory registered in accounting records and the final inventory valued at replacement must be treated as an appreciation of the final inventory, which percentage is at least:

for taxable year 1992:	5%
1993:	10%
1994:	15%
1995:	20%
1996:	30%
1997:	40%
1998:	50%
1999:	60%
2000:	70%
2001:	80%
2002:	100%

The result obtained under the foregoing rules is charged to the inventory account and credited to the MCA.

14. Dividends and profit shares distributed to partners, shareholders or members, whether Colombian companies or resident individuals, are normally not taxable (more precisely not considered to be income or capital gain) in the recipient's hands, provided they are paid out of income that has been reported by the distributing entity.
If the distribution is paid out of income derived before 1 January 1986, it is also necessary in order for the distribution to be exempt that such income be registered as retained income in the income tax return of the distributing entity corresponding to taxable year 1985.
If the distribution is paid out of income derived as from 1 January 1986, it is taxable for that part of the distribution which exceeds either:
- 7/3 of the income tax liability of the distributing entity, before the deduction of tax refund certificates (Certificados de Abono Tributario – CERTs); the limit is increased for that part of dividends and profit shares received by the distributing entity which is exempt under the same rules; or
- the after-tax business profits derived in the taxable year by the distributing entity.

A withholding tax is levied on that part of dividends which is taxable under the foregoing rules at rates specified by the Government (specification is still pending).

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Evolving Sales Taxation in Tanzania and Kenya

John F. Due, Francis Mwega and Nehemiah Osoro*

In many parts of the world, sales taxation is undergoing change, generally in the direction of use of the value added form. Iceland, Trinidad and Jamaica are all moving toward introduction of the value added tax to replace existing forms of indirect taxes (retail sales tax in Iceland, a group of consumption duties in the other 2), on 1 January 1990 for the first 2, Jamaica likely in April. Canada is converting its manufacturers sales tax into a value added tax as of January 1991 after years of debate over reforms in the tax, with considerable remaining controversy. In British Commonwealth Africa, the manufacturers sales tax form has been dominant (except in Zimbabwe, with a retail tax) but growing concern has been developing about the precise form of the taxes and the possibility of converting the tax to the value added form.

DEVELOPMENT OF THE SALES TAXES

The first sales tax in East Africa was introduced in Uganda in 1968 with the assistance of an Israeli adviser, to increase revenue and lessen reliance on income taxation.[1] The approach used was unique among sales taxes at the time: rates were imposed separately by BTN (tariff classification) number.

Successful use of this tax led the other 2 East African countries, still united in the East African Community, to consider the tax as well, and Tanzania did so in 1969, using essentially the same form as Uganda. In Kenya the question was debated for several years, the tax finally introduced in 1973, with a standard rate applied to all commodities other than those exempted or subjected to a special rate; such commodities were designated by BTN number. While changes have been made in the taxes over the last 2 decades, the structures in Tanzania and Kenya have remained much the same. Currently, however, substantial changes are in process, some made, further ones contemplated.

TANZANIA

Since the tax in Tanzania is the oldest of the 2 countries, it will be considered first.[2] The government has been reviewing the tax carefully in the past 2 years and the President of the country has appointed the Presidential Commission for Public Revenues and Taxation. The task of the Commission is to carry out a comprehensive evaluation of the tax system, determine what changes are necessary to meet the needs of additional revenue through a broadened tax base, and strengthen the collection machinery at central and local government levels. The Commission shall carry out its inquiry and make recommendations in various areas of the tax system.

Rates

When the sales tax was introduced in 1969, 5 ad valorem and 5 specific rates were established. Substantial revisions were made in 1976. By 1980, there were some 25 different ad valorem rates and an equivalent number of specific rates. Principal rates in 1980 included 12% on many foods and other items regarded as necessities, 24% on a wide range of goods regarded as luxuries, 25 to 50% on motor vehicles, 50% on cigarettes and liquor, and high rates on various textile products not produced in the country. By January 1989, sales tax rates exhibited a wide range from 0 to 300% and a multiplicity of rates among closely related goods. The complexity was aggravated by 4 diverse objectives in framing the structure: revenue, equity, protective and sumptuary.

Typical rates as of 1 January 1989 are shown in Table I, with a notation of changes on 1 July 1989. Commodities subjected to excise duties on 1 July 1989, in addition to the sales tax, are indicated by ED. About 384 items are exempted from sales tax as zero rated.[3] They include foods, medicines, some building materials, various raw materials, farm and industrial machinery, etc. The basic tax rate applying to a wide range of food and other widely used goods (consisting of 315 items) is 25%. The other major rate, in terms of number of items covered (161 items), is 50%, applying to some processed food, consumer durables, radios, toys, etc. The rates above 50% were imposed on 167 items regarded as super luxuries such as cosmetics, perfumes, pearls and precious stones, glass beads, private cars, motor caravans and micro-buses, musical instruments, textiles, revolvers, pistols for personal use, etc. and TV sets. With the establishment of the excise duties on 1 July 1989, these rates were reduced to 50%.

Legislation also provides exemptions in the Second Schedule, Part A, for various organizations such as government, charities, embassies, etc., and Part B for various commodities, such as packing materials, scientific and educational equipment, etc. in addition to the zero-rated goods

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1. John F. Due, "The Uganda Sales Tax on Importation and Manufacture," *Eastern Africa Economic Revenue* Vol. 1 (June 1969) at 1-16.
2. Earlier experience in Tanzania and Kenya is described in the article by John F. Due, "A Comparison of Four Manufacturers Sales Taxes and Two Retail Sales Taxes – Ghana, Kenya, Tanzania, Zambia, Barbados, Iceland," 30 *Bulletin for International Fiscal Documentation* 11 (1976) at 464-76.
3. Zero rating is simply the system used to exempt various goods; it does not have the significance it has in a value added tax system.

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Table I

Typical Rates, Sales Tax, Tanzania
as of 1 January 1989 and July 1989 Changes

0%

milk, eggs, honey, vegetables, fresh, dried coffee, raw flour except wheat, maize meal, bread (some), cement (ED) sand, rock, gypsum, lime, coal, crude petroleum, medicines, medical appliances, glasses, raw rubber, hides, fir wood, plywood, wood objects, books, newspapers, wool, objects, books, newspapers, wool, twine, fishnets, linoleum, sacks, bottles, jars, brick, tile, basic glass, basic metals, steel plates, bars, wire, nails, bolts, fencing, hand tools, farm and industrial machinery, electric wire, farm tractors.

5%

diesel fuel, electricity

10%

fuel oil

20%

load carrying vehicles, spraying trucks, work trucks, trailers and semi-trailers.

25%

many foods: cream, butter, cheese, spices, wheat flour, cereals, lard, fats, sausage, processed meat and fish, macaroni, biscuits, bread, sauces, yeast, vinegar, ice cream.
Asphalt, dyes, ink varnish, glues, rain coats, sanitary equipment, sinks, pipe, tyres, tubes, furniture (some), rubber products, paper products, shoes, tableware, pans, razors, blades, scissors, cutlery, locks, filing cabinets, internal combustion engines, pumps, sewing machines, costume jewelry, pens, pencils, data processing equipment, batteries, light bulbs, wheelbarrows, aircraft, athletic goods.

30%

tea, coffee, bicycle chains, vegetable oils, animal fat oils, olive oil, margarine, boxing gloves, pins, hair pins, curling grips, boilers, travel goods, shopping bags, handbags, briefcases, wallets, harness, furskin.

43%

regular gasoline

50%

cocoa, jam, preserved fruit, vegetables, cigarettes (ED), soap waxes, polish, film, fur garments, hats, umbrellas, some furniture, mirrors, stoves, safes, air-conditioners, typewriters, office machines, batteries, shavers, domestic appliances, water appliances, water heaters, radios, baby carriages, glass mirrors, optical appliances, cameras, watches, clocks, tape measures, image projectors, water pumps, guns, microphones, loudspeakers, most toys, film in rolls, cotton yarn. Rates reduced to 50% on 1 July 1989 and the goods subjected to excise duty.

53%

premium gasoline

60%

sugar

70%

glass beads

75%

clothing, cartpets, textile articles, garments made from synthetic fabrics, bed linen, old clothing, artificial flowers, glass beads, imitation jewelry, washing machines, wringers and mangles, shaker tumblers, tumble dryers, ironing machines, steam presses, dry cleaning machines, TV sets, radiograms, TV parts and accessories, passenger motor cars (including saloons, station wagons, vans, mini-buses and the like) not exceeding 1,200 cc, motor caravans, micro-buses and the like with seating for not less than 8 passengers and more than 14 passengers, musical instruments, cosmetics.

100%

raw silk, silk yarn, man-made fibres, wool, flax and ramic yarn, cotton woven fabrics, clothing, rayon fabrics, wigs, human hair, pearls and precious stones, jewelry, passenger-carrying motor cars (including saloons, station wagons, vans, mini-buses and the like) exceeding 1,200 cc, revolvers and pistols for personal use, manufactured tobacco, vermouth and other wines.

110%

snuff, pipe tobacco

120%

still wine, sparkling wine

125%

cement

130%

soft drinks

150%

cigars, cheroots, cigarillos

160-210%

cigarettes

250%

beer

300%

spirits

shown in the rate tables. There are also discretionary exemptions which the Minister of Finance can make in the public interest.

Collection

Tax is collected at importation on duty paid value, and on the sale by the manufacturer at the time goods are removed from the premises, including shipment from the factory to branches even though there has been no sale. In 1986/87, there were about 1,000 active files – about the same number reported a decade ago. There is no formal exemption for small firms but the government does not seek to tax the smaller establishments either for sale or income tax purposes. Discretion is left to the inspectors and a decision is based primarily on the availability of records.

Cascading

There is no systematic, general exclusion of goods used in production. The taxation of such goods is minimized by a number of special rules, but some cascading occurs. Some basic materials are free of tax (as shown in Table I) as are some farm and industrial machinery. But other materials are subject to the basic 25% rate, as are various intermediate goods. Firms possessing registered dealer certificates (RDCs) can purchase raw materials free of tax under the suspension system and pay sales tax on final products. There are currently 134 holders of valid RDCs. These features are comparable to those in the original Uganda law.

Revenue

The sales tax is by far the country's major revenue source. It yielded 17% of total tax revenue in its first year of operation; by the 1973-74 year it was the largest revenue source. Table II indicates the revenue by major tax source from the 1987-88 fiscal year down to the 1990-91 projected figures.

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Table II

Tax revenue by major source, Tanzania, 1987-88 to 1990-91

Source	000,000 shillings				percent of total tax revenue			
	1987-88	1988-89	1989-90 est.	1990-91 proj.	1987-88	1988-89	1989-90	1990-91
Customs	5,572.7	10,044.0	12,760.0	15,000.0	13.0	15.2	14.8	15.9
Excises	0	0	1,649.0	1,760.0	0	0	1.9	1.9
Sales tax	22,736.6	35,955.0	46,124.0	51,400.0	52.8	54.4	53.5	54.4
Motor vehicle, license, tolls	624.9	835.8	1,120.9	1,247.0	1.5	1.3	1.3	1.3
Misc. licenses and taxes	2,201.9	2,949.4	4,788.9	5,363.6	5.1	4.4	5.6	5.7
Total indirect	31,136.1	49,784.2	66,442.8	74,770.6	72.4	75.3	77.1	79.2
Income taxes	11,846.9	16,185.1	19,494.6	19,449.6	27.5	24.5	22.7	20.6
Property (estate) taxes	77.9	112.5	185.4	203.4	.1	.2	.2	.2
Total tax revenue	43,060.9	66,081.8	86,122.8	94,423.6	100.0	100.0	100.0	100.0

Source: United Republic of Tanzania, *Financial Statements and Revenue Estimates,* 1 July 1989-30 June 1991. Dar es Salaam: Government Printer, 1989.

The tax yields well over half of total tax revenue, the highest figure of any country except Burma as shown by statistics prepared by the International Monetary Fund.[4] The figures are somewhat misleading on a comparability basis, however, since the sales tax revenue includes substantial amounts from cigarettes, liquor and motor fuel, subject only to excises in many countries. Even so, the yield is very impressive.

Of equal interest is the very high percentage of the revenue collected from domestic producers, compared to that collected at importation, as shown in Table III. Roughly 75% of the revenue currently comes from domestic production, an unusually high figure for a developing country.[5] One reason is the relatively limited volume of imports which are curtailed by shortages of foreign exchange. Another is the high percentage of revenue collected from a few industries as noted below. The suspension of duty on importation of many inputs used as materials, rather than use of the value added technique, increases the importance of the domestic production figure.

Table IV provides historical data on the relative importance of the yield at importation and domestic production.

As noted, contrary to the usual picture in developing countries, the percentage collected at importation has risen from 7% in 1979-80 to around 25% in recent years. The low figures in the early years and the decline in 1984-85 are the products of drastic restrictions on imports due to foreign exchange shortages. Liberalization of imports in recent years has allowed a substantial increase in collection at importation.

Table V shows the sales tax revenue by major category for 1987. The first 3 categories, with rates in excess of 100% (maximum of 300%), yielded over half (54%) of the tax revenue and the 5 categories listed accounted for 70% of the total. Some 315 items taxed at 25% yielded about 7% of the total. It must be stressed that in 1987 there were no excises on these goods; all of the revenue came from the sales tax. Beginning with the current fiscal year they are subject to excise duties as noted below. The sales tax also applies but at a lower rate. While the total revenue from them will remain much the same, the sales tax portion will of course be less.

Table III

Portion of sales tax and excise duty revenue collected at importation and on domestic production Tanzania 1987-88 to 1990-91

Revenue source	1987-88	1988-89	1989-90	1990-91
Sales tax				
Imports	21.8	24.4	24.2	24.1
Domestic production	78.2	75.6	75.8	75.9
Excise duties				
Imports	–	–	8.5	9.1
Domestic production	–	–	91.5	90.9

Source: United Republic of Tanzania, *Financial Statements and Revenue Estimates,* 1 July 1989-30 June 1991. Dar es Salaam: Government Printer, 1989.

Table IV

Historical data on sales tax revenue on imports and domestic production, 1979-80 to 1986-87

Year	Local collection	Collection at importation	Total	Collection at importation as % of total
1979-80	2,740	1,203	2,942	6.9
1980-81	3,933	410	4,343	9.9
1981-82	4,375	716	5,092	14.06
1982-83	5,178	886	6,044	14.10
1983-84	6,393	1,493	7,886	18.9
1984-85	8,879	1,276	10,154	12.56
1985-86	9,058	1,524	10,582	14.4
1986-87	12,395	3,671	16,066	22.84
1987-88	13,337	3,423	16,761	20.42

Source: United Republic of Tanzania, *Financial Statements and Revenue Estimates,* respective years. Dar es Salaam: Government Printer.

4. John F. Due and Carrie Meyer, "Major Determinants of Tax Structures of Market Economy Countries", *Tanzania Journal of Economics* Vol. 1 (July 1989) at 47-66.

5. For example, the percentages collected at importation are 66 in Ghana, 64 in Zambia, 47 in the Philippines, 40 in the Ivory Coast. John F. Due, *Indirect Taxation in Developing Countries,* Reve. Ed. Baltimore: Johns Hopkins University Press (1988) at 109.

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Table V

Relative sales tax revenue by major category, Tanzania, 1987

Percentage of total commodity	Sales tax revenue	
Beer	27	70
Soft drinks	9	
Tobacco products	18	
Textiles	8	
Petroleum products	8	
Goods subject to 25%	7	
All others	23	

Problems with the tax

The government of Tanzania is well aware that the tax in its present form is not satisfactory; some changes have been made in the last 2 years, more are contemplated and an enquiry commission has been appointed to provide further review. The tax is so productive of revenue, however, that changes have to be made with great care. The major difficulties can be noted briefly.

First, the rate structure is very complex despite some simplification in the last year. Until 1989, rates ranged from zero to 300%. The great majority of commodities fall into 3 rate groups, 0%, 25% and 50%, but there were 22 other rates as well in 1988, and there are still 8. Some of the rates differ only slightly – there are 25, 30, 40 and 50% rates, for example. The general aim has been, of course, to place heavier rates on goods regarded as "luxuries" as well as the traditional sumptuary goods. But combining 4 motives for differences – revenue, equity, protection and sumptuary – has added to the complexity. There is of course no scientific basis for classifying goods in one category or another. One consequence is unclear delineation lines, which have no logical basis and which make correct application of the tax almost impossible. Eggs cooked in the shell are exempt, fried eggs are taxable. Cloth used to make school uniforms is taxed at 25%, that for other purposes 50%, but there is no way of knowing at the time of taxable sale what the ultimate use will be. Fruit juice produced in restaurants is taxed at 50%, that made in canneries has been taxed at higher rates. These are mere examples. Consequences include misapplication of tax, outright evasion by misclassification, costs to the taxpayers and the administration, corruption and discouragement of voluntary compliance.

Part of the difficulty is caused by the use of CCCN designations to define exemptions and rate differences. This produces a very complex Act, particularly objectionable because most of the revenue is collected on domestic transactions, not at importation, where personnel are more familiar with tariff nomenclature.

A second basic defect is the failure to provide any systematic technique for keeping the tax off production inputs, with consequent cascading. A number of ad hoc methods are used – exemption or zero rating of some materials and some farm and industrial equipment, other discretionary exemptions, use of registered dealer certificates – but by no means is there complete, systematic exclusion. The consequences include distortion of production methods, a haphazard and uneven burden on various consumption goods and adverse effects on exports.

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There are serious problems with the administrative structure. Some critics have maintained that the Customs and Sales Department has too many functions to perform them all effectively. The department is understaffed, lacks adequate trained personnel, and adequate equipment, facilities, and housing for personnel; these problems are particularly severe at some of the major border posts, such as Namanga.

The amount of evasion is not known. There is believed to be considerable evasion at importation, through undervaluation and smuggling, especially at land borders. There is some evasion, of course, on domestic transactions, through misclassification, underreporting sales and splitting of firms to avoid liability for tax collection.

Solutions

There are a number of approaches toward improvement in addition to the obvious ones of increasing salaries, facilities, training, and staff size.

Much of the complication in rates and structure has been created by use, until this past year, of the sales tax to reach traditional excisable commodities. The approach of merging the excises into the sales tax, introduced in 1980, is not without merit in lessening the number of separate taxes with which firms must deal. But the consequence is substantial complexity in the tax structure. To lessen this problem, in July 1989 a group of excise duties was introduced, in general applying to all goods subject to a sales tax rate higher than 50%, the sales tax rate being reduced to 50% on these goods. The new excise duties have some specific rates, whereas the sales tax application to these goods did not; the specific rates were introduced at the request of the producers who feared the effects of high ad valorem rates on competitive relationships. Excise duties apply to importation as well as domestic production.

Table VI indicates the major commodities subject to excise duties and the typical rates. They remain subject to the sales tax.

Thus the list goes far beyond the traditional sumptuary excises. The net effect of the change was to simplify the sales tax rate structure somewhat, but at the expense of having 2 separate levies, use of some excises the logic of which can be questioned, and a substantial number of different rates.

Several approaches can be taken to eliminate taxation of inputs and cascading. One is to move in the same direction as Kenya by introducing the value added tax credit feature which would eliminate cascading and assist in ensuring that tax is applied to the final product. Thus far the approach has been rejected on the grounds of complexity, lessening liquidity of firms and raising prices through failure to recognize the tax credit feature in pricing. The alternative is to increase the use of the RDC system, perhaps for all inputs. This would allow great simplification of the rate structure and avoidance of special discretionary actions but it would of course reduce tax revenue and pave the way for some possible abuse and evasion. Careful control would be needed. Creation of a separate sales tax department and improved staffing would aid enforcement.

KENYA

Kenya was the third of the East African countries to introduce the tax, in 1973, applying at the time a basic rate of 10%, with a 20% rate on goods regarded as luxuries, and 15 and 30% rates on a few commodities, together with some

Table VI

Excise duty introduced 1 July 1988

Sugar:	
A. Jaggery	10%
B. Others	1,000 shs per ton
Soft drinks	25% plus 16.50 shs per litre
Beer	25% plus 94.40 shs per litre
Chibuku	2.20 shs per litre
Wines	50-70%
Spirits:	
Local	25% plus 450 shs per litre
Imported	25% plus 1,000 shs per litre
Cigars	100%
Cigarettes	50% plus 400 shs per 1000 cigarettes – 50% plus 1,200 shs per 1000 cigarettes
Snuff	50%
Pipe tobacco	50% plus 80 shs per kg
Cement	125 shs per ton
Petroleum oil and petroleum products:	
(1) Premium gasoline	4.50 shs per litre
(2) Regular gasoline	1.00 shs per litre
(3) Jet A	20 cents per litre
(4) Industrial kerosene	90 cents per litre
(5) Furnace oil	25 cents per litre
(6) Residual oil	25 cents per litre
(7) Lubricating oil	500 shs per cu.m.
(8) Lubricating grease	75 shs per kg
Perfumery, cosmetics	50%
Fabrics	50-75%
Clothing	25% and 50%, by type, plus some specific
Linen	25%
Artificial flowers	25%
Human hair	50%
Wigs	50%
Glass beads, etc.	25%
Glass curtains	25%
Precious stones and jewelry	50%
Imitation jewelry	25%
Spin dryers	25%
Dish-washing machines	25%
Laundry and domestic washing machines; wringers and mangles; shaker tumblers; tumble dryers; ironing machines and steam pressers for pressing garments; dry cleaning machinery	25%
Television parts	25%
Passenger-carrying motor cars (sedan, station wagons, vans, mini-buses and the like) where the maximum engine capacity does not exceed 1200 cc	75%
Motor caravans, micro-buses, mini-buses and the like, with a seating capacity for not less than 8 passengers	25%
Musical instruments, sound recorders and reproducers; television image and sound recorders and reproducers; parts and accessories of such articles	25%
Firearms (revolvers and pistols) for personal use	50%

N.B.: Excise duty on locally produced goods is to be based on selling price excluding sales tax while excise duty on imported goods to be based on customs value plus import duties exclusive of sales tax and any other taxes.

As of October 1989 the Tanzania shilling was worth .7 of a U.S. cent.

specific rates. Initially imports of materials by registered firms were freed of tax by the suspension technique. To check evasion, this rule was replaced in 1976 by use of the value added rule; tax applied at importation with credit for this tax against subsequent tax on sales. Sales between domestic manufacturers were excluded from tax under the suspension rule, as in Canada. Limited use of the value added tax has continued down to the present and has now been made general. The tax is confined to the import and manufacturing sector. The tax has typically yielded about 25% of total tax revenue.

Change to the value added tax

By legislation of 25 August 1989, Kenya replaced the sales tax by a new levy labelled a value added tax, thus carrying forward the tax credit rule long utilized in the country, the only example in British Commonwealth Africa. The new tax, however, in many respects resembles the previous sales tax. It is confined to the import and manufacturing sectors and the complex rate structure of the old tax is continued. Furthermore, a number of production inputs are exempted outright instead of being excluded by the tax credit technique. The new tax does incorporate more services than the old levy.

The change was made, from all indications, for 2 major purposes: to permit the government, without formal legislation, to extend the tax forward beyond the manufacturing sector when believed feasible and to facilitate taxation of additional services. But the tax is far removed from the value added taxes of Western Europe and Latin America.

Exemptions

The list of exemptions from the tax is substantial. There is no zero rating and thus it is necessary to exempt many inputs outright to keep tax elements off the final products. The Act does give power to the Minister to grant zero rating when warranted. The following are typical of the exempt commodities:

Live animals
Many foods (but not most processed foods):
- meat, fish, fresh, frozen, dried, smoked; oil, fats, milk, eggs
- vegetables and fruit, fresh and dried coffee
- grain, flour
- sugar
- seeds, bulbs, plants
- infant food

Most medicines and vaccines
Farm inputs:
- fertilizer
- seeds
- weed killers, herbicides, disinfectants, hand tools

Various building materials:
- sand, stone, wood, nails, steel, brick

Basic materials:
- ores, coal, gases, acids, chemical compounds, dyes, rubber, skins, hides,
- wool, cotton, some fabrics

Wood pulp, newsprint paper, books, newspapers, sheet music
Cigarettes and other tobacco products subject to excises

Rates

The basic tax rate is 17%, but there is a very substantial range of higher rates, typical examples of which are provided in Table VII. There are 14 ad valorem rates, plus several specific rates.

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Table VII

Rates on various taxable categories
Kenya value added tax, September 1989

Major rate categories:

17% – basic

35%
cocoa, chocolate products, jams, canned fruits, wine, dog and cat food, wooden furniture, refrigerators, freezers, data processing equipment, smaller buses, some types of industrial equipment

50%
distilled spirits, cosmetics, toilet water, film, trunks, handbags, gloves, watches, clocks, carvings, beads, artificial flowers

100%
most household electrical appliances, record and cassette players, amplifiers, recorders, TV sets and parts, cameras and related other items

Minor rate categories:

25%
some processed food, costume jewelry, base metals

40%
certain photographic preparations, some radio receivers

60%
radios

70%
mineral water

75%
games, lighters, wigs

80%
some TV items

Special:

Motor vehicles: 20%, up to 120% and 210%, based on engine capacity.
Specific: beer, cider, motor fuel, other petroleum products, certain film.
Cigarettes are subject to a special excise duty.
Clothing and shoes, except fur garments, are taxed at the basic rate.

Thus while there are more different rates than in the Tanzanian tax, there is also more concentration on one rate, the basic 17% figure.

Services

Services subject to tax are listed in the Third Schedule, primarily services rendered to business firms:

1) Accounting and bookkeeping
2) Management and other consulting services
3) Computing and related services
4) Legal services
5) Services of architects, surveyors and draughtsmen
6) Engineering services
7) Auctioneers, estate agents and property valuers
8) Commission agency services
9) Licensed brokers
10) Secretarial, typing and photocopying services.

Tax paid on acquisition of these services by registered firms constitutes input tax for which credit may be taken.

Other aspects

The Fourth Schedule lists various goods as "designated goods"; primarily precious metals and jewelry items for which special registration and procedures are used for enforcement.

Tax is due at the time of supply, invoicing, or payment, whichever occurs first, and is payable monthly to the government. A penalty of 3% of the amount due is applied each month of delinquency. Failure to pay can result in the use of a distress warrant.

Firms with sales under 200,000 KSh. (about US$ 10,000) a year are excluded from the registration requirement (other than dealers in designated goods).

Registered firms are required to issue a tax invoice within 14 days of the sale, except for retail transactions under 500 KSh.[6] a day to one customer, for which simpler procedures may be followed.

Provision is made for credit for sales tax that had been paid on stock on hand at the time the new tax goes into operation.

Problems with the tax

While the shift to the value added form obviously has merit given the general advantages of this form of levy, the tax as currently structured is by no means ideal.

First, there are far too many different rates. There is no possible logic in taxing some goods at 20%, some at 25, some at 40, for example. Universal experience with the value added tax has indicated that use of a single rate, or not more than 2 rates, is essential for effective operation. The tax credit feature encounters serious complications with multiple rates even more severe once the tax is extended beyond the manufacturing level.

Second, inadequate use is made of the value added tax credit technique. Combining exemptions of some producers goods and use of the tax credit technique on others is an unnecessary complication.

Third, as is well recognized, while confining the tax initially to the manufacturing sector is necessary, ultimately there is merit in extending the levy to wholesale distributors and larger retailers. Not only will this improve enforcement and increase revenue but it will also avoid the tendency for manufacturers to shift functions forward beyond the point of impact of the tax to minimize tax burden. Obviously a tax cannot be applied for years to come to the typical small retail or craft shop in Kenya but larger distributors can be brought within the scope of the tax.

CONCLUSION

The sales taxes of Tanzania and Kenya, which in part evolved out of the Uganda sales tax of 1968, have been highly productive of revenue, particularly in Tanzania, where the tax has yielded over 50% of total tax revenue. They have been limited to the manufacturing level plus some services. A serious defect has been the multiplicity of rates, designed to increase equity and lessen the importation of luxury goods or their ingredients. The use of multiple rates seriously complicates compliance with and administration of the taxes, and many of the rate differences appear to lack a logical basis. The second major defect has been failure to eliminate completely taxation of inputs, thus resulting in cascading of tax. Thirdly, the taxes are undoubtedly subject to considerable evasion.

In the last year, changes have been made to mitigate some of the problems. Kenya, by moving to the value added form, has improved somewhat the elimination of cascading and facilitated application of tax to final products but the system is by no means uniform. Tanzania has never used the value added technique. The Kenya tax still retains a multiplicity of rates, particularly objectionable with the value added technique. In 1988 and 1989 Tanzania has a lessened

6. As of October 1989 the Kenya shilling is worth about 5 U.S. cents.

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multiplicity but there are still a number of rates, although less than in Kenya.

If one were to design an optimal sales tax for each of these countries in light of the circumstances of the country, it would likely have the following features:
1) Use of the value added technique, including zero rating, to lessen cascading and evasion because of the audit trail the value added tax provides.
2) Use of not more than 2 rates, a basic rate and a higher one on "luxury" goods, to simplify operations. Goods for which a significantly higher burden was desired for equity and import-restriction reasons would be subject to special excise duties applying to both imports and domestic production, as Tanzania has done, the administration being coordinated with that of the sales tax. Application, however, would be limited to a small number of commodities obviously justifying higher rates by usual standards: beer, spirits, cigarettes, motor fuel, motor vehicles, and perhaps a very small number of other items.
3) Ultimate extension of the tax to larger wholesale distributors and larger retailers to bring these margins into the base of the tax and reduce the incentive for firms to transfer functions forward beyond the point of impact of the tax.
4) Devotion of additional attention and effort to operational aspects of the tax.

Conference Diary

JUNE 1990

Steuersituation USA. Munich (G.F.R.), 6 June (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG., Postfach, CH-8022 Zürich, Switzerland.

Een Nieuw Fiscaal Regime voor Beleggingsinstellingen. Amsterdam, 7 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Offshore Tax Planning – the Uses of IOFCs and Tax Havens. Geneva, 11-12 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Successful Structuring of Cross-border and Multinational Operations and Investment in Europe for the 90's. Paris, 12 June (French); Brussels, 20 June (English); Stockholm, 21 June (English):
OM Conferences, Fideal, Chemin Taverney 13, CH 1218 Grand-Saconnex, Geneva, Switzerland.

Effective Tax Planning for Takeovers, Buyouts and Group Reorganisations. London, 13 June (English):
Institute for International Research, 44 Conduit Street, London WIR 9FB, United Kingdom.

The Valuation of Intangible Assets including Accounting Treatment of Goodwill & Brands. London, 15 June (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Intercompany Pricing U.S.A./Europe: New Developments, Strategies and Planning. Paris, 18-19 June (English):
The American Tax Institute in Europe, S.A. 9 avenue Matignon, 75008 Paris, France.

Werken met de nieuwe deelnemingsvrijstelling. Amsterdam, 19 June (Dutch):
Kluwer Seminars, Postbus 23, 7400 GA Deventer, the Netherlands.

Planning through Transcontinental Trusts – The Fourth Annual Conference on the Use of Trusts and their Underlying Companies in International Planning. London, 25-26 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Taxation of Branches and Subsidiaries. Brussels, 25-26 June (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands.

Practical International Corporate Tax Planning. Cambridge, 28-29 June (English):
Karen Mellor, Members Services, Directorate, P.O. Box 433, Chartered Accountants' Hall, Moorgate Place, London EC2P 2BJ, United Kingdom.

AUGUST 1990

44th Congress of the International Fiscal Association: I. Taxation of Cross-border Leasing; II. International mutual assistance and exchange of information. Seminars: 1. The Nordic multilateral tax treaty; 2. Double tax treaties between industrialized and developing countries, the OECD and U.S. models – a comparison; 3. The extension of tax sovereignty – especially in connection with emigration; 4. Tax reform in Scandinavia. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125, 3001 DE Rotterdam, The Netherlands.

SEPTEMBER 1990

Monte-Carlo Workshop: Entertainers and Athletes (inbound transactions); Taxation of international shipping. Monte-Carlo, 17-18 September (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

The Tax Effective Management of an International Treasury. London, 20-21 September (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

7th European Congress of Tax Consultants. Cannes (France), Lectures 27 September, working group 28 September (multilingual):
C.F.E. General Secretariat, Dechenstrasse 14, Postfach 1340, D-5300 Bonn 1 (G.F.R.).

OCTOBER 1990

International Conference on Computer and Law, organized by the Buenos Aires Bar Association and the French Association pour le Développement de l'Informatique juridique. Buenos Aires, 16-19 October (English, French, Spanish):
Secretaria del Congreso Internacional de Informatica y Derecho, Uruguay 485, piso 3°, 1015 Buenos Aires, Argentina.

NOVEMBER 1990

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

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INTERNATIONAL FISCAL ASSOCIATION

NEWS

INTERNATIONAL FISCAL ASSOCIATION

U.S./DUTCH JOINT MEETING IN AMSTERDAM

When: Thurs.-Fri., 23-24 August 1990 before the International Fiscal Association Congress opens in Stockholm on Sunday 26 August.

Location: In the "Koepelkerk" (Dome Church, an old building recently renovated as a Sonesta conference center) near the Central Railroad Station.

Hotels: A block of rooms has been reserved across the street in the Sonesta Hotel at:

Dfl. 250 (single) = $ 135*
Dfl. 290 (double) = $ 155*

* Exchange rate estimated at Dfl. 1.88 to the dollar.

Rooms are also available at "De Roode Leeuw" Hotel, Damrak 93, about a 5 minute walk:

Dfl. 165 (single) = $ 90
Dfl. 220 (double) = $ 120 room includes breakfast

Air fares: KLM would be

$ 618 to Amsterdam
$ 421 to Stockholm from Amsterdam
$ 1,039 when purchasing 2 round-trip tickets

Martinair, flying only Mondays NY-AMS could cut the $ 618 to ± $ 400.

Alternatively, $ 1,114 circle route NY-AMS-Stockholm entirely by KLM, or $ 707 to AMS via Pan Am, plus $ 16 U.S. tax (21 day advance reservation, 7 day minimum reservation), plus $ 440 tourist class AMS-Stockholm via SAS.

Registration fee: $ 100 or Dfl. 200 (includes lunches and dinner Thursday).

For more information, U.S. members should contact:

Mr. Richard L. Goldman
Goldman & Goldman
522 Fifth Avenue
Suite 2150
New York, New York 10036
FAX (212) 398-0201

Dutch members should contact:

Mr. A. Overbosch
Intercena
Postbus 2011
1000 HC Amsterdam
FAX (020) 256807

U.S./DUTCH JOINT MEETING PROGRAM
23-24 August 1990: Thursday through lunch Friday, dinner party Thursday evening

Thurs., 23 August 1990:

Opening
Subject I: U.S.–Dutch Treaty Revision (including rules limiting those entitled to benefit and the likely future for the Act of the Kingdom with the Netherlands Antilles, including Aruba).
U.S. Speaker: Mary C. Bennett, Baker & McKenzie, Washington, D.C.; ex-Deputy International Tax Counsel
Dutch Speaker: Maarten Ellis, Loyens en Volkmaars, Rotterdam

Subject II: Europe 1992, including Harmonizing EEC Taxes
Dutch Speaker: Jos Westerburgen, Unilever, Rotterdam
U.S. Speaker: Nicholas van der Kloot, Coopers & Lybrand, New York City

Subject III: Direct Investment into the U.S.
U.S. Speaker: Carl L. Estes II, Vinson & Elkins, Houston, Texas
Dutch Speaker: Fred de Hosson, Caron & Stevens, Amsterdam

EVENING DINNER PARTY (including accompanying persons)

Friday, 24 August 1990:

Subject IV: Portfolio Investment into the U.S.
Dutch Speaker: Marcel Romeyn, Moret Gudde Brinkman, Rotterdam
U.S. Speaker: Robert I. Stricoff, Arthur Andersen & Co., New York City

Subject V: Investment in the Netherlands
U.S. Speaker: Erik J. Stapper, Stapper & Van Doren, New York City
Dutch Speaker: Frank van Brunschot, Stibbe en Blaisse, Amsterdam

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NEW ZEALAND:

Foreign Investment Policies

D.J. Hasseldine and P. Tindill

Mr. Hasseldine is a full-time lecturer in Accountancy at the University of Canterbury and is the author of numerous articles.

Mr. Tindill works for the Reserve Bank of New Zealand, and is Secretary of the Overseas Investment Commission of New Zealand. He is a graduate of St. Patrick's College and Victoria University of Wellington. Mr. Tindill is also a member of the New Zealand Society of Accountants.

Recently the New Zealand Government amended New Zealand's Overseas Investment Regulations (the Regulations) which govern foreign investment in New Zealand so that now the vast majority of investment proposals no longer need to obtain the statutory consents previously required. This article describes the general nature and scope of foreign investment surveillance in New Zealand and details the Regulations as they currently stand.

As Australia and New Zealand are major investors in each other, it is appropriate to outline the current state of cooperation between the 2 countries before discussing foreign investment in detail. The Closer Economic Relations Trade Agreement (CER) came into force in 1983 and was expanded in 1988 so that free trade in goods across the Tasman Sea is now scheduled for 1 July 1990. Currently, annual trans-Tasman trade is about $ 5 billion with the trade balance being approximately equal. In a related measure, the respective Governments have pledged to work together towards the harmonization of business law and regulation – although the extent to which this harmonization process will impinge on tax legislation is still unclear.

New Zealand welcomes foreign investment without discrimination. This is reflected in the liberal approach currently adopted towards foreign investment by the Government. The Government's foreign investment policies are administered via the Overseas Investment Commission (O.I.C.), which acts under powers delegated from the Minister of Finance. This body was established by the Overseas Investment Act 1973 to rationalize existing foreign investment policy and provide a focus for all matters concerning foreign investment. The O.I.C. consists of 2 members from the business community, including the chairman, plus a representative from each of the Ministry of Commerce and the Reserve Bank of New Zealand. The Reserve Bank has an additional role in that it provides the Secretariat for the Commission. An application is first submitted to the Secretariat for processing to ensure it meets the Commission's requirements, thereby enabling it to make a decision on the proposed investment.

The Commission's overall functions can be described as follows:
1) to allow the Government to monitor overseas investment proposals and provide an avenue through which benefits can be promoted, and those few undesirable proposals rejected;
2) to provide a means of control over the level of foreign ownership of natural resources including land and sea;
3) to provide a means of control over the level of foreign ownership in certain sectors deemed to be sensitive;
4) to allay public concerns regarding the operations of foreign interests in New Zealand that could arise if they were not supervised.

As part of the fulfilment of these functions the O.I.C. is required to advise the Government on all matters relating to foreign investment.

The Government positively welcomes foreign investment but does reserve the right to refuse permission where a significant or sensitive foreign investment proposal is considered undesirable. This right is rarely exercised: in the last 3 years only 2 applications have been declined. In recent times the emphasis of the Commission has shifted from control of foreign investment to more of a monitoring role.

The few controls and obligations that New Zealand places on the foreign investor are found in the Overseas Investment Regulations 1985, which are administered by the Overseas Investment Commission. Essentially the Regulations outline the types of investment that require the prior consent of the Commission before they are allowed to proceed. The Regulations of 1974 were replaced in 1985 to take account of the fact that all exchange controls had been removed in 1984. It may be worth noting here that with the removal of these controls the repatriation of capital and the remittance of profits and dividends is permitted in any amount and for any purpose without administrative hindrance so long as an authorized foreign exchange dealer handles the transaction.

In 1989 a review of the Regulations was completed. This concluded that for the many uncontroversial foreign investments undertaken in New Zealand, the Regulations were merely a burden on the business community and there was some scope for liberalization. As a result, the Government decided that the consent procedures for non-significant investments could be removed provided they were not in a sector of the economy deemed to be "sensitive". It was decided that a "significant" investment would be one in which $ 10 million or more was involved. The amended Regulations came into force on 24 August 1989.

The Overseas Investment Regulations 1985 are relatively simple and straightforward in their application. A non-New Zealand entity is referred to in the Regulations as an "overseas person". More specifically, an overseas person is any company formed overseas or any individual not ordinarily resident in New Zealand. In addition, the definition includes any New Zealand company in which 25% or more of the voting power is held by overseas persons. A "specified business" is any business carried on involving broadcasting, commercial fishing or the use of rural land.

An "overseas person" must now only obtain consent to:
- establish a new business (other than in a specified sensitive sector) where the total expenditure to be incurred in setting up the business exceeds $ 10 million;
- acquire 25% or more of the ownership or control of a New Zealand company (other than in a specified sector) where the consideration for the transfer or the value of

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the offeree's assets (as set out in the latest accounts) exceeds $ 10 million;
- increase the proportion of shares held in a New Zealand company (operating in a non-specified sector) where:
  - the consideration for an acquisition of shares exceeds $ 10 million or the value of the offeree's assets exceeds $ 10 million;
  - the total value of all the shares issued or allotted exceeds $ 10 million or the consideration payable on a new issue or allotment of shares exceeds $ 10 million;

  unless the total overseas shareholding is less than 25%;
- acquire the assets of an existing business (in a non-specified sector) where the consideration for the acquisition exceeds $ 10 million;
- acquire any assets or make any investment (regardless of dollar value) which will give an overseas person 25% or more of any class of shares or voting power in a company carrying on business in a specified sensitive sector.

The 25% threshold as it relates to overseas persons is not an indication of preferred levels of investment; it is merely a trigger point for possible O.I.C. involvement. The consent of the O.I.C. is not required where an overseas person wishes to acquire less than 25% of the shares in a New Zealand company.

Investment proposals requiring consent are assessed according to the Commission's net benefit criteria. These criteria were liberalized in 1979 and have not been changed since. Investors' proposals have therefore been treated with a high degree of consistency during the 1980s. Under the net benefit criteria, an applicant must demonstrate that net benefits will accrue to New Zealand from his investment.

The following factors are considered by the Commission when assessing an application:
- added competition to local industries, lower prices and greater efficiency;
- the introduction of new technology, managerial or technical skills;
- the development of new export markets or increased market access;
- the creation of new job opportunities;
- the promotion of New Zealand's economic growth.

In weighing up a proposal, factors such as the potential impact of the proposal on the environment and the implications of the proposal for the Government's other economic and industrial policies may also be considered. Where the presence of any of the previously mentioned benefits outweighs the disadvantages then it is likely the investment will be approved without difficulty.

In addition, where such benefits to New Zealand can be shown, application for up to 100% overseas ownership will be favourably considered. Only 2 sectors stipulate maximum levels of foreign ownership for entities seeking to invest in those sectors. Prior to 1985 several other sectors were also restricted, but in line with the general trend towards liberalization those restrictions were removed as they were no longer necessary.

Restrictions still apply in the following areas:
- Commercial fishing: 24.9% is the maximum allowable level of overseas ownership.
- Broadcasting: radio stations are allowed up to 25% foreign ownership while television stations are allowed up to 15% foreign ownership.
- Rural land: this is considered a particularly sensitive sector in New Zealand. Applicants generally require consent from the Minister of Lands in addition to normal O.I.C. approval. This is the only sector where a dual consent may be required. However, consent for 100% overseas ownership is possible.

As part of its monitoring function the O.I.C. compiles statistics on the number of applicants it has received. These show, perhaps not surprisingly, that Australia is by far the most significant offshore investor in New Zealand, in terms of the number of applications received by the O.I.C. Of the 1380 applications received by the Commission in the first 9 months of 1989, 708 were Australian while 107 were from the United Kingdom, 110 from the United States, 79 from Japan and 376 from all other countries (in terms of the direct ownership of the applicant). Statistics on the number of investment applications collected since 1974 show that in the last 15 years there has been a steady growth in foreign investor interest in New Zealand and in the last few years this growth has been particularly strong.

It is intended that the changes to the Overseas Investment Regulations will signal that New Zealand seeks to encourage foreign investment and correct any overseas perception that New Zealand is restrictive in its foreign investment policies. As a result New Zealand now has policies that compare very favourably with its major trading partners and New Zealand should be better placed to take advantage of the benefits foreign investment can bring.

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INDIA:

TAX ON DIVIDENDS

The Issues and Non-issues[1]

Amaresh Bagchi

Dr. Amaresh Bagchi is Director National Institute of Public Finance and Policy, New Delhi.

Tax on dividends has been lately an important subject for the Indian press, and a persistent plea has been put forward for its abolition as a necessary step to stimulate the capital market. Except for 1 or 2 dissenting voices (e.g. V.R. Gupta in the *Economic Times* of 21 June 1988), the arguments have been mostly one-sided. In fact, a virtual campaign seems to have been mounted in order to remove dividends from the tax net, without regard to the issues involved or the implications of such a move. While the question of double taxation of dividends and its possible ill effects under a system of separate taxation of corporate profits and dividends cannot be dismissed outright, it should be noted that the subject is highly controversial with expert opinion sharply divided and that one-sided pleas for indefensible measures like total exemption of dividends only serve to weaken the case for relieving double taxation. This article attempts to set out briefly the relevant issues and implications of the possible alternatives to the tax on dividends in order to develop an accurate perspective.

THE CASE FOR DIVIDEND EXEMPTION

The proposition that dividends should not be taxed in addition to a separate tax on corporate profits is based on a fairly straightforward argument, i.e. it involves the double taxation of corporate earnings which is considered to be inequitable and economically inefficient.

The above equity argument essentially rests on the view that companies are not "persons" and have no independent tax-paying capacity of their own (they are "conduits" through which income accrues to their owners, i.e. the shareholders). Hence, strictly speaking, there is no justification for levying a tax on corporate earnings as such. Corporate profits, whether distributed or retained, should be attributed to shareholders and assessed as part of their income, i.e. fully integrated into personal income taxation. Under this view, separate taxation of companies offends both horizontal and vertical equity principles because persons in similar economic circumstances are taxed unequally and, under a system of progressive taxation, shareholders not otherwise liable to personal income tax are burdened by taxation while those normally liable to taxation are either arbitrarily undertaxed or overtaxed, depending on the payout ratio and the spread between the effective rate of corporate tax and the marginal rate of personal income tax.

The only solution to this inequitable treatment is complete integration of corporate earnings into personal income. Despite its apparent appeal, full integration, however, has not found acceptance in any country because of the practical problem of identifying shareholders to whom the retained profits can be attributed.[2] In addition, shareholders face a liquidity problem if taxed on the imputed share of retained profits. Exempting corporate entities altogether from tax, on the other hand, opens up opportunities for tax avoidance by accumulating profits under the corporate cover and realizing the gains later in the form of capital gains. Taxation of capital gains, which is thought to offset the advantage, does not quite plug the loophole since capital gains cannot be taxed like ordinary income. Thus, retention always remains advantageous. For these reasons, a system of personal income tax is invariably accompanied by a tax on corporate profits. Corporate income tax constitutes a major source of Government revenue in most countries, and it is unrealistic to expect any Government to relinquish this source. Given that corporate taxation is inescapable, it is argued that fairness dictates that either the tax be confined only to retained profits or alternatively that dividends not be subject to tax.

The efficiency case draws attention to the distortions caused by the separate taxation of corporate earnings and dividends (the classical system) in decisions regarding retention vis-à-vis distribution of corporate profits, the choice between debt and equity financing, and the choice between corporate and non-corporate forms of doing business. An obvious consequence of imposing tax on dividends in addition to the tax on companies is the discouragement of corporate distributions, prevention of the flow of corporate surplus into the capital market and thus the efficient use of such surplus. This, it is argued, helps companies with a large cashflow to expand at the expense of new companies. Such a system would also appear to encourage mergers and accentuate monopolistic tendencies to the disadvantage of new enterprises. The classical system also puts a premium on debt as opposed to equity financing, thereby discouraging risk taking while increasing the possibility of bankruptcy by making the company more vulnerable to adverse business conditions.

Double taxation of company profits may also distort the choice between corporate and non-corporate forms of doing business. A premium is put on the corporate form, resulting in a distortion in the allocation of capital between the corporate and non-corporate sectors and a reduction in the rate of return on capital in the economy. This process adversely affects capital accumulation and growth. The logical solution to these distortions and the resulting inefficiencies is complete integration of corporate earnings with shareholders' income, regardless of whether such earnings are retained or distributed.

THE CASE AGAINST DIVIDEND EXEMPTION

However persuasive they may appear at first glance, the arguments put forward above have yet to find universal acceptance. In fact, there are many (including several influential fiscal economists like Musgrave) who favour retaining the classical system which, incidentally, still operates in the United States. The conduit view is rejected on the basis that companies are separate legal entities, and can be looked upon legitimately as having taxable capacity of their

1. The views expressed here are the personal views of the author and do not necessarily represent the views of the Securities and Exchange Board of India.
2. This is particularly true in the case of large corporations with a constantly changing body of equity owners.

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own. This would appear to be particularly true of large corporations where control and ownership do not go together, and the interests of the company (management) do not coincide with that of the owners. An additional argument put forward by Stiglitz to strengthen the separate entity view looks upon the corporation tax as an excess profits tax. It is also believed by many that the corporation tax is not borne entirely by the owners of capital; a good part of the tax is passed on to suppliers, consumers or employees (via purchase and sale prices and adverse impact on investment, output and employment), depending on market conditions. The late Stanley S. Surrey of the United States went so far as to say that preference for the conduit theory and integration is no more than "tax theology" and therefore beyond reason.

Several other arguments are advanced in favour of maintaining the status quo where the classical system is in effect; for example, an old tax is a good tax, and the tax on dividends must have been capitalized through share prices and so any relief now will only benefit existing shareholders.

The efficiency arguments for integration or dividend relief have also not gone unchallenged. Whether the taxation of dividends encourages retention is itself not beyond doubt. On its face (and this has been the traditional view), it would appear that under the classical system the overall tax incidence on equity income works out as a weighted average of the tax rates on retained earnings and distributed profits, and thus depends on the proportion of dividends to total corporate earnings. According to a new view of equity taxation, propounded by Auerbach (*Journal of Economic Perspectives,* Summer 1987), the relevant tax incidence on dividends is determined by the effective capital gains tax rate, and does not depend on the payout ratio. If this view is correct, tax liability on equity earnings over time is independent of corporate decisions regarding distribution *vis-à-vis* retention and consequently, the form of corporate taxation is of no relevance for dividend decisions. Evidence in support of this hypothesis, however, is not conclusive.

Granting that tax on dividends discourages distribution, few tax experts have in the past favoured elimination of the tax based on the consideration that retention may not be undesirable for a developing economy. As Richard A. Slitor, a noted fiscal expert, said in the context of tax reform in Colombia:

> The realities of the Colombian situation suggest, however, that company reinvestment is a major source of growth funds and would not adequately be replaced by shareholder savings out of, in response to, increased dividend payments on stock. (Quoted in *The Taxation of Corporations and Shareholders,* Martin Norr.)

In addition, a larger distribution of corporate funds may not lead to their efficient use unless the country has an efficient capital market. Even in countries with well-established capital markets (e.g. the United States), not all corporations have equal access to the market. Thus, retained earnings become a main source of funds for these companies.

As noted in a summary of the recommendations by tax missions to underdeveloped countries, tax discrimination in favour of retained profits "is a rough, but reasonable incentive in the right direction". Another tax survey noted that retention of profits is "historically the primary source of capital accumulation in Western industrialized nations". Apart from the possible adverse influence on savings, integration or dividend relief by encouraging distribution is likely to discriminate against new, expanding companies in favour of large and well-established ones, since a new company is seldom in a position to distribute dividends in its early years.

Another argument (put forward by David Bradford), based on a theoretical analysis using the rational expectations hypothesis, suggests that dividend taxation may not have the adverse consequences on corporate financial structure attributed to it since the present value of the tax liabilities remains the same whether the distribution is made currently or with a lag. While one may not accept the abstract reasoning of Bradford, many would be inclined to think that, in India, if distribution is encouraged, corporate savings may decline without a compensating increase in shareholder savings. In any event, the funds that might ultimately flow into the capital market would go primarily to the few established giants with high payout ratios, totally bypassing new companies. As a result, the share prices of these corporations will soar, and result in windfall gains for the shareholders. With the dividend tax, top-notch companies carry huge premiums on their new issues while many lesser known companies, even when backed by powerful underwriters like the State Bank of India, find no takers. The situation will probably be aggravated if dividends are exempted totally from tax.

FOREIGN PRACTICE

The tax systems of several countries, especially countries in the European Economic Community (EEC), do provide some relief for the tax on dividends through a system of "partial integration or imputation", whereby credit is given to shareholders for a part of the tax paid by the company. However, none of the methods which are used to implement the systems is simple.

The system of partial integration which is in vogue in the United Kingdom requires companies paying out any dividend to deposit an "advance corporation tax" (ACT) on the amount paid to the shareholders at a rate given by the formula t/1-t (t is the basic rate of personal income tax). The ACT may be set off against the mainstream corporation tax. Where the mainstream tax is insufficient to absorb the ACT paid (because of tax preferences, etc.), the surplus may be carried back to offset the tax paid in the 6 previous years or carried forward indefinitely. The cash amount of the dividend received by the shareholder is grossed up by the tax paid by the company and included in the shareholder's income to be taxed at the applicable rate; credit is given for the ACT paid by the company. If the shareholder falls below the taxable income bracket, he receives a refund. For example, if a company distributes a dividend of £ 75 and the basic rate of personal income tax is 25%, the company will be required to pay ACT of £ 25, and the shareholder will be deemed to have received a dividend of £ 100 with a tax credit of £ 25. If the shareholder falls below the taxable limit, £ 25 will be refunded, but if he is liable to tax at a marginal rate of say 40%, the shareholder will be required to pay an additional amount of £ 15 (£ 40 – £ 25) as tax on his dividend income. The benefit of the gross-up and credit method is generally not available to non-residents, except under a tax treaty.[3] Tax-exempt organizations, however, receive the credit.[4]

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3. *Editor's note:* An important exception to the rule that ACT tax credits are not available to non-residents is to be found in Sec. 232(1) Income and Corporation Taxes Act (ICTA) 1988. This section extends to certain non-residents the provisions which entitle U.K. residents who receive dividends (and other qualifying distributions) to tax credits corresponding to the rate of ACT on those dividends. By far the most important class of non-resi-

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France operates a system of "partial imputation", with a tax credit to shareholders equal to 50% of the dividend distributed. Where the dividend is paid out of profits partly or wholly tax-exempt or taxed concessionally, the company is required to pay a tax (précompte) equal to the tax credit given on the dividend or the part of the dividend paid out of untaxed profits.

The Federal Republic of Germany (FRG) has a 2-rate imputation system with distributed profits taxed at a lower rate than retained earnings (36% and 50%,[5] respectively); and full credit is granted to resident shareholders for the tax paid by the company upon distribution. Thus, the FRG completely eliminates double taxation of dividends not by exempting dividends from taxation but through a system of split rate taxation and full credit for tax paid on distributed profits.

All 3 systems (France, Germany and the United Kingdom) seek to ensure that relief is available from double taxation only when there is double taxation; no relief is available if the profits out of which the dividends are paid do not suffer taxation because of exemptions, allowances, etc. Thus, in the United Kingdom the ACT must be paid upon distribution. France allows credit only when corporate income tax is paid at the full standard rate. In the FRG, companies must enter their retained earnings available for distribution under 3 different accounts: (1) amounts taxed at the 50% rate; (2) amounts taxed at 36%; and (3) those which have suffered no tax. Companies with an effective tax rate falling between the specified rates are required to allocate the profits between the 2 rates, so that the weighted average rate equals the 36% corporate income tax rate due upon distribution of profits. Dividends are presumed to be distributed first out of the account bearing the highest rate and the balance set off against the next account and so on.

Expressing concern about the distortions in corporate decisions regarding capitalization, etc. caused by the disparate tax treatment of debt and equity, the U.S. Treasury suggested that 50% of dividends be allowed to be deducted from the corporate tax base provided the dividend was paid out of profits actually taxed and not out of "tax-preference income".[6] For this purpose a "Qualified Dividend Account" would have to be maintained. The proposal was not put into legislation, but it underlines the problems which are encountered in any scheme of dividend relief, especially when there are many exemptions or concessions in corporate taxation.

It may be recalled that the Indian Income-tax Law also provided for partial integration through a system which allowed dividends to be grossed-up by the effective corporate income tax rate (but not supertax); credit was given to shareholders. With the introduction of various incentives into the tax system (tax holidays, development rebates, etc.), the gross-up method became very difficult to operate and was repealed in 1959-60.

ON BALANCE

The above arguments are not intended to assert that the question of double taxation of corporate earnings under the classical system of taxation merits no consideration, but merely to point out that the case for exempting dividends from tax is not as obvious as is asserted in current literature. The classical system of taxation, which taxes company profits and dividends separately, has its merits in that it helps to promote retention and corporate savings.

Moreover, complete neutrality is unattainable since full integration involves acute practical problems. The only feasible way to relieve the tax on dividends is to devise some form of partial integration either through imputation or a dividend deduction from the corporate tax base (although, according to many, full integration is the real answer and partial integration serves no purpose as it does not achieve neutrality; rather, it causes unanticipated distortions). However, imputation or integration, whether complete or partial, gives rise to serious practical problems. There is no escape from these complications so long as the tax system permits tax preferences and the incidence of tax on corporate profits remains uncertain. The fact that a large number of Indian companies are in the "zero rate tax bracket" should not be overlooked.[7] With the recently introduced minimum tax provision, the effective tax rates on corporate income can vary widely between companies, depending upon their capital structure, payout ratios, quantum of tax-exempt earnings or the extent to which the company is able to manipulate its accounts in order to distort book profits.

It is also worth pointing out that the dividend exemption does little or nothing to improve equity; in fact, it may give rise to greater inequity than at present as between top bracket income earners and those in the tax-exempt or lower tax brackets. Appendix I indicates the extent of overtaxation and undertaxation of shareholders under the existing system (as compared to what they would be requested to pay if subjected to tax only on their dividend income) at varying corporate and individual tax rates: (a) with no dividend distribution and (b) with a 50% dividend payout. With separate taxation of company profits and dividends, shareholders who fall below the taxable limit are overtaxed (whether or not the dividend is taxed), while shareholders liable to pay personal income tax are undertaxed or overtaxed, depending on the spread between the corporate tax rates and the marginal rates of personal income tax. With no dividend distribution and an effective corporate tax rate of 30%, shareholders in the 25% tax bracket are overtaxed while those in the top brackets are undertaxed. With a 50% dividend payout ratio, the degree of undertaxation in the top brackets is reduced while overtaxation in the 25% bracket is accentuated. The payout ratio in Indian companies is on an average below 50%. For companies assisted by the Industrial Credit and Investment Corporation of India, a trading and lending institution, the average was 31% in 1985-86 and 40% in 1986-87.

With a total dividend exemption, the extent of undertaxation of top bracket shareholders increases while overtaxation in the lower brackets continues and those in the 25% tax bracket are undertaxed if one assumes an effective corporate tax rate of 20%. The effective tax rate on corporate profits is unlikely to exceed 30% on the average, thanks to the "funding scheme", investment allowances and other incentive provisions in the tax laws. In a large number of

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dents to whom the section applies are those Commonwealth (including the U.K.) and Irish citizens who have made a claim to a proportion of personal reliefs under Sec. 278(1) ICTA 1988.

4. *Editor's note:* Secs. 235 and 236 ICTA 1988 contain anti-avoidance provisions designed to counter dividend stripping by exempt persons. The provisions operate by withdrawing exemption from the income represented by dividends (and other qualifying distributions) received by an exempt person where that person holds at least 10% of the shares giving rise to the distribution.

5. The 50% rate is effective from 1 January 1990.

6. These proposals led to the sweeping tax reforms of 1986.

7. According to the latest survey conducted by the Industrial Credit and Investment Corporation of India Ltd. (ICICI), as many as 107 out of 417 companies surveyed in 1986-87 fall into this category.

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cases, the effective rate would be 20% or even less, notwithstanding the minimum tax. The effective tax rate would be less if allowance is made for the possibility of shifting. This takes no account of the capital gains tax. However, the incidence of capital gains tax in India is not high as many ways are available to avoid or reduce it. Further, taxation of capital gains with no corresponding tax on dividends would give rise to new distortions by creating a strong disincentive for any retention and penalizing those who prefer to retain their profits in the companies.

Given this background, exempting dividends totally from taxation would be irrational and will serve no useful purpose. Rather it will create grave inequities and only serve to enrich the few established large companies with no benefit to newcomers. Indeed, it is not a solution worth serious consideration. To my knowledge, no tax system in the world allows such an exemption.[8]

The present practice in India of granting a dividend exemption of up to a certain limit, i.e. 10,000 Rs.[9] (Sec. 80L of the Income Tax Act) is subject to all the arguments mentioned above against a total dividend exemption without regard to the profits from which the distribution was given place. In many cases this may result in total remission of tax on company earnings even after distribution (e.g. when dividends are distributed out of past profits) which obviously militates against all norms of equity in taxation. The only point in its favour is that the damage caused is contained by the ceiling of 10,000 Rs.

In sum, while it is doubtful that the economy will gain, the equity of the tax system will suffer if dividends become fully exempted in addition to present corporate tax incentives. If relief from double taxation is to be provided to shareholders, there must be a system to ensure that the corporate profits would indeed be taxed twice. For that, as pointed out in this article, there is no simple way. Whether the complications which would unavoidably creep into the law if some relief was provided on dividends through a system of imputation or partial integration or dividend deduction against corporate tax base are worth the benefits likely to flow, is the real issue and not whether the tax on dividends should be eliminated. It is a pity that proposals for tax measures which may have a profound impact on the tax system are put forward with little evidence of any awareness or recognition of their likely overall consequences.

8. *Editor's note:* However, some countries (Japan and Pakistan) do exempt intercorporate dividends.
9. 13,000 Rs. from 1 April 1989.

APPENDIX I

Tax incidence on 100 Rs. of corporate-source income
at varying rates of personal income tax and corporation tax

			Dividend payout ratio					
			Zero			*50%*		
1.	Shareholder's marginal tax rate	(%)	0	25	50	0	25	50
2.	Effective corporate income tax*	(a)	40	40	40	40	40	40
		(b)	30	30	30	30	30	30
		(c)	20	20	20	20	20	20
3.	Net corporate	(a)	60	60	60	60	60	60
		(b)	70	70	70	70	70	70
		(c)	80	80	80	80	80	80
4.	Dividend	(a)	—	—	—	30	30	30
		(b)	—	—	—	35	35	35
		(c)	—	—	—	40	40	40
5.	Personal I.T. on dividend	(a)	—	—	—	0	7.5	15
		(b)	—	—	—	0	8.75	17.5
		(c)	—	—	—	0	10	20
6.	Total tax (2 + 5)	(a)	40	40	40	40	47.5	55
		(b)	30	30	30	30	38.75	47.5
		(c)	20	20	20	20	30	40
7.	Overtaxation (6 − 1)	(a)	40	15	–10	40	22.5	5
		(b)	30	5	–20	30	13.75	− 2.5
		(c)	20	− 5	–30	20	5	–10
8.	Percentage overtaxation ($^{7}/_{1} \times 100$)	(a)	~	60	–20	~	89	10
		(b)	~	20	–40	~	55	− 5
		(c)	~	–20	–60	~	20	–20
9.	Overtaxation with no tax on dividend (2 − 1)	(a)	40	15	–10	—	—	—
		(b)	30	5	–20	—	—	—
		(c)	20	− 5	–30	—	—	—
10.	Percentage overtaxation with no dividend tax ($^{9}/_{1} \times 100$)	(a)	~	60	–20	—	—	—
		(b)	~	20	–40	—	—	—
		(c)	~	–20	–60	—	—	—

* On assumption of 40%, 30% and 20% effective rate respectively.
Adapted from C. McLure, Jr., *Must Corporate Income Be Taxed Twice?* Table 2 : 1 (Brookings Institution, 1979).

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India and the ATA Carnet System

G.K. Kwatra

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In late 1988 industry and business circles were informed of the Indian Government's decision to accede to the ATA Convention.[1] The accession, albeit only for goods, exhibitions and trade fairs, was welcome news – more so since this had been a long-standing demand of the trade and industry sectors. This article examines the background of the ATA Carnet System, how it operates and its impact on Indian businesses in an international market.

In March 1989 the Government followed up on its decision by inviting the Federation of Indian Chambers of Commerce and Industry (FICCI) to accept appointment as the National Issuing and Guaranteeing Association (NIGA) for ATA Carnets. The ball has now been set rolling and, although belatedly, India joins the elite group of nations, which includes some developing countries like Sri Lanka and Mauritius, which together form the ATA chain.

ORIGIN OF THE ATA CARNET SYSTEM

The ATA Carnet System is the product of the expanding internationalization of the market place in the contemporary world economic order. It has now become imperative for the exporting community to focus on methods of commanding customer attention in a market that transcends political boundaries in order to create, consolidate and enlarge the market share. Such a goal requires the temporary export of goods, either as valuable samples, goods to be displayed at international trade shows and exhibitions, or professional equipment used to exhibit products and technologies. Such exports have 3 features in common:

(1) the goods are not intended for sale and have as their last destination the country of origin;
(2) the period of their stay outside the home country is brief; and
(3) the goods may need to be transported to more than one nation before finally being shipped home.

Because such goods may cross more than one national border in a single journey, a series of customs declarations at the check post of each nation must be made. This process can be a time-consuming irritant, the intensity of irritation being unambiguously set forth in the customs legislation of each nation. It is precisely this problem that the International Chamber of Commerce and International Bureau of Chambers of Commerce (IBCC) is determined to resolve. Meeting under the auspices of the Customs Cooperation Council and the GATT, a host of nations evolved and signed the ATA Convention on 6 December 1961 in Brussels. This Convention endeavoured to streamline the customs procedure applicable to the temporary movement of goods between nations which acceded to the Convention. Today, as many as 41 nations, including some developing countries, have signed the Convention. A measure of the growing popularity of the use of Carnets is evident from the following table:

Year	Number of Carnets issued	Value of Carnets (US$ million)
1963	624	1.50
1965	8,179	32.41
1970	85,840	381.00
1975	128,158	1,387.00
1980	186,911	348.00
1984	253,968	4,244.00
1985	268,076	4,700.00
1986	273,484	7,020.00
1987	283,624	7,300.00

A wide variety of goods are covered under the Carnets.[2] Goods intended for processing or repair are specifically excluded from coverage. A typical list of goods for which Carnets have been issued includes computers, office equipment, transformers and electric generators, surgical equipment, jewelry and precious stones, audio-visual and photographic equipment, musical equipment, agricultural machinery, machine tools, leather, sporting goods, clothing, etc.

OPERATION OF THE ATA CARNETS

ATA Carnets make it possible for goods which must be temporarily exported to move between ATA member nations without obtaining a customs declaration at border points. There is no need for a personal or real guarantee by the exporter in the country of importation. Each nation accepts the ATA Carnet in lieu of its national customs documents and as due security for the import duty on goods which may not be re-exported.

A Carnet is valid for only one year, beginning from the date of its issue (i.e. goods for which a Carnet has been issued must be re-imported within a year). In addition, the Carnet itself specifies the names of the countries in which it is valid.

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1. ATA is a combination of 2 English and French phrases, i.p. AT in French is an acronym for "Admission Temporaire" and TA in English "Temporary Admissions".
2. The ATA Convention covers goods temporarily imported under
(1) the Customs Conventions adopted in Brussels in June 1961 for:
   (a) professional equipment, and
   (b) goods for display or use at exhibitions, fairs, meetings or similar events;
(2) other international temporary importation Conventions or for temporary admission procedures under the national laws of a country.

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Adding to the list of goods for which the Carnet was originally issued is not permitted.

SYSTEM OF GUARANTEES

The ATA Carnet System is based on the principle of reciprocity between member nations. The IBCC has set up an international customs sureties chain to effectuate this principle. The Government of each nation which becomes a contracting party to the Convention is required to appoint an apex level Chamber of Commerce as the NIGA. The function of issuing and guaranteeing Carnets may be further delegated to local Chambers of Commerce but under cover of the guarantee of the NIGA.

To explain the operation of the guarantee system, let us consider the case of 2 countries: Country E, which exports goods, and Country I, which imports goods under the Carnet. A firm in Country E wants to export exhibition material to Country I. The firm must obtain a Carnet from the NIGA of Country E. Under cover of the Carnet, the goods will be brought to Country I. If the goods are re-exported from Country I, all liabilities under the Carnet cease. However, if the goods are not re-exported, the NIGA in Country I will be liable to the customs authorities of Country I for import duty on the goods and any other sums due in the event of non-compliance with the conditions of temporary admissions or transit applicable in Country I. This liability is, however, limited to a maximum of 10% in excess of the amount of import duty.

Having discharged the liability of the customs authorities in Country I, the NIGA of Country I will make a claim on the NIGA of Country E which issued the Carnet. It will then be the responsibility of the NIGA of Country E to settle the account with the NIGA of Country I. The NIGA of Country E will then proceed to recover such amount from the exporting firm. To sum up, the NIGA in each nation stands guarantee to the customs authorities of that nation for the payment of import duties on goods covered by a Carnet which have not been re-exported. The NIGA of one nation guarantees reimbursement of the duties paid by the NIGA of another nation in respect of the Carnet issued by the former and, finally, the exporting firm must guarantee payment of duties on goods not re-imported by it to the NIGA that issued the Carnet.

Under the Protocol on the organization of a system of international customs deposits in respect of ATA Carnets which must be signed by every nation acceding to the ATA Convention, the IBCC has detailed a procedure for settlement of accounts between the NIGAs of member nations. To ensure that restriction on foreign exchange remittance in individual nations does not hinder the settlement of accounts, the IBCC also insists on a letter from the national authorities (in the case of India, the Reserve Bank of India) empowering the NIGA to receive/remit all funds in connection with the operation of the ATA Carnet System.

Under the Protocol, it is also mandatory for the respective NIGAs to provide the IBCC with the security demanded by the latter as evidence of the NIGA's ability to comply with its obligations in respect of the guarantees of duties and taxes payable on goods covered by ATA Carnets.

The IBCC recommends that the NIGA protect itself against default by the exporting firm to which a Carnet is issued by:

(1) a security deposit in cash, stocks and shares or the freezing of funds on deposit;
(2) a joint and several undertaking by solvent, natural or corporate persons, or banks, insurance companies or guarantee organizations authorized to guarantee such operations.

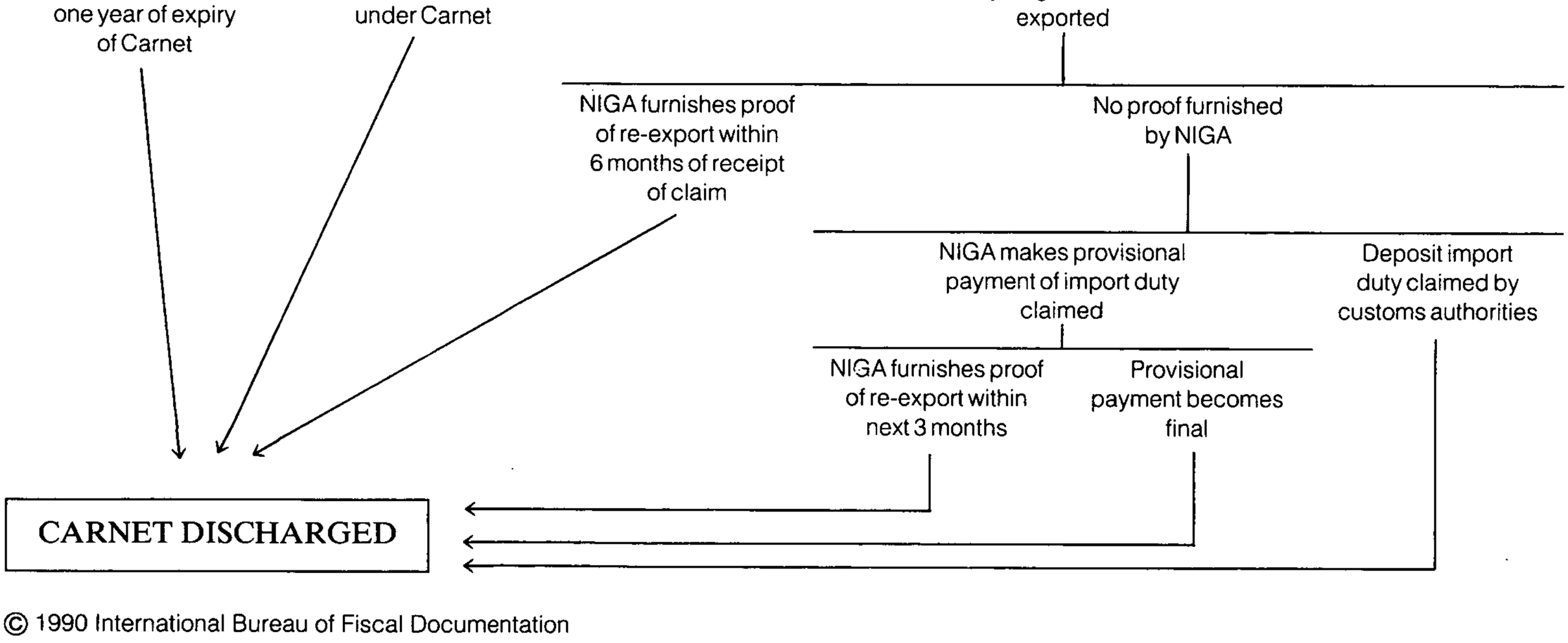
The guarantee should cover the amount of the highest possible import duties, all sums payable by the NIGA for failure to fulfil the conditions governing temporary exports and imports, plus an extra 10%.

It is also recommended that the exporting firm buy insurance coverage against the risk of marine hazard, fire, theft or destruction as the customs authorities do not normally agree to abandon claims for duty on goods lost or destroyed.

DISCHARGE OF CARNETS

The discharge of the NIGA from liabilities arising under a Carnet issued by it is best explained in the chart set out below.

DISCHARGE OF CARNET



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Evidence of re-exportation of goods under a Carnet is provided by the certificate of re-exportation completed in the Carnet by the customs authorities of the importing country. The authorities can accept as proof of exportation a certificate of subsequent importation of the goods in question to another member country or in the country of origin itself.

In the event of fraud, contravention or abuse, each nation is free to institute proceedings against the beneficiaries of the Carnet for the recovery of import duties and other sums payable and for the imposition of penalties. The NIGA is expected to cooperate with the customs authorities in this regard.

INDIA

As stated above, the Indian Government has decided to make a limited accession to the ATA Convention. It is indeed a belated but, nevertheless, welcome step.

At present, the Indian customs legislation provides for temporary importation facilities by way of issuance of notifications. Notifications have been issued to cover temporary imports of the following types:

Notification	Items importable
84/71	Scientific equipment
46/74	Pedagogic material
185/76	Samples and price lists
186/76	Commercial samples as personal baggage
116/79	Goods for fairs and exhibitions
149/79	Goods for trial, demonstration or training

Although these notifications have made it possible to import goods temporarily into India without payment of duty, exporting firms in India are not assured of such benefits when they take their goods abroad. The quid pro quo is missing which puts the exporting firms at a disadvantage. Clearance formalities under the Carnet System are also minimized which has made it possible to clear goods covered under an ATA Carnet within 24 hours.

The sine qua non of the ATA Carnet System is the guarantee chain that has been meticulously developed by the IBCC, and this chain has fortified and preserved the system for the past 25 years. Although it is the developed world which has largely subscribed to the system, it is inconceivable why the developing nations like India should not benefit from it as well.

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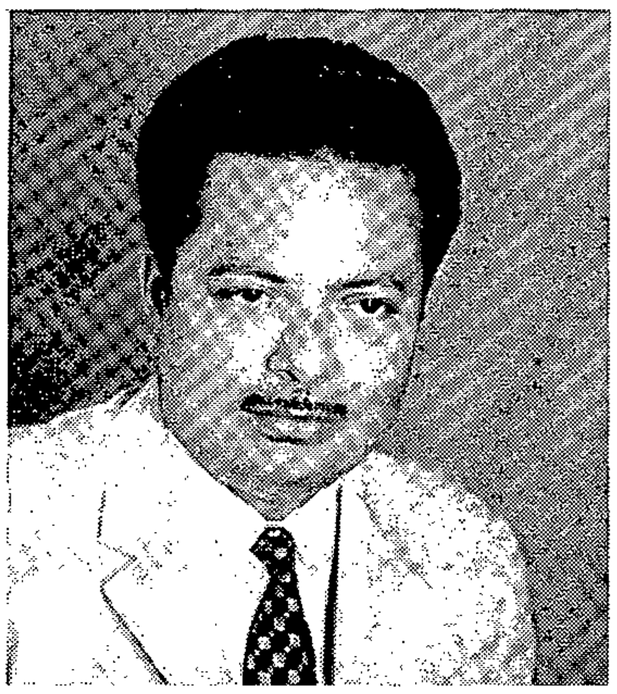

BANGLADESH:

Budget Speech of the Finance Minister: 1989-90

Highlighted by K.A. Gofran

Mr. Gofran, B.A., LL.B., is editor of *Bangladesh Tax Decisions* (a journal of tax cases).

I. INTRODUCTION

The Finance Minister presented the National Budget for the fiscal year 1989-90 to the National Assembly on 15 June 1989, disclosing an estimated revenue receipt of 72 billion[1] taka and estimated revenue outlay of 69 billion taka, leaving a surplus of 3 billion taka. The Development Budget for the year is estimated at 580 billion taka of which 87% is to be financed by foreign aid.

The new Budget contains a number of fiscal measures to generate 7 billion taka from internal resources in order to meet the resources gap in the ADP. These measures will effect both direct and indirect taxes. The levy of indirect taxes, which only needs mentioning, covers household goods and services such as utensils, plastic containers, sugar, cigarettes, beverages, soaps, electricity, gas, postage, court fees and foreign travel. Even the price of news print will increase due to the abolishment of the tax rebate. The Finance Minister also announced the abolition of the shop tax, investment allowance of machinery for balancing, modernization and replacement (BMR), reduction of the tax on medical instruments, scientific apparatus, raw materials for printing ink, electric fans and agriculture appliances.

II. DIRECT TAXES

Income tax

In his Budget Speech the Finance Minister underscored the need to increase the volume of investment in the country for the purpose of economic development and creation of employment opportunities. He referred to the incentives given in the year 1987-88 to taxpayers other than companies, to declare income of any amount by paying income tax at 20% under the head "Income from other sources". He also referred to the liberal provision of taxing income at 10% if 90% of the income declared is invested in specified industries. This facility of payment of income tax at the concessional rate has now been extended for current assessment year in order to stimulate industrial development and create new employment opportunities. Accordingly, it has been provided that:

(a) if a taxpayer, other than a company, declares any income under the head "Income from other sources" in his *return* of income for the assessment year 1989-90 and pays income tax at the rate of 20% on it, that income will be accepted without any questions being asked; and
(b) if, however, 90% of the income declared is invested within 2 years from 1 July 1989 in specified industries, the declarant will pay income tax at the rate of 10% in place of 20%.

Presently, there are provisions for the deduction or collection of tax at source in certain areas. It is necessary to expand the scope of the deduction or collection of tax at source in order to widen the tax base and to ensure collection of tax. It is, therefore, provided that:

(a) tax at the rate of 5% on the commission payable to a distributor engaged by any corporation including its units or a company for distribution and marketing of certain specified goods manufactured by it will be deduction and collected at source; and
(b) the list of 16 items subjected to collection of advance income tax as per the present Income Tax Rules at the rate of 2% of the import value will be expanded.

According to existing provisions, if a new industrial undertaking is set up by 30 June 1990, it may make use of the tax holiday for different periods, depending on its location. In the interest of unhindered industrialization, this time limit has now been extended to 30 June 2000.

If a specified new industrial undertaking is established by 30 June 1990, there is provision which allows an accelerated depreciation allowance, subject to various conditions, in respect of the machinery used in that industrial undertaking. This time limit has also been extended to 30 June 2000.

Apart from the depreciation allowance, there is no other benefit under the existing income tax law in respect of new machinery set up in the industrial undertakings under the BMR programme. It is necessary to induce investment in balancing, modernisation and replacement of the machinery. It has been provided to allow investment allowance at the rate of 25% of the amount invested in the new machinery set up in the industrial undertaking under BMR programme.

Under Finance Act 1988, a 10% surcharge was imposed on income tax payable for the assessment year 1988-89. In the interest of increasing mobilization of internal resources, the surcharge will be increased to 15% for assessment year 1989-90.

The present arrangement of paying tax at the rate of 30% by non-resident shipping companies on ⅙ of the total freight earnings has been replaced by a system of paying tax at the rate of 8% on such total freight earnings. Under the modified procedure no filing of the return is necessary, as was the practice earlier.

In order to remove the bottlenecks in the air shipping business, the present tax rate of 30% on the pro rata income of non-resident air lines engaged in the air transport business

1. *Editor's note:* Amounts are rounded to the nearest billionth taka.

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will be replaced by a 3% tax on total air freight earnings arising in Bangladesh. In the new provision there is no requirement for filing tax returns, as was done hitherto. The tax paid will be deemed to be the final discharge of the tax liability.

The present provision regarding taxation of income from oil exploration and production businesses is based on the royalty principle. In order to encourage capital investment by foreign oil companies for the exploration of oil and gas in Bangladesh, the Government is now following the principle of production-sharing. As a result, amendments are likely to be made to the existing tax laws with respect to such companies.

According to the present provisions, income arising from fish, poultry, cattle, dairy and frog farming activities and horticulture is fully exempt from income tax until 30 June 1990. The above-mentioned activities have been allied to the agricultural sector and are capable of playing a significant role in augmenting production, creating employment opportunities and expanding exports. It has therefore been provided to extend the tax exemption period to 30 June 2000.

Presently, some initiatives are being noticed in areas such as cultivation of mulberry, cocoon, mushroom and floriculture. As it is considered possible that increased production of these activities will employment opportunities and boost exports, it is necessary to encourage these activities by providing tax incentives to producers. Accordingly, it is now provided to fully exempt the income arising from these activities from 1 July 1989 to 30 June 2000.

Under the existing provision, the fees for filing an appeal to the Appellate Joint Commissioner of Taxes, a revision petition to the Commissioner of Taxes and an appeal to the Taxes Appellate Tribunal by a taxpayer are payable at the rate of 25, 25 and 100 taka, respectively. These fees have not been changed for some time. However, the expenses incurred by the Government for handling such appeal and revision cases have meanwhile increased. It has therefore been provided to raise the existing fees to 100, 100 and 300 taka, respectively.

According to the present provisions, if a taxpayer owns a small or cottage industry situated in the "Less Developed Area" or "Least Developed Area" and is engaged in the production of goods, he will be entitled to a rebate on the income tax paid on income of the current taxable year on the basis of the increased production in relation to the preceding year. If production in the current taxable year in relation to that of the preceding taxable year exceeds 15%, the income tax rebate will be applicable at the rate of 2.5%. If, however, production exceeds 25% of that of the previous year, the rebate will be applicable at the rate of 5%. With a view to encouraging production in small or cottage industries situated in the "Less Developed Area" and "Least Developed Area" and creating job opportunities, it is now provided to raise existing income tax rebate rate to 5% and 10%, respectively.

For the failure to withhold tax at source and to pay the tax so withheld the Income Tax Ordinance imposes a prison term of 1 year and/or a fine. But, currently, there is no penalty for failure to collect tax at source or for failure to pay the tax collected. It is, however, now provided to impose similar penalties for failure to collect tax and pay at source.

Presently, in respect of investments and donations, 1/3 of the total income or 200,000 taka, whichever is the less, is deductible when computing the income tax liability. In the case of donations paid in the "4 areas", the condition that any sum paid as a donation to the "4 areas" shall not exceed 30% of the taxpayer's total income has been repealed.

III. OTHER TAXES

Foreign travel tax

At present, foreign travel tax is payable at the rate of 5% of the fare, but not less than 100 taka or more than 750 taka. This rate has not been changed since the introduction of this tax in 1980. The existing rate, however, is not consistent with the present cost of tickets. Considering this and the need to increase revenue, it is now provided to raise the rate of foreign travel tax to 12.5% of the fare, but not less than 250 taka or more than 2000 taka. However, for air travel to SAARC countries, the foreign travel tax is proposed to be charged at the flat rate of 500 taka per ticket.

The foreign travel tax rate for land travel needs to be rationalised. It has been, therefore, provided to charge 250 taka per passenger in place of the existing 100 taka per passenger for land travel. In the case of sea travel, it is now provided to raise the existing rate from 400 to 800 taka per passenger.

Air ticket tax

With respect to international travel, a foreign travel tax is applicable, and the same has been increased. As it is not reasonable to charge air ticket tax on the same foreign travel, the tax on air tickets purchased for international travel has been repealed.

Currently, the air ticket tax is applicable at the rate of 30 taka per ticket for domestic travel. This rate is very low compared to the average cost of tickets. Thus, in the interest of increasing revenue, it has now been provided to raise the tax for domestic travel to 50 taka per ticket.

Electricity duty

Electricity duty is presently being collected at the rate of 5 paisha per unit of electricity consumed. This rate was introduced in 1983, and there has been no change since then. It has now been provided to raise this rate to 10 paisa per unit.

Shop tax

Shop tax was introduced in 1984. The tax is based on the floor space of each shop. Thus, shops having more space are required to pay more tax. For various reasons, the turnover and profit of a shop with less space may be higher than that of a shop with more space. Because of the resulting inequity and low collection of the tax, the same has been abolished.

Stamp duty

The receipt of money exceeding 20 taka or any other property valued at more than 20 taka is subject to a stamp duty at the rate of 0.50 taka. This rate was enacted in 1 July 1980. To meet the printing cost of stamps which has now increased and in the interest of increasing revenue collection, it is provided to raise the rate to 1.00 taka.

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RATE OF INCOME TAX

The rates and schedules of income tax applicable for fiscal year 1989-90 are shown at Annexure A & B.

ANNEXURE – A

For individuals, Hindu undivided families, unregistered firms, associations of persons and artificial juridical persons referred to in Section 2(46) of the Income Tax Ordinance, 1984 (XXXVI of 1984), not being a case to which para. B applied.

Rates

(1)	on the first 55,000 taka of taxable income	10%
(2)	on the next 55,000 taka of taxable income	20%
(3)	on the next 55,000 taka of taxable income	30%
(4)	on the next 55,000 taka of taxable income	40%
(5)	on the balance of taxable income	50%

Provided that:

i. no income tax shall be payable on a total income, which before the deduction of the sums, if any exempted under paragraphs 1-14, 17, 18 and 20 of Part B of Sch. 6 to the Income Tax Ordinance, 1984 (XXXVI), does not exceed 36,000 taka; and

ii. the income tax payable shall in no case exceed:

(a) one third of the amount by which the total income exceeds 36,000 taka, or

(b) the amount representing 50%, of the total income, whichever is less.

ANNEXURE – B

For companies and local authorities and in every case in which, under the provisions of the Income Tax Ordinance, 1984 (XXXVI of 1984), income tax is to be charged at the maximum rate:

(1) on the whole of the total income excluding the amount representing income from dividends from a company having its registered office in Bangladesh:

(a)	in the case of every industrial company being a publicly traded company	40%
(b)	in the case of every industrial company not being a publicly traded company	45%
(c)	in the case of all other companies including banks, financial institutions and local authorities	45%
(d)	in the case of a person not being a company who is not resident in Bangladesh	30%

RATE OF SURCHARGE FOR 1989-90 (Part 2 of the 4th Sch. 6)
(Sec. 14 of Finance Act 1989)

In the case of all persons referred to in Sec. 2(46) of Income Tax Ordinance 1984, 15% of the income tax payable.

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Dér Finanzminister betonte in seiner Haushaltsrede, dass das Ziel Singapurs darin liege, nach einem hohen Wachstum zu streben. Zu diesem Zwecke beinhalten die für den Haushalt 1990 vorgeschlagenen Steueränderungen eine Reduzierung des Körperschaftsteuersatzes, desweiteren eine Liberalisierung, Ausdehnung und Erweiterung verschiedener Steueranreize.

Dr. M.M. Sury:

Indien: Theoretische und praktische Aspekte der Besteuerung von Veräusserungsgwinnen *277*
Der Autor beginnt mit einer Untersuchung der Argumente für und gegen eine Besteuerung der Veräusserungsgewinne unter Einbeziehung der Fragen, wie man mit der Inflation fertig werden kann, ob die Steuer auf realisierte oder auf nicht realisierte Gewinne erhoben werden soll, ferner, ob eine Unterscheidung zwischen Langzeit- und Kurzzeitgewinnen gemacht werden soll. Anschliessend wendet sich der Autor dem indischen System zu, unter welchem Kurzzeitgewinne wie gewöhnliches Einkommen behandelt werden, während für Langzeitgewinne verschiedene begünstigende Bestimmungen in Anspruch genommen werden können. Der Autor beschliesst mit der Schlussfolgerung, dass diese Vorzugsbesteuerung für Langzeitgewinne unhaltbar ist.

Dr. Erwin Spiro:

Südafrika: Der Haushaltsetat für 1990 ..... *282*
Der Autor beschreibt kurz die Hauptpunkte der vom Finanzminister gehaltenen Haushaltsrede.

Mark Friezer:

Australien: Gesetzesentwurf im Hinblick auf ausländische Einkünfte *285*
Vor kurzem legte die australische Regierung einen Gesetzesentwurf zusammen mit den entsprechenden Erläuterungen vor. Der Gesetzesentwurf enthält das für ausländische Einkünfte vorgeschlagene Besteuerungssystem. Der vorliegende Artikel bringt einen vorangegangenen Artikel, der in der Januarausgabe 1990 des *Bulletin* erschienen war, auf den neuesten Stand. Dieser Artikel umriss den Inhalt des Informationspapiers, das der Vorläufer zu dem jetztigen Gesetzesentwurf war.

IFA Meitteilungen *286*

Neuseeland: Programmerklärung in bezug auf Sec. 99 ..... *288*
Am 1. Februar 1990 veröffentlichte der Präsident des Inland Revenue eine wichtige Programmerklärung, die die Anwendung von Neuseelands allgemeiner Steuerumgehungsregelung betrifft (Sec. 99). Der Programmerklärung war eine kurze Anmerkung beigefügt, die die Erklärung in ihrem Kontext erläutert. Beide Dokumente sind in dieser Ausgabe abgedruckt.

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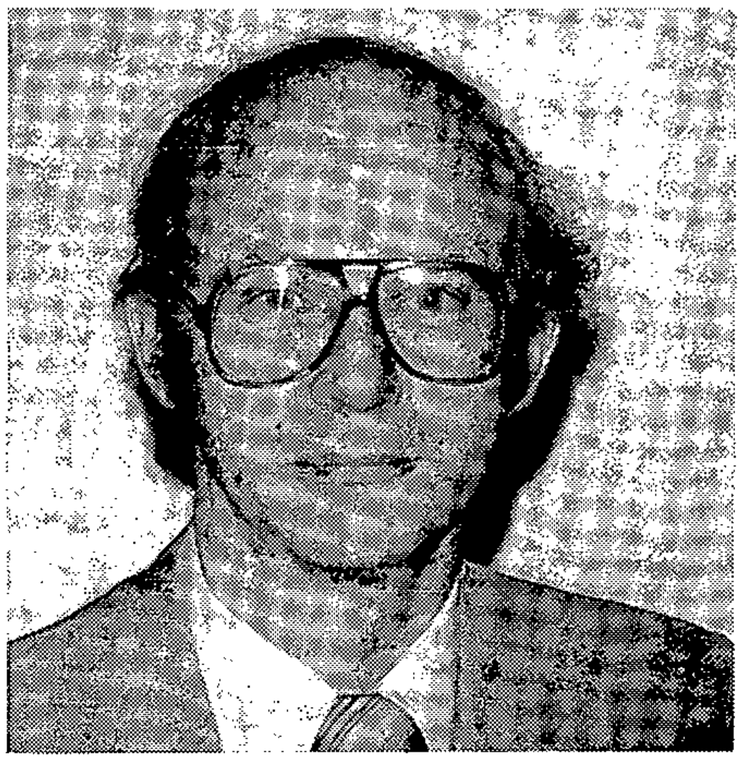

INTERNATIONAL:

Expenditures, Administration and Tax Reform in Developing Countries

Richard M. Bird*

Mr. Bird is Professor of Economics, University of Toronto, Toronto, Canada.

It may seem a bit peculiar to begin a discussion of tax reform with a discussion of expenditures. But just as it is meaningful to characterize the end of production as being consumption, so is it meaningful to characterize the end of taxation as being expenditures. The basic aim of taxes from an economic point of view is not to raise money to finance government expenditures, since governments can always simply print any money they need: it is rather to reduce inflationary pressure by taking money away from the private sector in as fair and efficient a fashion as possible. Nevertheless, most people clearly view taxes as intended to finance the expenditures of government – and they are, of course, right to do so.

How people feel about taxes to at least some extent reflects how they feel about expenditures. Governments which enjoy widespread popular support, and which most people think are doing a good job, are more able to depend on a certain degree of public acceptance of the need for taxation than are governments in countries in which the popular belief is that, as a Brazilian saying reputedly has it, "the country grows by night, while government sleeps" (Hirschman, 1963). When people are antagonistic to government, when they feel that it is wasting their money and not acting in their best interests, taxes are likely to be even more unpopular than usual.

This line of argument should not be misunderstood. I am not arguing that a good tax system is one in which there is a high degree of "voluntary compliance". Such voluntary compliance is largely a myth in any society. Even if every individual citizen fully supports all government actions and willingly accepts a resulting high tax level in principle, it is still so much in his individual interest to reduce his share of the total tax burden that he must be expected to take every reasonable measure to do so. Any effective tax system thus rests more upon taking money away from people before it gets into their hands – and scaring them into paying the balance – than it does on good will. Nonetheless, the boundaries of what is considered "reasonable" in terms of tax evasion in any society are very elastic, and how far these boundaries are stretched will depend at least in part upon how the government is perceived by its citizens.

A telling demonstration of this point may be found in the well-known study by Peacock and Wiseman (1967) of the growth of public expenditure in the United Kingdom. A central argument in this study is that the pattern of expenditure growth reflects changes in what the authors call the "tolerable" level of taxation. At any one time, the argument goes, there is an accepted level of taxation in any country which governs, within limits, the level of sustainable government expenditure. Only when this tolerable level of taxes is increased – as commonly happens in wartime, for example – can expenditure increase. After the war (or other emergency) passes, although the immediate need for military expenditures is clearly lessened, people are now accustomed to a higher level of taxation, and politicians and officials seldom have difficulty in finding sufficient good things on which to spend to prevent taxes from falling back to their pre-war level. The level of expenditure will thus, as a result of the "displacement" of taxes that occurred during the war, remain permanently higher than it would otherwise have been.

Similar studies for a number of other countries, including some developing countries, have subsequently demonstrated a similar linkage between tax and expenditure levels, to a greater or lesser degree. The once-popular view of the need for an expanded public sector development effort as in some sense morally equivalent to a "war" on poverty and economic backwardness may perhaps explain why so many analysts have found this so-called "displacement" hypothesis worthy of exploration in developing countries. While others (Bird, 1972) have been more sceptical of both the underlying argument and its empirical tests, it remains true that countries in which the role of the public sector in development is taken seriously have amply demonstrated their ability to raise taxation, and hence expenditure, to what were once considered wartime levels. A recent spectacular example is Nicaragua, in which a "State-minded" government raised the level of taxation from 10% to 40% of (a declining) GNP in only 6 years (Bird, 1985).

Tax *increase,* whether in Nicaragua or anywhere else, is of course not necessarily tax *reform,* in the sense of a change in tax structure that improves both its distributive and allocative effects. On the contrary, the evidence is overwhelming that in almost every developing country in which taxes have increased significantly the increased revenues have come not from the direct taxes on income, expenditure and wealth that have customarily been stressed by tax reformers but rather from a variety of indirect taxes on consumption – taxes which have equally conventionally been condemned as regressive and (in the forms they have generally taken in developing countries) inefficient. In Nicaragua, for example, virtually the entire increase in tax revenues was attributable to such indirect taxes.

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* I am grateful for comments from Carl Shoup and Amaresh Bagchi on an earlier version of this paper, although I alone am responsible for its contents.

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Those versed in the rhetoric and literature of tax reform sometimes seem to find this result hard to understand, perhaps particularly in countries like Nicaragua where simplistic Marxist explanations in terms of the interests of the ruling class are not readily applicable (Best, 1976). What the preponderance of indirect taxation demonstrates clearly, however, is the severe constraints imposed by administrative possibilities on the nature of tax reform in developing countries, as argued later in this article.

An important assumption underlying the widespread call for increased taxes in developing countries in the early postwar period (e.g. Kaldor, 1964; Lewis, 1966) was that increased taxation would result in the increased savings needed to finance the investment that was in turn needed to produce the desired rate of economic growth. Such calculations of the so-called "required" rate of taxation were at one time almost mandatory in developing countries and are still by no means uncommon. Nevertheless, even the first link in this chain of reasoning is highly questionable as was first pointed out in a prescient article by Stanley Please (1967). As Please observed, and as since has been evident in many countries, increases in tax revenues in developing countries have often been matched, or more than matched, by increases in current expenditures, with the result that there has been no corresponding increase in public sector saving. Empirical studies of this so-called "Please effect", like those of the displacement effect mentioned earlier, are by no means conclusive (e.g. Please, 1970; Heller, 1975; Chhibber, 1985). Nevertheless, there is enough evidence in enough countries to cast substantial doubt on the validity of the traditional chain of reasoning that development requires additional saving, that the public sector is the most efficient saver, and that increased taxation is the best way to secure the needed additional saving.

Indeed, this argument has been called into question on two such distinct grounds. The first is the "supply-side" concern (Ghandi, 1987) with the disincentive effect of taxes on private saving, a concern evident since at least to Bauer (1957). The second is, as just mentioned, the Please concern that increased taxes will be eaten up by increased current expenditure (often in the form of a higher public sector wage bill) and hence yield no increase in public savings. Of course, if *both* of these bad things happen, as has occurred at times in some countries (Jamaica in the 1970s is one instance that comes to mind), the result of increasing taxes might even be a net *decline* in savings, and hence perhaps a fall in the rate of economic growth. The Kaldor-Lewis vision of a world in which increased taxes fuel increased development is thus completely reversed in the Bauer-Please world, in which the opposite occurs.

Such an outcome is bad enough. But matters will clearly be much worse if the expenditure financed by the increased taxes is itself so structured as to do little good in developmental terms. Indeed, the evidence that in many countries much government expenditure is at best misguided and at worst almost a complete waste from the point of view of development seems even stronger than the evidence questioning the role of taxation as a means of generating public saving. Almost every developing country could, it appears, use substantial expenditure reform to accompany, support and perhaps even to some extent replace tax reform (Bird, 1984; World Bank, 1988).

Perhaps the most important conclusion emerging from the modern "positive" analysis of public expenditure policy is that the process by which such policies are made bears almost no resemblance to the model which still seems to be implicit in much development literature, namely, that expenditure decisions are made by a rationally calculating benevolent all-powerful dictator whose sole object in life is to improve the economic welfare of his citizens and who possesses the incredibly detailed knowledge that enables him to do so. The problem is not simply that the dictator is seldom that benevolent, although that too is true. The problem is more that even where there is a dictator, as there all too often is in developing countries, not only is his knowledge limited but so also is the span of his authority. Even the most absolute dictator's power is limited by his need to balance the interests of the conflicting groups that keep him in power. Such balancing acts are of course, if not necessarily more delicate, even more obvious in a democracy than in a dictatorship.

Political scientists sometimes define the two principal functions of government as delivering services and managing conflict. Traditionally, economists have considered only the first of these objectives. Those who study public expenditure cannot, however, neglect the reality of conflicting interests. Even the best-intentioned government can live up to its good intentions only if it is in power, and it can stay in power only if it can muster sufficient support. Some may support it because they agree with its intentions; others because they dislike its opponents even more. The evidence in all countries, however, is that some critically needed support will generally come from groups to whom, so to speak, government delivers the goods, often in terms of public expenditures favouring their interests – whether it be food subsidies to urban workers, irrigation projects in a particular region, new military equipment, or the subsidization of inefficient but employment-generating public enterprises.[1] Moreover, expenditure policy is implemented by a public bureaucracy which expects, and generally receives, its own substantial share of the public sector pie.

There is, it must be emphasized, nothing evil about this process. In the real world, unlike Utopia, things get done by rewarding those whose support and cooperation is needed to ensure that they get done. The result of this natural process, however, is that it is excessively naïve to expect that an extra dollar of tax revenue will necessarily provide an extra dollar of either public savings or benefit to whatever group or groups are the supposed target of public sector policy at any particular time. Either a substantial fraction of the dollar will go to other, perhaps also worthy (but undoubtedly powerful) groups, or well over a dollar in taxes will be needed to deliver the promised dollar's worth of services to the target group.[2] Increases in taxes that result in increased spending on education – or whatever – may perhaps provide additional education in the end, although this is far from certain in many countries. But what is certain is that such use of tax dollars will certainly provide more, and better-paid, jobs for teachers and those who staff the educational bureaucracy. Subsequent pleas for still more taxes to finance still more education may understandably be received with scepticism by taxpayers who perceive such results.

This is not the place to develop such arguments at length. The point is simply that at the present time in many developing countries it is probably more important to spend wisely than to tax more. Just as we are frequently told that the need

1. As pointed out in Bird and Horton (1989), the poor are not likely to be the most powerful interest group in this process – a reality which goes far to explain the commonly- noted failure of structural adjustment programs to protect the poor (Chhibber and Khalizadeh-Shirazi, 1988).
2. In addition, of course, the marginal cost of raising an extra dollar in taxes is usually considerably in excess of a dollar (Usher, 1986).

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to invest huge sums in new sources of energy can be reduced by much cheaper measures to curtail energy-inefficient activities, so the need for new taxes can be reduced by measures to curtail inefficient expenditure activities. Citizens in most countries seem to think that there are many such activities. They are probably right, even though, as has often been noted, they are seldom able to articulate clearly exactly where they think the money is wasted, and even if they always seem to be convinced that any particular expenditures that directly benefit them are fully justified.

The existing structure of expenditure (like that of taxation) in any country, is, in a sense, the necessary result of its economic and political structure. Drastic changes in either taxes or expenditures thus cannot be expected in the absence of similarly drastic changes in these underlying factors or in exogenous events which alter the relevant costs at the margin of spending (or taxing) in one way or another (Hettich and Winer, 1988). It may therefore seem to be hopelessly quixotic to call for a serious attempt to reform public expenditures in developing countries so as to get more development impact for each tax dollar.

Such a conclusion is too pessimistic, however. Reforms in budgetary processes, in expenditure analysis, management, control and appraisal systems are neither glamorous nor easy to accomplish. But experience in a number of countries shows that something can be done along those lines and that such changes can have some beneficial influence, at least at the margin (Premchand, 1983). Similarly, changes in transfer programs, whether to individuals or firms or sub-national governments, may, again with difficulty, be accomplished and may, over time, lead both to less need for more taxes to accomplish desired policy ends and perhaps even, if the result is to induce a little more faith that something useful will result, to less resistance to those increases that are necessary, as well as to somewhat greater accountability to citizens as to how the money is spent (Bird, forthcoming).

DIRECTIONS FOR TAX REFORM

Those concerned with promoting development in a fair and efficient way would thus seem well-advised to pay more attention to expenditure. Moreover, one key to meaningful tax reform may be precisely to link expenditures and revenues more explicitly than has usually either been done in practice or advocated in the tax reform literature.

This linkage is sometimes discussed, often disparagingly, under the label of "benefit taxation". The principle of benefit taxation – of levying taxes in accordance with the benefits received from the expenditures they finance – is of course an old one, with a rationale well-grounded in terms of both equity and efficiency (Bird, 1978). Few seem to realize, however, the extent to which this approach both can and should be applied in the modern world, particularly in developing countries which find it difficult both to raise taxes and to spend the proceeds efficiently.

One reason for this relative neglect of the virtues of the benefit tax approach may simply be that the virtues of the competing "ability to pay" approach to taxation seem so much more obvious in the context of countries in which inequalities are usually great, and sometimes growing. Nevertheless, in many countries the sorts of progressive taxes applied have been quite arbitrary in their impact and this impact has not been particularly progressive (Bird and De Wulf, 1973). Redistribution can be achieved through taxation only by taking from those who have, and they generally have, among other things, the power to block the effective implementation of such policies. Moreover, as emphasized already, there is little evidence that the money thus raised has been well spent.

Benefit taxes have in the past suffered from an unduly bad press, partly perhaps because there have been clear misuses of the principle of linking taxes and expenditures, partly because of the quite mistaken view that charging for public services is inherently regressive (if not positively evil), and partly because of the implicit comparison with some non-existent omniscient benevolent monarch busily equating at all margins and producing the optimal size and structure of public sector activities.

The distributive objection to charging for public services clearly has merit in principle with respect to an important range of explicitly redistributive public services, just as other public services cannot, even in principle, be charged for owing to their inherent "social good" character. Equally clearly, however, the distributive objection has little or no merit with respect to many public sector outlays. Even in fields such as education and health, for example, where the plea for the free provision of public services is commonly heard most loudly, study after study, including many in developing countries, has shown that the principal beneficiaries of such policies are precisely those groups in society that can best afford to pay (Bird and Horton, 1989). In part, this result no doubt emerges because of the distorted nature of the services provided – heart transplants instead of primary health care and so on. But more importantly, such studies show clearly the importance of access to public services as the key to who benefits. And if, as some evidence suggests, one result of providing services free is – perhaps paradoxically – to restrict the expansion of such services, and hence to limit access to them, the redistributive results of *not* charging may be exactly the opposite of those asserted by the proponents of this policy.

The precise outcome of public sector charging policies of course depends very much on the details of the particular expenditures and financing methods in question. Generalizations are thus suspect in this as in most areas of economic policy. Nevertheless, it seems safe to say that one place where more use needs to be made of benefit finance is with respect to the financing of urban public services. There is almost never a case for using scarce general public sector revenues to finance, for example, urban roads or water systems. Such infrastructure can and should be financed in one way or another primarily by the direct beneficiaries, a policy which, incidentally, has the additional benefit of redressing, at least marginally, the usual incentives to over-urbanization prevailing in most countries (Bird, 1984). Similar things happen in rural areas, of course, with respect to irrigation schemes and the like. The major problem with proposals for reform in this area is, as always, political; it is extremely hard to take away benefits once bestowed. Nevertheless, more can and should be done along these lines in most countries.

Of course, even a well-designed benefit tax system with good political backing needs to be administered properly to be effective. J.K. Galbraith (1965) once noted that if he were writing on economic development again, after further experience in developing countries, he would put much greater emphasis on the importance of economic administration. I agree fully. Indeed, neglect of the administrative factor has led to much of the futility evident in so many tax reforms in developing countries. There are some things governments just cannot do, or at least do well enough to

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be worth doing – and there are, inevitably, many more such things in a developing country.[3]

Tax administration in any country inevitably reflects to a large extent the nature of the country itself. If the country is a sea of corruption, as some are, the tax administration will not be an island of incorruptibles, and it is foolish to pretend it is. If most traders in the country are illiterate and keep no written records, no accounts-based tax (such as income or modern sales tax) can be levied on them, and it is not only futile but a mistake to pretend to be doing so. If land titles are in chaos in rural areas, no effective rural land tax can be levied. Moreover, if officials are judged solely by the taxes they produce and little else – as in some countries – they are likely to get those taxes from the politically weaker sectors of the population, regardless of what the law says. If the only way for an honest official to make a living wage is to travel a lot and claim travel allowances, he is forced to do so even if it is a complete waste of his time. If only the incompetent and untrained are left to deal directly with taxpayers – as in many administrations where advancement comes only in the form of being, so to speak, promoted to a desk job – then taxpayers will meet only the incompetent and untrained. Even competent honest and dedicated tax officials in most countries – and it is amazing how many of them there are, even in the most corrupt countries – can seldom do their jobs properly, for lack of adequate political support on the one hand and the minimal resources needed on the other.

All of these problems, and more, are common in different developing countries. What has not been properly understood, however, is their critical importance in altering both tax design and tax reform. Taxes must be designed so that they will work with a poor administration. Tax reforms, therefore, must not aim at producing a finely tuned masterpiece that will work wonders if properly implemented, but will fall apart or produce poor or perverse results if poorly administered, because such reforms will, in all likelihood, be poorly administered. It is critical to design taxes that are, so to speak, *robust* to poor administration (Bird, 1977). Highly progressive income taxes, refined taxes on personal expenditure and wealth, European-style value added taxes, elaborate taxes on the potential income of agricultural land – such clever ideas tend to come crashing to earth when put into place with the usual inadequate administration in poor countries. Moreover, since this is not only the way things are but how they are going to remain for some time, no reform proposals that simply presume, implicitly or explicitly, that administration will be improved mean anything. Indeed, too often, proposals for such "gadgets" have been seized upon as a sort of magic elixir to enable governments to solve this or that problem without tackling the hard task of introducing the sort of technically competent, honest and dedicated administration that such proposals usually assume already exists, or can readily be brought into being.

It is thus crucial that those proposing tax reforms understand thoroughly the existing administration and assess realistically the possibility of rapid improvement. The aim of reformers should be to design a tax reform that will "work", that is, produce better results than the present system with an administration of the calibre of that which now exists, and is likely to continue to persist in most developing countries. Complex proposals such as interlocking income expenditure and wealth taxes (Kaldor, 1956) or taxes on the presumptive income of agricultural land (Wald, 1959) should therefore be shunned. Such schemes have not worked, and they will not work, in the conditions of most developing countries. Too often tax designers have let themselves be led astray by the futile search for the perfect fiscal instrument, not realizing that the perfect is often the enemy of the good, in the sense of a roughly acceptable tax system – one that can be administered roughly and still produce acceptable results.

In the income tax field, for example, the key to success in many countries is likely to be a good withholding system supplemented by some sort of legally based presumptive assessment method on the hard-to-tax groups (Bird, 1983): both of these approaches work best if rates are not too high or steeply progressive. In the sales tax field, for some countries the best that can be done may be a physically-controlled excise system – most revenues come from alcohol, tobacco and fuel in any case – though obviously use of the value added principle is both feasible and desirable within limits in many developing countries. Small, open countries with little domestic production and relatively low tariffs on most items may, however, achieve much the same results by levying a uniform tariff on imports, while exercising due care to avoid fostering inefficient industrial development (Bird, 1989). As for wealth taxes, simple flat-rate taxes on urban and rural property, coupled with special assessments to finance urban public works, are probably about all that can be hoped for in all but the most advanced developing countries (Bird, 1974).

The "brave new world" of tax reform sketched in the previous paragraph may not sound either very brave or very new, but it is, alas, the world in which most developing countries live. Since he who would change the world must first understand it, starting from such a basis offers more prospect of attaining a genuinely fair, generally efficient, tax system than the finest academic dream of perfection.

CONCLUSION

The main conclusions about tax reform in developing countries emerging from this brief article are three. Firstly, since tax "reform" in such countries almost invariably means tax increase, it is critical that such reform be accompanied or perhaps even replaced by expenditure reform. Secondly, more attention should be paid to the benefit principle of finance, broadly conceived, both in the sense of charging for public services where feasible (and distributionally acceptable) and particularly in the sense of matching expenditure and tax responsibilities in at least the richer urban areas. And, thirdly, whatever tax changes are carried out should be "robust" in the sense that they will produce the desired results however poorly they are administered.

None of these recommendations is easy to implement. The first requires a detailed and painful examination of expenditure policy and management, and will undoubtedly encounter substantial political opposition from powerful beneficiaries. Much the same is true of the second, which in addition has to overcome the philosophical hang-ups of many concerning the free provision of "public" services. And the third requires both, again, a closely detailed examination of reality and, in all likelihood, the establishment of fairly modest "reform" goals. Indeed, in saying such things I feel rather like a vendor of second-hand clothes competing with salesmen who promise to produce new clothes out of nothing. The lure of the new – computerization, value added taxation, personal expenditure taxation, "supply-side" incentives, or whatever – is always great. I can only hope that at least some government will prove strong enough, and wise enough, to cease chasing after such fundamentally

3. The argument of the remainder of this section is more fully developed in Bird (forthcoming).

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non-existent panaceas to their fiscal problems and to begin paying adequate attention to such mundane but important concerns as those emphasized in this article.

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JAPAN:

MULTI-NATIONAL AND EXPATRIATE TAX PLANNING

Gregory Delany

For the non-Japanese, understanding the workings of the Japanese tax system and developing tax planning ideas is as mysterious and difficult as understanding other aspects of Japanese culture. As a U.S. tax practitioner assigned to work in the Ernst & Young tax office in Tokyo, I spent the past 5 years dealing with the challenges and complexities of understanding Japanese tax law. Although it may seem, at first blush, impractical to assign a U.S. practitioner to work in the tax field in Japan, since Japanese tax law is more or less modelled on the U.S. Internal Revenue Code, the law is somewhat more comprehensible to American practitioners than those from other foreign countries.

The currently existing Japanese self-assessment tax system is based largely on the work of Professor Carl S. Shoup, a visiting U.S. professor who led a mission in the late 1940s to review the Japanese tax system. Many of the recommendations submitted by this mission were included in the overall tax reform plan for Japan which was implemented in 1950. As an American professor, Professor Shoup naturally recommended many provisions that were in existing U.S. law at that time. The law was modified somewhat to take into account differences in Japanese business, culture, etc., but since the post-war economy was in a state of development, there was not a strong economic model to which to adapt these laws. As a result, the current corporate marginal tax rate of about 58% and individual marginal tax rate of 65% were mostly put into effect in an economy that no longer exists.

Unlike the United States where it seems to have become almost a practice to significantly modify the federal tax law every few years, in Japan there continues to be strong resistance to change. Thus, the tax law that was implemented in 1950 remains largely unchanged. Arguably, the first major change in Japanese tax law since that time is the recently enacted consumption tax which has received so much unfavorable public reaction in Japan in the past year. Thus, the Japanese have managed to continue using a tax system which was designed when the economy was entirely different from the modern economy in Japan. Although the Japanese are reluctant to implement major changes, there are significant pressures within the society today to change the tax structure to serve the economy that presently exists in Japan.

To provide a framework for discussing tax planning in Japan, it is important to consider some commonly held beliefs about the system of taxation in Japan, the approach of Japanese tax consultants and the relationship that exists between the taxpayer and the Government:

- Some Japanese tax consultants feel their responsibility to the Government is equal to or greater than their responsibility to clients when developing tax planning ideas. This is coupled with a general shortage of tax consultants in Japan who are conversant in Japanese tax law.
- Japanese tax law provides little in the way of specific allowances, credits, etc. which can be utilized to minimize corporate or individual taxes.
- Many Japanese business people are hesitant to implement tax planning ideas which may result in conflict with Government tax authorities because they stray into areas of interpretation with which the Government may disagree. This follows from the respect with which Government authorities are viewed as representatives of the State who should not be challenged.
- Japanese tax consultants seem to have developed more tax planning ideas related to outbound investment than to inbound investment because of the comparatively lenient rules related to taxability of offshore income.

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In many regulatory areas, including taxes, the Japanese Government tends to limit the amount of interpretive material provided. Some speculate this system exists to enable Government ministries to administer the law by issuing informal interpretations which can be modified to reflect the current position of the Government. As a result, tax planning depends as much on understanding the Government structure and determining the government's position on the particular issue as understanding the law itself. Since this situation is quite different than that existing in the United States where substantial information is available from Government pronouncements, court cases, etc., U.S. and other multinational companies often have great difficulty in understanding how to do business in Japan, how to deal with regulatory authorities, and, in particular, how to cope with Japanese tax laws. Some have asserted this system is one of the structural impediments to increased sales to Japan. Given the importance of administrative interpretations and the impact Government officials will have on the enforcement of the law, let us briefly review some of the cultural factors that may affect the personnel who become Government officials.

The Japanese education system is generally considered to encourage rote learning. The ability to memorize what is taught and repeat this information is considered to be a valuable skill. In addition, a very strong socialization process takes place in the Japanese education system, starting at an early age. The combination of these two factors, it is often speculated, has led to the significant amount of social conformity one senses on a visit to Japan. At the same time, these factors also tend to discourage individuals from putting forth new and creative ideas where such behavior causes the individual to stand out from the crowd. Thus, unlike another country where an individual may be willing to stand up and be different, it is very difficult to find individuals in Japan who are willing to face the social criticism they may receive if they express different views. This situation must be duly considered when dealing with Government officials and searching for creative tax advice in Japan.

During the past 5 years, as a lecturer at the Japan National Tax College, I worked each year with 20 students selected from among the senior auditors of the National Tax Administration to further develop their English language skills and their understanding of international taxation and accounting. This exposure allowed me to become familiar with the approach of and views taken by the National Tax Administration auditors. Although well educated and heavily experienced, the typical student will not present an opinion or position unless the student is pretty certain the position will be generally supported by the other students. How does this classroom behavior translate into the audit approach during a tax examination? One apparent effect is that Japanese tax auditors will typically narrow their investigations to those clarified by the tax authority and will generally not stray into other areas where there is no specific guidance. This audit approach may create some tax planning opportunities in unsettled areas of the tax law but mostly causes significant uncertainty for companies trying to adopt tax planning strategies in Japan.

The Japanese Tax Reform Bill of 1988 was passed after domestic pressure reached a critical stage because more and more groups complained the tax system did not conform to the modern needs of Japanese society. Some of the stated reasons for the tax reform were to provide a fairer apportioning of the tax burden among income levels and type of income; to reduce the tax rate to encourage economic activity; to broaden the tax base; to impose a consumption tax and so simplify the tax system. The tax reform as enacted did bring about a number of changes. It reduced the maximum individual national and local tax rate from 76% to 65%; eliminated excise taxes on luxury goods; imposed a 3% consumption tax; added a capital gains tax on sales of securities and somewhat lowered the tax rates. The reform also set the stage for future changes once the newly enacted laws became accepted. For example, increases in the consumption and capital gains tax rates should be more easily accomplished once the basic concept had become accepted. (However, subsequent political events would make it seem extremely difficult to increase these taxes in the foreseeable future.)

Japanese tax reform did not make a number of other fundamental changes which were expected. It did little to simplify the complex tax rules; it gave very little relief overall to the working-man; it introduced no significant changes to reduce what is considered to be widespread under-reporting of cash income; and it provided insignificant reductions in corporate tax rates, particularly for corporations which pay out their earnings in dividends. Finally, almost nothing was done which would alter the need or the basic approach to planning an effective strategy to minimize taxes in Japan.

In recent years the National Tax Authority (NTA) has undertaken a number of actions which reflect an increasing awareness of the importance of multinational transactions to the tax base in Japan as the Japanese economy continues to internationalize. As one example of recent actions, there have been a number of in-depth reviews of multinational industries, such as pharmaceutical and financial services, to identify issues and develop transfer pricing policies to capture the full amount of Japan-source income on multinational transactions. Increasingly, deductions for items such as management fees paid to non-resident parent companies and bonuses to non-resident directors have been disallowed. In addition, staffing has been increased in the Office of International Operation of the NTA in order to identify potential revenue sources from international transactions. In 1988 the first combined examination of a U.S. multinational corporation by the NTA and the U.S. Internal Revenue Service was conducted. Furthermore, increased emphasis on audits of foreign executives working in Japan has resulted in significant tax assessments and has accelerated the pace of departure of Japan-qualified expatriates. Combined with the excessively high tax rates in Japan, these executive audits have dramatically altered the business plans of U.S. companies in Japan.

Given the factors outlined above, what steps can a multinational company take? Some companies have decided not to have a physical presence in the market. In most cases, this has been an unsuccessful strategy. Chances of successfully conducting business in Japan without a presence are poor. On the other hand, establishing a presence without adequate consideration for tax planning can also undermine the success of the operation.

Since, in the area of corporate tax planning, there are very few tax incentives available, most tax planning involves reducing the income of the Japanese operation. Although there are numerous ways to reduce this income, most involve changes in business operations to reduce profits earned in Japan. In some cases, this can easily be done. In some cases, these profits can be sheltered by a treaty exemption. In some cases, this would entail foregoing the profits altogether – not a viable alternative unless such profits could also be earned in a lower tax jurisdiction. Absent these possibilities, there are several areas which should be reviewed: a careful analysis of transfer prices to ensure minimum profits are allocated to Japan; ensuring a charge

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to the Japanese operation for all costs incurred outside Japan which benefit the Japanese operation; arranging business transactions to minimize income earned in Japan; and charging maximum royalty rates for intangible assets used in Japan. In addition to these broad general ideas, it is prudent to review all Japanese charges to ensure the appropriate minimum amount of profits is earned in Japan.

Expatriates located in Japan have a different problem to contend with. Because of the very high individual tax rates and the high cost of living in Japan, tax reimbursement costs become a significant issue within a short period of time. Usually within about 5 years the amount of an individual's tax reimbursement is equal to or greater than his base salary. As a result, in order to keep costs within reason, companies generally find an expatriate assignment must be limited to a maximum period of 5 or 6 years.

Employers can minimize the amount of tax burden imposed on an expatriate by limiting the amount earned during the Japan assignment and taking-advantage of tax saving provisions available under Japanese tax law. For example, by restructuring compensation during the assignment to Japan and planning the compensation package to ensure favorable taxation of such benefits as employer-provided housing and home leave, the company can keep the tax reimbursement costs within reason during the first 7 or 8 years. Beyond this, no one has found a way to structure an expatriate assignment such that an individual can remain in Japan indefinitely. The need to transfer expatriates from Japan at an arbitrary date as a result of the high tax reimbursement costs continues to impose an impediment to the success of multinational businesses in Japan, since it often takes several years before an expatriate executive learns how to function within the Japanese culture and can truly contribute to his company's success in Japan.

In summary, there is more than a grain of truth to the comment that Japanese tax planning is more an art than a science. It is also clear that failure in the tax planning arena in Japan may ultimately result in failure to succeed in business in Japan. In order to deal with this challenge, multinational companies will continue to need to devote resources and attention to Japanese tax planning to properly manage their Japanese tax costs.

Conference Diary

JUNE 1990

Intercompany Pricing U.S.A./Europe: New Developments, Strategies and Planning. Paris, 18-19 June (English):
The American Tax Institute in Europe, S.A. 9 avenue Matignon, 75008 Paris, France.

Werken met de nieuwe deelnemingsvrijstelling. Amsterdam, 19 June (Dutch):
Kluwer Seminars, Postbus 23, 7400 GA Deventer, the Netherlands.

Planning through Transcontinental Trusts – The Fourth Annual Conference on the Use of Trusts and their Underlying Companies in International Planning. London, 25-26 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Taxation of Branches and Subsidiaries. Brussels, 25-26 June (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands.

Practical International Corporate Tax Planning. Cambridge, 28-29 June (English):
Karen Mellor, Members Services, Directorate, P.O. Box 433, Chartered Accountants' Hall, Moorgate Place, London EC2P 2 BJ, United Kingdom.

AUGUST 1990

44th Congress of the International Fiscal Association: I. Taxation of Cross-border Leasing; II. International mutual assistance and exchange of information. Seminars: 1. The Nordic multilateral tax treaty; 2. Double tax treaties between industrialized and developing countries, the OECD and U.S. models – a comparison; 3. The extension of tax sovereignty – especially in connection with emigration; 4. Tax reform in Scandinavia. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125, 3001 DE Rotterdam, The Netherlands.

SEPTEMBER 1990

Monte-Carlo Workshop: Entertainers and Athletes (inbound transactions); Taxation of international shipping. Monte-Carlo, 17-18 September (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

The Tax Effective Management of an International Treasury. London, 20-21 September (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

7th European Congress of Tax Consultants. Cannes (France), Lectures 27 September, working group 28 September (multilingual):
C.F.E. General Secretariat, Dechenstrasse 14, Postfach 1340, D-5300 Bonn 1 (G.F.R.).

OCTOBER 1990

International Conference on Computer and Law, organized by the Buenos Aires Bar Association and the French Association pour le Développement de l'Informatique juridique. Buenos Aires, 16-19 October (English, French, Spanish):
Secretaria del Congreso Internacional de Informatica y Derecho, Uruguay 485, piso 3°, 1015 Buenos Aires, Argentina.

International Taxation – Management Techniques: Transfer Pricing; Mergers and Acquisitions. Paris, 18-19 October (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

NOVEMBER 1990

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

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KOREA:

TAX REFORM: A RESPONSE TO ECONOMIC AND SOCIAL CHANGES

Janet Brooks*

INTRODUCTION

Pending reforms to the Korean tax system are aimed at equalizing the tax burden imposed on individual taxpayers and generating revenue to support the nation's growing needs. The reform proposals will have both a domestic and a foreign impact.[1]

TAXATION OF FINANCIAL ASSET INCOME

Real Name Financial Transactions

A "Real Name Financial Transaction" system was to be implemented in Korea in 1991 or 1992. However, actual implementation has been temporarily postponed. This system will require disclosure of the identity of the individual conducting financial transactions. Currently, financial activities, such as the purchase and sale of stock, receipt of bank interest, etc. can be accomplished without divulging the recipient's name.

With the introduction of a "real name" system, the tax authorities will be able to more accurately identify recipients of profits derived from passive sources, such as interest and dividends, stock transfers and real estate transactions.

In addition, it is anticipated that the types of income that are either non-taxable or that qualify for tax exemption or reduction will be decreased.

Consumption or "high wealth" tax

The Korean tax authorities are considering the possibility of imposing a consumption or "high wealth" tax on certain taxpayers whose standard of living clearly exceeds their reported income. An evaluation of similar types of taxes that are imposed in France ("Exterior Signs of Wealth"), Italy ("Standard of Living"), Japan ("Consumption") and West Germany ("Consumption") will be undertaken to determine whether a tax of this focus can be enforced in Korea.

TAXATION OF CAPITAL GAINS

Capital gain exclusions

Under existing Korean tax law, resident individuals are only taxed on the capital gains associated with assets specified by statute. The assets specified by statute are "real property assets", which include land, buildings and rights in real property.[2]

Excess land profit tax

The Korean Government is seriously concerned about evasion of tax on land sales and speculation. To discourage the purchase of land for speculation purposes only, an excessive land profit tax has been proposed. New legislation will impose a 50% tax on the increase in the value of real estate, regardless of whether the property has been transferred or sold.

In conjunction with the excess land profit tax, the types of real estate that currently qualify for tax exemption or reduction from capital gains tax will be decreased. The existing capital gains exemption applies to the following:

- income arising from the transfer of land and/or buildings located in an urban redevelopment district;
- income arising from the transfer of land to the Korean Land Development Corporation, Korean National Housing Corporation or other governmental/public body;
- income arising from the transfer of land between cooperatives governed by the Agricultural or Fisheries Cooperatives; and
- income arising from the transfer of land for public projects.[3]

In addition, in the event raw land is sold and within 6 years the purchaser builds a structure on the land, the seller is entitled to a 40-80% reduction in capital gains tax.[4]

As of 1 August 1989 individuals who sell real property may calculate capital gain by using the tax assessment valuation as the sales price for tax purposes, provided they can prove they did not have speculative intent. Typically, tax assessment valuations are substantially less than the sales price paid for the property, resulting in significant tax savings for the seller.

TAX RATE STRUCTURE

Korean income tax is levied on taxable income at graduated rates, ranging from 5% to 50% for individuals, and 20% to 33% for corporations.[5] A defense surtax is assessed at the rate of 10% or 20% of the income tax, and a resident surtax is assessed at 7.5% of the income tax.

The Ministry of Finance is contemplating following the international trend by decreasing the existing 8 individual income tax brackets (prior to the tax reform enacted on 1 January 1989, the Korean individual tax system had 16 income brackets).

CORPORATE TAX PROVISIONS

The present Korean tax system does not provide for consolidated tax reporting. Regardless of affiliations, each Korean corporation reports its taxable income separately.

To counter manipulation of tax-deductible expenses among affiliated entities, consolidated tax reporting will be implemented for certain expenses, such as entertainment expenses and contributions.

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* International Tax Manager, Price Waterhouse.

1. Information of the proposed tax reform measures is derived from the "Basic Direction in Operation of System of Law", a policy statement issued by the Korean Ministry of Finance, dated September 1989 (issued in Korean).
2. Corporation Tax Law – Enforcement Decree (hereinafter CTL-ED), Art. 124-3; Income Tax Law (hereinafter ITL), Art. 23.
3. Tax Exemption and Reduction Control Law (hereinafter TERCL), Arts. 57-61.
4. TERCL, Art. 63.
5. ITL, Art. 70.

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"Entertainment expenses" for tax purposes are currently defined as entertainment expenses, confidential business expenses and other gratuities.[6] Entertainment expenses are tax-deductible to the extent they do not exceed the sum of 6 million won per year; 2% (annually) of monthly average paid-in capital; and 1/10 of 1% of annual revenue.[7] Confidential business expenses, i.e. expenditures for which no receipts or records need be maintained, are tax-deductible to the extent they do not exceed the sum of 1% of average paid-in capital per year plus 0.5% of annual revenue.[8]

Due to the vagaries in the definition and record-keeping requirements of entertainment expenses, these expenses are susceptible to abuse. It is proposed that the scope and definition of the types of expenditures that qualify for tax deductions will be reviewed and more strictly defined.

FOREIGN INVESTMENT INCENTIVES

Korean tax law provides some very favorable incentives for foreign investment to encourage foreigners to infuse capital into Korea and provide employment opportunities for Korean inhabitants.

Some of these tax incentives have been enacted to counter the difficulties faced by foreigners in establishing business activities in Korea.

As the Korean Government eases the restrictions on foreigners in entering the domestic market, such as allowing the establishment of wholly-owned subsidiaries, they are proposing to retract many of the tax incentives formerly available.

Qualifying foreign investment

The present tax laws encourage certain foreign investment by providing an exclusion from income, corporate, acquisition and property taxes for a period of 5 years.[9] To qualify for these tax incentives, the foreign investment must fall within one of 3 statutory classifications: the transfer of advanced technology, investments in small and medium-sized enterprises, and projects that positively impact the international balance of payments.[10]

Tax reform proposals would abolish most types of incentives available to foreigners, with the exception of investment in advanced technology (effective 1 January 1990).

Investments in high technology

Under the existing Foreign Capital Inducement Laws, foreign investment in advanced technology projects qualifies for tax benefits not available to domestic companies.

For example, foreign nationals working under an approved technical assistance agreement are exempt from individual income tax for 5 years.[11] An investment tax credit is allowed in the amount of 3% of the value of investments in new assets (10% if the equipment was manufactured in Korea).[12] A depreciation deduction of 30% of the price of new assets is also available (50% if the assets are manufactured in Korea).[13]

These types of tax incentives would be reduced, with the result that the incentives available to foreigners would mirror those currently available to domestic enterprises engaged in developing technology.

Investments in small and medium-sized enterprises

Foreign investment in small and medium-sized enterprises qualify for certain tax-favored treatment in Korea.

Although varying among industries, a small enterprise is typically characterized by having 200 to 1,000 employees, and 8 to 30 billion won in assets.[14] Wholesale and retail businesses will qualify as small enterprises if they have a maximum of 20 employees.[15]

The types of tax incentives available to small enterprises include a special depreciation deduction in addition to the regular depreciation taken.[16] A tax deduction for certain start-up reserves may also be available.[17]

Small and medium-sized high technology manufacturing companies that are incorporated after 1 January 1990 and are located in certain metropolitan areas will be allowed a 50% tax exemption for the first 4 years of operation. A 30% tax exemption will be available for the subsequent 2 years.[18]

EXPIRATION OF DEFENSE SURTAX

The defense surtax is levied on both the individual and corporation income tax. The surtax is assessed at 10% or 20% of the individual income tax, and 20% or 25% of the corporation tax.[19]

Scheduled to expire on 31 December 1990, it is anticipated that the revenue lost from the defense tax will be absorbed by the reduction in tax exemptions and the increases in taxation of financial asset income.

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6. CTL, Art. 18-2(2).
7. CTL, Art. 18-2.
8. CTL-ED, Art. 44-2(1).
9. TERCL, Arts. 19, 20, 85 and 85-2; Foreign Capital Inducement Law-Enforcement Decree (hereinafter FCIL-ED), Art. 13.
10. FCIL-ED, Art. 13.
11. ITL, Art. 6.
12. TERCL, Art. 18; TERCL-ED, Art. 15.
13. Ibid.
14. TERCL-ED, Art. 11(1).
15. Id.
16. TERCL, Art. 14.
17. TERCL, Art. 13.
18. TERCL, Art. 15, Para. 2.
19. Defense Tax Act.

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SINGAPORE:

1990: Celebration Budget for a Maturing Nation

Lee Fook Hong, MBA, FCIS, FAIA

I. INTRODUCTION

On 2 March 1990, the Minister for Finance, Dr. Richard Hu presented Singapore's 1990 Budget to Parliament. The 1990 Budget statement was divided into 3 parts:

Part I : Review of the economy
Part II : The financial year 1990 Budget
Part III: Revenue and tax changes

In his review of the economy, the Minister dealt with the economic performance in 1989, the management of economic growth and the outlook for 1990. The Singapore economy would be expected to grow in 1990 at between 6 to 8%, above the long-term sustainable rate, but less quickly than in 1989.

In Part II, the Minister presented the FY90 Budget. On fiscal policy objectives, the Minister stated that although the objective was to achieve a balanced budget over the long term, given the limitations of Singapore's natural resources and the heavy dependence on external trade, the aim must be to augment the reserves with surpluses from good years so that Singapore would have the financial strength to see through periodic downturns in the international business cycle.

In Part III, the Minister explained the Government's revenue position and the proposed tax changes for the financial year 1990.[1]

II. TAX CHANGES

A. Tax on companies

1. Company income tax

The rate of corporate tax was reduced from 33 to 32% in 1989. In 1990, the corporate tax rate will be reduced by an additional 1%, i.e. from 32 to 31%.

The move to reduce the corporate tax rate is to ensure that Singapore tax rates remain competitive worldwide. As the 31% tax rate will take effect from year of assessment 1991, any dividends paid on or after 1 January 1990 would carry a tax credit of 31%. (Consequent upon this reduction, it is expected that the current withholding tax rate of 32% in respect of payments to non-residents, including non-resident directors' fees, will be reduced to 31%.)

2. Stamp duty for share transactions

The Stock Exchange of Singapore will commence scriptless trading on its Main Board from April 1990. To keep the Singapore stock market competitive, stamp duty on electronically made transfers will not be subject to stamp duty in order to lower the costs of transacting securities on the scriptless system.

Transactions on the scriptless trading system will be subject only to the existing stamp duty on contract notes of $ 1 per $ 1,000 or part thereof of the stock or shares transacted.

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4. Relief for the foreign maid levy
5. Deduction for CPF contributions of self-employed persons
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1. All changes are effective from the year of assessment 1991 unless otherwise noted.

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3. Treasury and Finance Centre (FTC) Incentive

To encourage multinational companies to set up and expand their operations in Singapore, a tax incentive will be granted for the establishment of finance and treasury centres in Singapore. This incentive will spur such institutions to perform treasury and financing and other financial services for their own account and for companies in their group. Income accruing to such centres from trading in foreign exchange, offshore investments and provision of financial services to related companies will be taxed at a concessionary rate of 10%.

4. Approved International Trader (AIT) Incentive Scheme

Under the Approved Oil Trader Scheme, introduced in 1989, traders are granted a concessionary tax of 10% on approved offshore oil trading activities. To develop Singapore as a global entrepot and to promote international trading of other major commodities in Singapore, the 10% concessionary tax rate will be granted to approved international trading companies, trading in approved commodities. Approved commodities will include rubber, timber, edible oils, coffee, cocoa, metals and minerals and bulk chemicals. This scheme will essentially be similar to the Approved Oil Trader Incentive and will be administered by the Trade Development Board in consultation with the Revenue Division of the Ministry of Finance and the Inland Revenue Department.

5. Tax guidelines on financial leasing and incentive for offshore leasing

In 1982 tax guidelines were proposed to regulate the tax treatment of financial leasing transactions. Such guidelines will be simplified and the criteria for determining whether a leasing contract will be treated as a genuine lease agreement for tax purposes will be relaxed.

To prevent financial leasing transactions from being used as a tax shelter, capital allowances for leased assets will not be allowed to be deducted against non-leasing income of the lessor. This scheme will apply to assets leased under lease agreements made on or after 1 April 1990. This restriction on the capital allowance deduction will not apply to operating leases, such as the hiring of vehicles (see Chart I below for the revised guidelines).

Following the revision of the leasing guidelines, offshore leasing activities should be encouraged by taxing income from offshore leasing at a concessionary rate of 10% to be in line with the existing incentives for promoting offshore financial services. However, capital allowances for assets leased overseas will only be allowed to be deducted against the offshore leasing income.

6. Extension of Offshore General Insurance Incentive

Currently, underwriting profits from insuring offshore general risks and the interest and dividends from investing such profits are taxed at a concessionary tax rate of 10%. To promote further growth, the concessionary tax rate of 10% is extended to cover dividends to broaden the capital base of insurance companies. A concessionary tax rate of 10% will apply to interest and dividends from investing the whole of the shareholders' funds which are used to support the offshore insurance business.

However, to prevent the Singapore tax base from being eroded, Singapore dividends and interest from investing the shareholders' funds and the offshore insurance fund, apart from interest from ACU deposits, will be excluded from the tax concessions.

7. Offshore Life Insurance Incentive

To promote the offshore insurance business, tax concessions similar to those granted to the offshore general insurance business will be extended to the offshore life insurance business.

A concessionary tax rate of 10% will therefore apply to interest and dividends from investing the offshore life insurance fund and the shareholders' funds supporting the

CHART I

TAXATION GUIDELINES FOR FINANCIAL LEASING

1. A lease agreement shall be treated as a sale agreement if:
   (a) the lessee is in effect given an option to purchase the leased asset during the lease term or at its expiry;
   (b) the leased asset is a "limited use" property;
   (c) the leased asset in a sale and lease-back transaction has been previously used by the lessee or any other person; or
   (d) the lessor and lessee are related persons and
      (i) the lessee or any other related person lends to the lessor any of the funds necessary to acquire the leased asset or guarantees any debt of the lessor incurred in connection with the lease;
      (ii) the terms of the lease are not determined on an arm's length basis; or
      (iii) the total value of such leases of the lessor in any year exceeds 50% of the total value of all leases entered into by him for the same year.

   Provided that any leveraged lease agreement shall be subject to a case by case evaluation to determine if it is to be treated as a sale agreement.

2. In determining the income of a lessor from such leasing transactions
   (a) any sale of the leased asset by the lessor, whether during the lease period or at its expiry must be at the open-market value. Where the price is below open-market value, the Comptroller shall substitute the price with the open-market value;
   (b) the lease rentals charged must be market rentals. Where the rentals charged are other than market rentals, the Comptroller shall substitute the rentals with market rentals; and
   (c) the capital allowances on the leased assets shall be deductible only against the lease rentals from such assets. Excess capital allowances may be carried forward to subsequent years, subject to the conditions in the Income Tax Act, to be deducted against rentals from such leased assets.

3. Definitions

   "limited use" property means any property
   (a) for which there is no alternative user;
   (b) where it is not commercially feasible for the lessor to lease the property to an alternative user; or
   (c) where the costs of dismantling and re-assembling the property are so high as to render a secondary lease not viable or improbable.

   "related persons" means persons where one has the ability to control the other or exercises significant influence over the other in making financial and operating decisions.

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CHART II

SUMMARY OF TAX CHANGES

A. COMPANY TAXATION

1. Company income tax
   – Down one point to 31% (w.e.f. Y/A 1991)
2. Stamp duty
   – No stamp duty on shares transferred electronically (w.e.f. April 1990)
3. Incentives for:
   a. International trading in major non-oil commodities
   – 10% tax rate for trading in rubber, timber, edible oil, coffee, cocoa, metals and minerals, bulk commodities (w.e.f. Y/A 1991)
   b. MNCs to set up finance and treasury centres (FTC) in Singapore
   – 10% tax rate for FTCs' income from foreign exchange trading, offshore investments, provision of financial services to related companies (w.e.f. Y/A 1991)
   c. Offshore leasing activities
   – 10% rate for income from offshore leasing (w.e.f. Y/A 1991)
   d. Offshore general insurance business
   – 10% rate on interest and dividends from investing all of shareholders' funds used to support offshore insurance business. However, Singapore dividends and interest from investing of shareholders' funds and offshore insurance fund, apart from ACU deposits interest will be excluded from the tax concession (w.e.f. Y/A 1991)
   e. Offshore life insurance business
   – incentive similar to that for offshore general insurance business (w.e.f. Y/A 1991)
4. Post-pioneer incentive
   – Extension of post-pioneer status by 5 to 10 years (w.e.f. Y/A 1991)
5. Operational Headquarters (OHQ) incentive
   – Extension of OHQ incentive to income from trading in foreign exchange and offshore investments on own account (w.e.f. Y/A 1991)
6. Financial leasing transactions
   – Relaxation of tax treatment of financial leasing transactions – guidelines simplified (w.e.f. 1.4.90)

II. PERSONAL TAXATION

1. Across-the-board once-off rebate of 5% on personal income tax (w.e.f. Y/A 1990)
2. Special tax rebates for families that have their second child earlier

Mother's age	Special tax rebate for newborn second child
under 31	$ 5,000
under 30	$ 10,000
under 29	$ 15,000
under 28	$ 20,000

Rebate is granted to second child born on or after 1.1.90.

Available for set-off against either or both parents' tax liabilities – up to a maximum period of 7 years.

3. Increased tax relief for care of aged and handicapped dependants from $ 2,500 to $ 3,500 (w.e.f. Y/A 1991)
4. Foreign maid levy relief extended to divorcees and widows with children (w.e.f. Y/A 1991)
5. Higher limit of tax deduction for CPF contributions by self-employed to 15% of assessable income subject to a limit of $ 10,800 per year (w.e.f. Y/A 1991)
6. Concessionary property tax rate of 4% extended to HDB owner-occupied flats (w.e.f. 1.7.90)

   Only $ 10 stamp duty on transfers of HDB flats within a family (w.e.f. 1.4.90)

III. OTHERS

1. No change to duties on liquor, tobacco and cigarettes and petrol
2. No consumption tax. Legislation may be introduced in 1990 but implementation may be delayed for some years.

offshore life insurance business. Singapore dividends and interest, apart from interest from ACU deposits, will similarly not qualify for the tax concessions.

8. Extension of Post-Pioneer Incentive

A Post-Pioneer Incentive was announced in the 1986 Budget Speech. This incentive provides for a concessionary tax rate of as low as 10% for companies undertaking approved activities and is granted for a period of up to 5 years.

The Minister has now proposed to extend the post-pioneer period by 5 years, i.e. a company can enjoy the concession for up to 10 years. This concession is designed to encourage pioneer companies to continue upgrading their operations in Singapore.

9. Extension of the Operational Headquarters (OHQ) Incentive

The Operational Headquarters Incentive scheme was first introduced in 1986 to attract multinational companies to set up their headquarters in Singapore to service the needs of their subsidiaries and related companies in the region.

With the growth and expansion of investments and trading opportunities, OHQs are increasingly called upon to provide finance and treasury services to their related companies. In providing such services, they may also derive income from trading in foreign exchange and offshore investments, on their own account. The OHQ incentive is extended to cover such income which will now qualify for the 10% concessionary tax rate.

B. Tax on individuals

1. Personal income tax

The Minister is satisfied that the existing personal income tax rates are fair and equitable and that there is no immediate need to alter the tax schedule. However, to reward effort and enterprise, he has proposed to give an across-the-board one-off rebate of 5% on personal income tax.

2. Procreation incentives

(a) Special tax rebate for second child born on or after 1 January 1990

To encourage families to have their second child earlier, the Minister proposed a special tax rebate as follows:
Families with the second child delivered before the mother reaches

	Tax rebate
(i) 31 years of age	$ 5,000
(ii) 30 years of age	$ 10,000
(iii) 29 years of age	$ 15,000
(iv) 28 years of age	$ 20,000

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The rebate can be used to set off against either or both of the parents income tax liabilities but must be utilised within a period of 7 years.

(b) Existing rebates of $ 20,000 for third and fourth child – period extended to 7 years

Regarding the existing rebates of $ 20,000 for new born third and fourth children and the additional rebate of 15% of the mother's earned income for the third and fourth children, the Minister proposed to extend the period within which each of the rebates can be utilised from 5 years to 7 years. The cumulative period within which the 3 rebates can be claimed will be 21 years.

3. Relief for aged parents and handicapped dependants

To further encourage families to care for their aged and handicapped dependants, the Minister proposed to increase the relief for both the aged and the handicapped dependants from $ 2,500 to $ 3,500.

4. Relief for the foreign maid levy

In 1989, the Minister for Labour announced that tax relief for the foreign maid levy would be given to married women to encourage them to continue working and raise families. The Minister has now proposed to extend this relief to divorced women and widows with children. The relief will be a sum equal to twice the annual levy paid in respect of one foreign maid.

5. Deduction for Central Provident Fund (CPF) contributions of self-employed persons

Currently, self-employed persons who make voluntary contributions to the CPF, including payments to Medisave, are allowed to deduct such contributions from their assessable income. The deduction is limited to 10% of the assessable income from self-employment, subject to a maximum of $ 7,200 per year. To encourage self-employed persons save more to provide for their own needs when they retire, the Minister has proposed to raise the limit for such deductions to 15% of the assessable income from self-employment, subject to a maximum of $ 10,800 per year.

6. Property tax on Housing Development Board (HDB) residential flats

In 1989 the Minister announced that the property tax rate of 23% will be reduced to 16% of annual value with effect from 1 July 1990. However, for non-HDB owner-occupied residential properties, a concessionary property tax rate of 4% of annual value will be levied. The Minister has now proposed to extend the same concessionary property tax rate of 4% of annual value to HDB owner-occupied residential properties.[2]

7. Stamp duty on transfer of HDB flats

The cost of buying and selling HDB properties was reduced from 1989 when the stamp duty on property transactions was reduced. The Minister has proposed to grant a further concession for transfers of HDB flats within a family by remitting the stamp duty in excess of $ 10 payable on any instrument executed in respect of such transfer. To obtain this concession, the transfer must not be for the purpose of profit and at least one of the original lessees must remain a lessee. This concession will be administered by the HDB.[3]

C. Other taxes

The Minister proposed no changes to the duties on liquor, tobacco and cigarettes or petrol.

III. CONCLUSION

In conclusion, the Minister emphasised that Singapore's objective was to strive for high growth, and the tax incentives proposed were aimed at promoting high value-added activities and offshore service to exploit Singapore's advantageous location, excellent infrastructure and first rate workers. He is confident that the momentum of progress can be maintained. Finally he added that, provided Singapore continues to match her competitiveness, she would within the next decade achieve developed country status.

While Hong Kong unveiled a sober budget with no big give-aways, most businessmen, unionists and families regard Singapore's budget as a celebration budget.

2. This change is effective from 1 July 1990.
3. This change is effective from 1 April 1990.

CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

We welcome the submission of articles which are of interest to tax professionals, executives and scholars to be considered for publication. The author should ensure that the significance of the contribution will also be apparent to an international readership.

The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

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INDIA:

Theoretical and Practical Aspects of Capital Gains Tax

Dr. M.M. Sury

THEORETICAL ISSUES

General

The treatment of capital gains is a major controversial issue in determining the scope of income for tax purposes. These gains arise from the sale of assets other than those held in the ordinary conduct of a business.[1] I will first discuss the justification of taxing capital gains and then analyse the problems associated with their taxation.

In terms of the "accretion principle"[2], capital gains should be treated as part of income. Their taxation is justified both on equity and efficiency grounds. From the equity angle, inclusion of capital gains in the income tax base is required because capital gains represent, like other sources of income, net accretion to spending power. The case for taxation of capital gains is further strengthened because they accrue unevenly among the population (i.e. wealth is unevenly distributed). On the efficiency ground, the taxation of capital gains discourages speculative activities and investment in unproductive assets (like gold, paintings, antiques, etc.).

It is sometimes argued that capital gains are unexpected and unsought, and therefore should not form part of taxable income. However, as Professor James Cutt has observed: "Even acceptance of the fact that a proportion of capital gains represent windfall or unexpected elements in no way diminishes the increase in satisfaction or increase in spending power derived from their acquisition. It is also far from certain that a substantial proportion of capital gains represent unintended, fortuitous receipts. Capital gains differ only in degree from other forms of income and are often deliberately sought".[3]

The proponents of tax exemption for capital gains contend that gains resulting from inflation are illusory as they do not represent a real increase in the taxpayer's spending power. Taxes on capital gains which merely compensate for the rise in price level are more in the nature of taxes on wealth than on increments in the value of wealth. No doubt an inflation-proof tax system is more certain and equitable in an inflationary economy but this is an ideal situation for all sources of income and not only for capital gains. Pragmatically, the solution lies in the revision of exemptions and allowances in light of inflation rates. Moreover, it is not unreasonable to assume that real estate prices during inflation move upward more quickly than the general index of prices.

The "adjustment for inflation" argument in the context of capital gains has 2 sides and both deserve consideration. To compensate for the inflationary rise in the value of an asset it might be suggested to increase the acquisition cost by the rate of inflation in the period between acquisition and realisation. However, looking at the other side of the argument, taxation of capital gains only on realization enables the taxpayer to postpone his tax liability until the date of realization and thus confers on him an interest earning advantage. In the words of the Meade Committee:

"The benefit of deferral is a loan free of interest of an amount equal to the tax liability on accrued gains. Thus suppose that a gain of £ 100 accrues in 1975 and is realised in 1977. With a rate of tax of 30%, £ 30 in tax is paid on a realisation basis in 1977 instead of in 1975. The taxpayer has kept the £ 30 for 2 years free of interest. If the tax paid in 1977 is to reflect this fact, then the £ 30 should be grossed up at compound interest for 2 years. To achieve this result it would be necessary to mark up the deferred tax liability by an interest rate factor. This process can be contrasted with the allowance for inflation, where it is necessary to mark up the acquisition cost by an inflation factor".[4]

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1. For example, gains derived from the sale of a house by the homeowner are capital gains while gains on the disposal of houses held by a real estate dealer are ordinary gains of business.
2. According to the widely accepted "accretion principle" (attributed to Robert Haig and Henry Simons), income is defined as the net accretion to economic power between 2 periods of time, or what accrues to an individual over a period of time as measured by the amount of his spending plus net accretion to his wealth. Stated comprehensively, this definition of income takes into account cash income (for example, wages, interest received or dividends), imputed income such as imputed rent from owner-occupied houses and accrued income like interest credited (instead of paid) and appreciation in the value of assets which continue to be held. For an interesting comparison of Haig-Simons and Irving Fisher's approaches to the concept of income, see J. Richard Aronson, *Public Finance* (New York: McGraw-Hill Book Company 1985) at 335-343.
3. James Cutt, *Taxation and Economic Development in India* (Delhi: Vikas Publications, 1969) at 115.
4. The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation:* Report of a Committee chaired by Professor J.E. Meade (London: George Allen and Unwin 1978) at 132.

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The Meade Committee devised a formula for reducing the tax burden according to an inflation factor and increasing it by an interest factor.[5] Apparently, the net effect will depend upon the rate of inflation and the interest rate assumed.

It is also argued that taxation of capital gains discourages the transfer of assets and therefore restricts the mobility of capital. Since transfers occasion a tax, investments remain tied up in their present form. This argument is untenable because most transfers are speculative in nature and cancel out at the national level, and are not related to issues in economic development. It is investment in new equity which is more relevant for the growth rate. In short, there exists a case for taxing capital gains.

The next issue pertains to the taxation of unrealized capital gains. The various arguments for and against the taxation of unrealised capital gains are best summarized by Musgrave:[6]

For	Against
1. Absence of consumption is not relevant in defining the base of an income tax.	Unrealised gains should not be taxed because the owner has refrained from consumption.
2. Measurement of unrealised gains may be difficult but this is not an insuperable obstacle.	Unrealised gains should not be taxed because in the absence of realisation we do not know whether they really exist.
3. As would be necessary with other debts that may become due, it is not unreasonable to ask the taxpayer to liquidate a part of his or her assets to make the tax payment if needed.	Taxation of unrealised gains requires the owner to pay a tax even though he or she has not obtained cash with which to pay it.
4. Separation is a matter of investment choice, whereas income accrues when the asset value is increased.	For income to be received it must be "separated" from the asset.

Strictly speaking, unrealised capital gains are part of accretion (to wealth) and should be included in the definition of income for tax purposes.[7] In spite of the foregoing theoretical justification for taxing unrealised capital gains, practical considerations make it difficult to incorporate them in tax laws. For example, capital assets would need to be valued each year, thus imposing a considerable administrative burden. It is, of course, relatively easy to estimate accrued capital gains each year for some assets (e.g. regularly quoted ordinary shares) but for most other assets it would be a Herculean task. Therefore, tax laws invariably exempt unrealised gains and bring only realised capital gains under the purview of taxation.

There is obviously less controversy regarding the taxation of realised capital gains. However, a selective approach is needed because it is neither feasible nor practical to tax the capital appreciation of all sundry assets. It would be unwise to ask taxpayers to report the capital gains on their washing machine, dressing-table, cooking range or hairdryer. Generally, the scope of realised capital gains for tax purposes is restricted to investment property (e.g. stock, real estate, etc.). Even these assets pose serious problems because valuation is required both when an asset is purchased and when it is sold. While the valuation of shares quoted on the stock exchange presents no problem, the valuation of other assets is not so straightforward. Clearly, the valuation problem is one which the tax administration cannot avoid.

I introduce at this stage the distinction between short-term and long-term capital gains. Gains derived from the sale of assets held for less than a specified period are short-term while gains derived from the sale of assets held longer than that period may be treated as long-term. For example, in India capital gain which results from the disposal of a capital asset within a period of 36 months from the date of its acquisition is treated as short-term. Any capital gain which is not short-term is treated as long-term capital gain and enjoys concessionary tax treatment.

Is preferential treatment of long-term capital gains justified? One argument in favour of such preferential treatment is that capital gains are irregular and therefore tend to suffer under a system using a progressive tax schedule. In other words, preferential treatment compensates for the absence of income-averaging provisions in the tax laws. Juxtaposed against this disadvantage are certain advantages which are available to income only in the form of capital gains. As already noted, there is an interest earning advantage for deferred tax payment on capital gains. Moreover, tax liability can be postponed indefinitely by not realising capital gains. If gains are allowed to accumulate in this manner, they will ultimately be transferred in the form of gifts or bequests to other persons. To deal with such eventualities, gift and estate taxes provide the second line of defence. However, gift and estate taxes are neither regular nor effective components of the tax structure in most countries. These taxes, which apply to value rather than a change in the value of property, are subject to a wide range of exemptions and therefore form a small proportion of total tax revenue even in the most developed countries.[8] Some countries do not even have gift estate taxes; other countries have abolished such taxes after unsuccessful experiments.[9]

As a proxy for income averaging provisions, tax systems commonly provide for set-off and carry-forward of capital losses. In view of these safeguards, the concessionary tax treatment of capital gains is unjustified. Such preferential treatment provides a strong incentive (particularly at a high bracket rate) to receive income in the form of capital gains rather than, say, business profits; such a tendency is not conducive to positive entrepreneurship in the economy.

NATURE AND SCOPE

Following the recommendations of Professor Nichlos Kaldor, a British economist, a capital gains tax was introduced in India in 1956. It is levied within the framework of the income tax system.

The Indian Income Tax Act, 1961, prescribes 5 broad heads under which the income of an assessee is classified for pur-

5. For this formula of adjustment, see *ibid.* at 133.
6. R.A. Musgrave and P.B. Musgrave, *Public Finance in Theory and Practice* (New York: McGraw-Hill Book Company, 1985) at 338-39.
7. In the long run, the distinction between unrealised and realised capital gains is not important because unrealised gain is realised at one time or another during the life of an individual or at the time of his death. Because the sums of unrealised and realised gains equal, the lifetime tax obligation of an individual is said to remain the same provided there are no significant changes in the rate structure.
8. For example, the relative share of taxes on property (OECD Code 4000) was as low as 1.7% of total taxation in New Zealand, and 1.9% in Belgium and Portugal in 1986. The average for the EEC countries was 4.3% for the same year. See: OECD, *Revenue Statistics of OECD Member Countries, 1965-1987,* Table 23 at 93.
9. For example, estate duty, introduced in 1953, was abolished in India in 1985 in view of complications of law and meagre revenue yield.

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poses of computation of total income and the charge of income tax. These heads are salaries, income from residential property, profits and gains of a business or profession, capital gains and income from other sources. The method of computing income and the permissible deductions differ for each head of income. Taxable income is first computed under different heads of income and then aggregated for levy of the income tax.

Broadly speaking, the system of income tax is global in nature in that income from various sources is pooled together to determine tax liability. However, elements of a schedular system exist insofar as agricultural income is excluded from the tax base, and capital gains, although included in the definition of income, are granted special concessions. Since capital gains are not annual accruals from a given source but represent appreciation in the market value of assets over a period of time, they are treated differently. The preferential treatment is granted only to long-term capital gains.

According to Sec. 45 of the Income Tax Act[10], any profits or gains arising from the transfer of a "capital asset" are chargeable to tax under the head "capital gains". The term "capital asset"[11] means property of any kind, movable or immovable, held by an assessee but it does not include stock-in-trade, consumable stores or raw materials held for purposes of a business or profession, personal effects (i.e. movable property such as clothes, automobiles, furniture etc., but excluding jewellery) held for personal use, and agricultural land in India.

In the context of capital gains, the act of transfer has a special and extended meaning under the law.[12] In addition to the sale of the asset or its exchange for another asset, transfer includes relinquishing the asset, extinguishing any rights to the asset, compulsory acquisition of the asset under any law, conversion of the asset into stock-in-trade, handing over possession of immovable property in part performance of a contract for the transfer of that property, and transactions which have the effect of transferring, or enabling the enjoyment of, any immovable property. However, certain transactions, although falling within the foregoing meaning of transfer, are not regarded as transfers: a transfer by gift, will, or an irrevocable trust; a transfer of shares of an amalgamating company in consideration of allotment of shares in an Indian amalgamated company; and a transfer of works of art, books, manuscripts etc., to the government, a university or any other specified museum or institution.[13] As regards the year of taxability, the basic rule is that capital gains are deemed to be income of the previous year in which the transfer giving rise to the gains takes place.[14] Thus, the year of charge is the year in which the sale, exchange, relinquishment etc. takes place. In case of conversion of a capital asset into stock-in-trade, the gains are deemed to arise in the year in which such stock-in-trade is sold or otherwise transferred.

The procedure to compute capital gains involves the following steps.[15] First, the full value of consideration received or accruing as a result of the transfer is ascertained. If the transaction is in cash the full value of consideration is the cash payment received. If the consideration for transfer is in the form of another asset, the fair market value of the asset received as consideration is ascertained. In addition, the value of any debt settled by way of consideration is included in the full value of consideration. The second step in the computation of taxable capital gains is to deduct from the full value of consideration any expenditure incurred in connection with the transfer (brokerage, legal expenses, etc.) and the cost of acquisition of the asset, including the cost of any improvements made to the asset.

The cost of acquisition is the amount for which the asset was originally acquired by the assessee. However, where the capital asset became the property of the assessee before 1 April 1974, he has the option to substitute for the actual cost the fair market value of the asset as on 1 April 1974. Furthermore, where the capital asset became the property of the assessee by succession, inheritance or under a gift or will etc., the cost of acquisition is the cost for which the previous owner of the asset had acquired it. If the asset was acquired by the previous owner prior to 1 April 1974, the assessee enjoys the option to substitute the fair market value of the asset as on 1 April 1974 for the cost of the asset to the previous owner. Any expenditure of a capital nature incurred by an assessee to increase the value of the asset is to be added to the cost of acquisition by way of the cost of improvement.

Long-term and short-term capital gains

The incidence of tax on capital gains depends upon whether such gains arise from the transfer of a short-term or a long-term capital asset. Under Sec. 2(42A), a short-term capital asset is one which is held by the assessee for less than 36 months from the date of its acquisition.[16] If the asset is held for a longer period, it is regarded as a long-term capital asset. Capital gains arising from the transfer of a short-term capital asset are taxable like ordinary income in the case of all assessees. However, capital gains relating to long-term capital assets receive preferential treatment. This concessionary treatment is provided in 2 ways. First, the Act provides for the exemption from tax of long-term capital gains arising from the transfer of certain assets in certain circumstances if certain conditions are fulfilled. Second, a special deduction is allowed in the computation of long-term capital gains. Neither of these preferences is available for short-term capital gains.

Long-term capital gains exempt from tax

Exemptions available to an assessee with regard to certain long-term capital gains may be classified into 3 categories.

Category A

Under Sec. 53, long-term capital gains arising from the transfer of residential property are fully exempt from tax if

10. The Act and the Sections hereinafter refer to the Income Tax Act, 1961, as applicable to the assessment year 1990-91.
11. Sec. 2(14).
12. Sec. 2(47).
13. Prior to the assessment year 1988-89, distribution of assets on the dissolution of a firm, body of individuals or other association of persons was also not regarded as a transaction resulting in taxable capital gain. However, for and from the assessment year 1988-89 the position has changed and such transactions are now regarded as transfers resulting in taxable capital gains.
14. According to Sec. 3 of the Act, the year during which the income is received or otherwise earned is called the "previous year" (i.e. the income year). It is a period of 12 months starting from 1 April of every year and ending on 31 March of the next year. The year immediately succeeding the previous year and in which the income so earned is assessed to tax is called the assessment year (i.e. the tax year). For example, income for the period 1 April 1989 to 31 March 1990 (i.e. 1989-90) is the income of the previous year relevant for the assessment year 1990-91.
15. See Sec. 48.
16. Shares in a company are treated as short-term capital assets if they are held for less than 12 months. The underlying objective of this reduced duration is to improve the mobility of capital.

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the taxpayer does not own any other residential property on the date of transfer and the full value of the consideration for the transfer does not exceed 200,000 Rs. If, however, the asset is transferred for more than 200,000 Rs., the capital gain is exempted proportionately, i.e. the amount of capital gain to be exempted bears the same proportion to the amount of capital gain arising from the transfer as the amount of 200,000 Rs. bears to the amount of the consideration.[17]

Category B

This category includes exemptions relating to capital gains which arise where an asset is transferred to acquire another asset of the same kind within the time specified for the purpose. The cases for which exemptions are allowed are as follows:

1) Capital gains arising from the transfer of residential property enjoy exemption if the assessee purchases new residential property within a period of 1 year before the date of transfer or within 2 years after the date of transfer or has residential property constructed within a period of 3 years after the date of transfer.[18] An assessee can claim exemption simultaneously under Secs. 53 and 54.

2) Capital gains arising from the transfer of land being used by the assessee for agricultural purposes for a period of 2 years immediately preceding the date of transfer are exempt from tax if the assessee purchases other land for agricultural purposes within a period of 2 years from the date of such transfer.[19]

3) Where an industrial undertaking is to be shifted as a result of compulsory acquisition of its land or buildings by the Government, the capital gain arising from the payment of compensation is exempt from tax if such land or building was used by the assessee for the purpose of the industrial undertaking for at least 2 years preceding the date of compulsory acquisition, and the assessee has purchased any other land or building within a period of 3 years from the date of acquisition or constructed a building within such period.[20] Moreover, the newly purchased land or building should be used to shift or re-establish the undertaking or set up another industrial undertaking.

4) Capital gains derived from the transfer of machinery, plant, land, and building, etc. forming part of an industrial undertaking, are exempt if the transfer is effected to move the industrial undertaking from an urban area to any other area, provided the gain is reinvested in approved relocation schemes within 1 year before or 3 years after the date of transfer.[21] The underlying philosophy of this exemption is to encourage industries to move from congested urban areas to reduce pollution and other hazards.

In all 4 cases, an exemption in respect of the entire amount of capital gain is allowed where the capital gain is less than or equal to the investment in the new asset. However, if the amount of the capital gain is more than the cost of the new asset, the difference between the amount of capital gain and the cost of the new asset is taxable. Again, for all 4 cases, if the new asset is transferred within 3 years of its acquisition, the capital gains exempted earlier become taxable. This is done by taking the cost of acquisition of the new asset as reduced by the amount of capital gain exempted earlier. In other words, if the newly-acquired asset is transferred within 3 years, the capital gain arising therefrom, together with the amount of capital gain exempted earlier, become chargeable to tax. It may be noted that exemptions regarding gains on the transfer of fixed assets of an industrial undertaking are available to all categories of assessees while exemptions of gains on the transfer of residential property and agricultural land may be claimed only by individuals.

There is yet another condition to avail the foregoing exemptions. If the amount of capital gain is not utilised by the assessee for the purchase or construction of the new asset before the due date for furnishing the income tax return for the relevant year, it must be deposited by him on or before the due date of the income tax return, in the Deposit Account in any branch (except rural branch) of a public sector bank in accordance with the Capital Gains Account Scheme 1988. The amount utilised for acquiring the new asset together with the amount so deposited is deemed to be the amount utilised for acquiring the new asset. If the amount deposited is not fully utilised for purchase or construction of the new asset within the stipulated period, then the amount not so utilised is treated as the capital gain of the year in which the period specified for investment in the new asset (3 years from the date of transfer of original asset) expires.

Category C

Exemption under this category is given on the basis of the nature of the asset in which the net consideration[22] for transfer is invested rather than by the type of asset transferred. Two cases fall in this category:

1) Capital gains on the transfer of a long-term capital asset other than residential property are tax-exempt if the net consideration for the transfer is invested in residential property.[23] This exemption is available to an individual assessee provided he does not own any residential property on the date the original asset is transferred. The investment in residential property must be made in case of purchase within 1 year before or 2 years after the date of transfer and in case of construction within 3 years of such transfer. Meanwhile, the amount of the net consideration or the unutilized part of it must be kept in the Deposit Account as in the other cases discussed above. If the cost of the newly-acquired property is less than the net consideration in respect of the asset transferred, the exemption is allowed only in respect of part of the capital gain proportionate to the ratio of the amount invested to the net consideration. As in the cases discussed above, the condition regarding withdrawal of the exemption if the new asset is transferred within 3 years of its purchase or construction also applies. In addition, the exemption may also be withdrawn if the assessee, within the time for acquiring a new property purchases or constructs another residential property in addition to the new property. In such a case the capital gains earlier exempted from tax are charged to tax as income of the year in which that second property is purchased or constructed.

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17. Or, exempt capital gain + $\frac{\text{capital gain} \times 200{,}000 \text{ Rs.}}{\text{full value of consideration}}$
For example, if a house was acquired for 300,000 Rs. on 1 May 1980 and sold for 800,000 Rs. on 1 August 1989, the rate of the capital gain exemption will be 25% (200,000/800,000). Since the capital gain is 800,000 Rs. – 300,000 Rs. = 500,000 Rs., the amount of capital gain exempted is $\frac{500{,}000 \times 25}{100}$ = 125,000 Rs.
18. Sec. 54.
19. Sec. 54B.
20. Sec. 54D.
21. Sec. 54G.
22. Net consideration in respect of the transfer of a capital asset means the full value of consideration after deduction of any expenditure incurred in connection with the transfer.
23. Sec. 54F.

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2) Exemption of capital gains is claimable if the net consideration (i.e. net sale proceeds) for the transfer of any long-term capital asset is invested in any of the specified assets within a period of 6 months from the date of such transfer.[24] The amount of earnest money or the advance received before the date of such transfer if invested in specified assets is regarded as part investment of net consideration within the stipulated time. If the investment in specified assets is less than the net consideration, the exempted capital gains are determined by the ratio of the amount invested in the specified asset to the net consideration (i.e. the amount invested in the specified asset × capital gain net sale proceeds). If the specified asset acquired by the assessee is transferred or converted into money within a period of 3 years from the date of its acquisition, the capital gain exempted is deemed to be income by way of a long-term capital gain of the year in which such specified asset is so transferred or converted into money.

Special deductions in computing long-term capital gains

Special deductions are made after excluding from capital gains the amounts exempt under various provisions discussed above. Deductions in computing the taxable amount of long-term capital gains are made in 2 steps.[25] First, a straight deduction of 10,000 Rs. is made for corporate as well as non-corporate assessees. If the capital gain is less than this amount, there will be no capital gain chargeable to tax. If the gain exceeds 10,000 Rs., a percentage deduction is allowed from the amount of gain in excess of 10,000 Rs. This deduction is allowed to corporate assessees at 10% and to non-corporate assessees at 50% if the gain relates to land, buildings, gold, bullion or jewellery. When the capital gain arises from the transfer of any other kind of asset, the deduction is allowed at the rate of 30% to corporate assessees and 60% to non-corporate assessees. If, in a year, the assessee has long-term capital gains relating to both categories of assets, the deduction of 10,000 Rs. is first made from the gains relating to transfer of land, buildings etc. The scheme of deduction is summarized in Table I.

The amount of gain remaining after these deductions is the net amount of long-term capital gain to be aggregated with the other taxable income of the assessee.

Table I

Amount of long-term	Corporate assessee	Non-corporate assessee
A. Where the amount of capital gain does not exceed 10,000 RS.	Whole of the capital gain is deductible	Whole of the capital gain is deductible
B. In any other case:		
1. In respect of gain relating to lands, buildings, gold, bullion, or jewellery	First 10;000 Rs. of gain + 10% of the balance	First 10,000 Rs. of the gain + 50% of the balance
2. In respect of gain relating to other assets	First 10,000 Rs. of gain + 30% of the balance	First 10,000 Rs. of gain + 60% of the balance

Set-off and carry-forward of capital losses

A capital loss represents the amount by which the full value of consideration for the transfer of an asset falls below the cost of acquisition and improvement of that asset and the expenditure incurred in connection with the transfer of that asset. Such a loss, whether arising from the transfer of a short-term or a long-term asset, may be adjusted against the gain from the transfer of any other asset. Any remaining loss can be adjusted against other income. However, before such an adjustment is made, the loss arising from the transfer of a long-term capital asset is scaled down in the same way as long-term capital gain is caled down. Thus, any long-term capital loss can be set off against other income only if it exceeds 10,000 Rs. In other words, long-term capital losses are reduced on the basis of slabs mentioned in Table I, i.e. the first 10,000 Rs. plus 50 or 60% of the balance in the case of non-corporate assessees and 10,000 Rs. plus 10 or 30% in the case of corporate assessees. If the whole of the capital loss available for adjustment cannot be set off against other income because of inadequacy of income, the loss remaining unadjusted may be carried forward to the following year to be adjusted against the capital gain of that following year. If in the following year the entire amount of loss brought forward cannot be adjusted, the remaining amount of loss can be carried forward for 8 years from the year for which the loss was first computed.

CONCLUSION

The Indian income tax system treats capital gains for tax purposes on a footing different from other sources of income. The differentiation is made for long-term capital gains which alone qualify for concessionary tax treatment. Since capital gains are accidental in nature and bear no relationship to efforts on the part of the recipient, their preferential tax treatment is contestable. Lenient treatment of this kind may induce people to earn income in the form of capital gains (often speculative) rather than as business profits, dividends or interest. The inducement is stronger at higher income levels because of the high tax rates applicable thereon. The concessionary treatment reduces the effective progressivity of income tax. Moreover, favourable treatment of capital gains produces differential tax liabilities at given levels of income, violating the principle of horizontal equity. In essence, preferential treatment of capital gains is untenable.

24. Sec. 54E. Specified assets mean specific Central Government securities, units issued under the Capital Gains Unit Scheme, 1983, National Rural Development Bonds, Capital Gains Debentures of the Housing and Urban Development Corporation Ltd. and debentures and bonds of the National Housing Bank.
25. Sec. 48(2).

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SOUTH AFRICA:

The 1990 Budget

Dr. Erwin Spiro

POLICY

The 1990 Budget is not so much based on a single uniform principle as on experience and the approval of recommendations of various commissions with an almost traditional bias towards fringe benefits and the trade income of married women. However, as repeatedly emphasized by Mr. Barend du Plessis, the Minister of Finance, the 3 basic policy objectives are economic restructuring to increase long-term growth potential, socio-economic development to raise the general standard of living and the pursuit of short-term economic stability.

MINING

The following additional concessions are proposed:
(a) the second step in the phasing-in of a lower tax formula for gold mines and the phasing-out of the surcharge on other mines;
(b) a partial lifting of the so-called "ring-fencing", i.e. 25% of the tax base can be used to write off a new mine's development costs in cases where both mines are the property of the same taxpayer;
(c) increase of the existing capital allowance for new gold mines from 10% to 12%.

CAPITAL VS. INCOME

It is proposed to accept the Tax Advisory Committee's recommendation to introduce a so-called "safe haven" for shares listed on the Johannesburg Stock Exchange which have been kept for more than 10 years; the profits from the realization of such shares are to be exempted from income tax.

Table I

Taxable income	Rates of tax in respect of married persons
Where the taxable income–	
does not exceed R 5,000	16% of each R 1 of the taxable income;
exceeds R 5,000 but does not exceed R 10,000	R 800 plus 18% of the amount by which the taxable income exceeds R 5,000;
exceeds R 10,000 but does not exceed R 15,000	R 1,700 plus 20% of the amount by which the taxable income exceeds R 10,000;
exceeds R 15,000 but does not exceed R 20,000	R 2,700 plus 22% of the amount by which the taxable income exceeds R 15,000;
exceeds R 20,000 but does not exceed R 25,000	R 3,800 plus 24% of the amount by which the taxable income exceeds R 20,000;
exceeds R 25,000 but does not exceed R 30,000	R 5,000 plus 27% of the amount by which the taxable income exceeds R 25,000;
exceeds R 30,000 but does not exceed R 35,000	R 6,350 plus 30% of the amount by which the taxable income exceeds R 30,000;
exceeds R 35,000 but does not exceed R 40,000	R 7,850 plus 33% of the amount by which the taxable income exceeds R 35,000;
exceeds R 40,000 but does not exceed R 45,000	R 9,500 plus 36% of the amount by which the taxable income exceeds R 40,000;
exceeds R 45,000 but does not exceed R 50,000	R 11,300 plus 39% of the amount by which the taxable income exceeds R 45,000;
exceeds R 50,000 but does not exceed R 55,000	R 13,250 plus 40% of the amount by which the taxable income exceeds R 50,000;
exceeds R 55,000 but does not exceed R 60,000	R 15,250 plus 41% of the amount by which the taxable income exceeds R 55,000;
exceeds R 60,000 but does not exceed R 70,000	R 17,300 plus 42% of the amount by which the taxable income exceeds R 60,000;
exceeds R 70,000 but does not exceed R 80,000	R 21,500 plus 43% of the amount by which the taxable income exceeds R 70,000;
exceeds R 80,000	R 25,800 plus 44% of the amount by which the taxable income exceeds R 80,000.

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EMPLOYEE TRAINING ALLOWANCE

The tax allowance with regard to employee training will be withdrawn and replaced by a direct subsidy from the Department of Manpower in order to stimulate certain types of training.

VALUATION OF TRADING STOCK

The value of consumable stores and spares and work in progress in the construction industry which are not presently considered as trading stock for tax purposes will now be included in taxable income, to be phased in over a period of 5 years.

LAST-IN-FIRST-OUT (LIFO) RESERVE

This reserve which existed since 1 April 1984 will be phased out completely at a rate of 10% per annum over the next 10 years.

FRINGE BENEFITS

The Budget deals, inter alia, with company cars, low interest or interest-free loans and also refers to the envisaged anti-avoidance measures of the income tax bill. The former can be usefully discussed only after the latter have been published.

INTEREST AND DIVIDENDS

To encourage savings, the Minister of Finance recommended that the present exemption to individual taxpayers of the first R 1000 of interest income and building society dividends be doubled to R 2,000; and other dividend income be fully exempted from normal tax in the hands of individuals and close corporations, the undistributed profits tax no longer being justified.

MARRIED WOMEN

To take separate taxation of husband and wife a step

Table II

Taxable income	Rates of tax in respect of persons who are not married persons
Where the taxable income–	
does not exceed R 4,000	15% of each R 1 of the taxable income;
exceeds R 4,000 but does not exceed R 8,000	R 600 plus 18% of the amount by which the taxable income exceeds R 4,000;
exceeds R 8,000 but does not exceed R 12,000	R 1,320 plus 21% of the amount by which the taxable income exceeds R 8,000;
exceeds R 12,000 but does not exceed R 16,000	R 2,160 plus 24% of the amount by which the taxable income exceeds R 12,000;
exceeds R 16,000 but does not exceed R 20,000	R 3,120 plus 27% of the amount by which the taxable income exceeds R 16,000;
exceeds R 20,000 but does not exceed R 24,000	R 4,200 plus 30% of the amount by which the taxable income exceeds R 20,000;
exceeds R 24,000 but does not exceed R 28,000	R 5,400 plus 33% of the amount by which the taxable income exceeds R 24,000;
exceeds R 28,000 but does not exceed R 32,000	R 6,720 plus 36% of the amount by which the taxable income exceeds R 28,000;
exceeds R 32,000 but does not exceed R 36,000	R 8,160 plus 39% of the amount by which the taxable income exceeds R 32,000;
exceeds R 36,000 but does not exceed R 40,000	R 9,720 plus 40% of the amount by which the taxable income exceeds R 36,000;
exceeds R 40,000 but does not exceed R 44,000	R 11,320 plus 41% of the amount by which the taxable income exceeds R 40,000;
exceeds R 44,000 but does not exceed R 48,000	R 12,960 plus 42% of the amount by which the taxable income exceeds R 44,000;
exceeds R 48,000 but does not exceed R 56,000	R 14,640 plus 43% of the amount by which the taxable income exceeds R 48,000;
exceeds R 56,000	R 18,080 plus 44% of the amount by which the taxable income exceeds R 56,000.

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further, all trading income of a married woman, including her salary and income from a business or profession, will not be taxed in her hands, but her earnings must be commensurate with her services. The wife's investment income remains taxable in her husband's hands.

ADDITIONAL REBATE FOR THE AGED

There are some additional rebates for certain aged groups.

FISCAL DRAG

The rates of tax proposed in the Annexes attached hereto represent only the first phase of the considerable adjustments that are planned.

Table III

Taxable income	Rates of tax in respect of married women
Where the taxable income–	
does not exceed R 4,000	15% of each R 1 of the taxable income;
exceeds R 4,000 but does not exceed R 8,000	R 600 plus 18% of the amount by which the taxable income exceeds R 4,000;
exceeds R 8,000 but does not exceed R 12,000	R 1,320 plus 21% of the amount by which the taxable income exceeds R 8,000;
exceeds R 12,000 but does not exceed R 16,000	R 2,160 plus 24% of the amount by which the taxable income exceeds R 12,000;
exceeds R 16,000 but does not exceed R 20,000	R 3,120 plus 27% of the amount by which the taxable income exceeds R 16,000;
exceeds R 20,000 but does not exceed R 24,000	R 4,200 plus 30% of the amount by which the taxable income exceeds R 20,000;
exceeds R 24,000 but does not exceed R 28,000	R 5,400 plus 32% of the amount by which the taxable income exceeds R 24,000;
exceeds R 28,000 but does not exceed R 32,000	R 6,680 plus 34% of the amount by which the taxable income exceeds R 28,000;
exceeds R 32,000 but does not exceed R 36,000	R 8,040 plus 36% of the amount by which the taxable income exceeds R 32,000;
exceeds R 36,000 but does not exceed R 40,000	R 9,480 plus 37% of the amount by which the taxable income exceeds R 36,000;
exceeds R 40,000	R 10,960 plus 38% of the amount by which the taxable income exceeds R 40,000.

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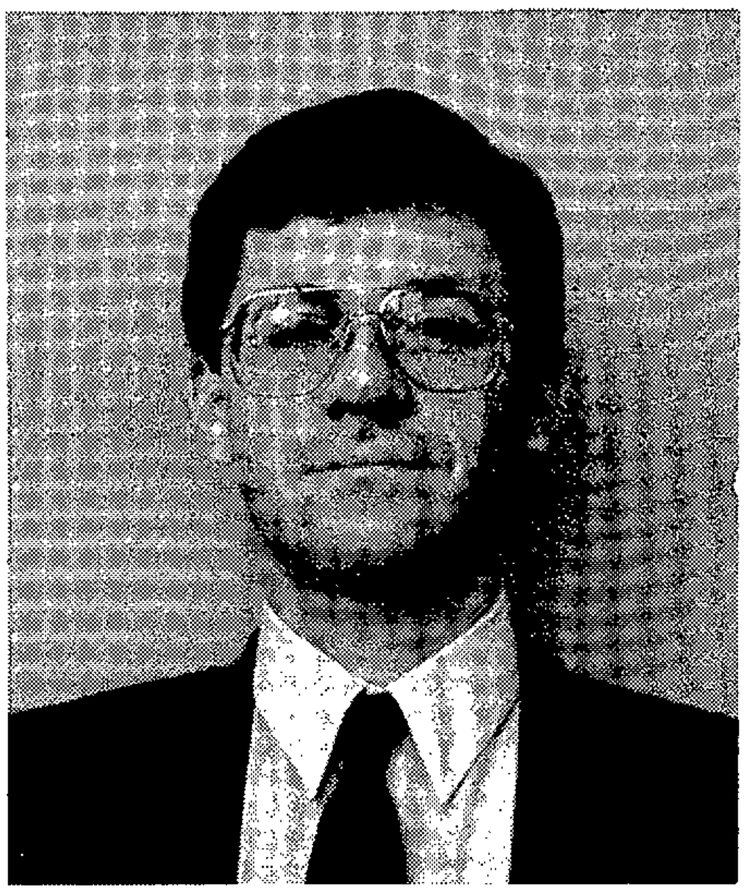

AUSTRALIA:

Draft Foreign-source Income Legislation

Mark Friezer

Mark Friezer is a tax manager in the Sydney office of Arthur Andersen & Co. specializing in international tax. He holds the degrees of Bachelor of Commerce and Bachelor of Laws from the University of N.S.W. He is a member of the Australian Institute of Chartered Accountants, the Taxation Institute of Australia and the International Fiscal Association. He is a frequent lecturer and has published several articles on international tax issues.

The January 1990 issue of the *Bulletin* contained an article on Australia's proposed system for the taxation of foreign-source income. The article was based on the "Information Paper" delivered by the Treasurer on 12 April 1989. The Information Paper set out in detail the design features of the proposed system. It represented the next step in the evolution of the rules following the "Consultative Document" on the taxation of foreign-source income issued on 25 May 1988.

Developing from that Information Paper the Government has now produced draft legislation and accompanying Explanatory Notes. This draft legislation is not yet ready to be introduced into Parliament but is to be the subject of a further consultative process prior to the development of a final bill which will be introduced to Parliament.

The purpose of this brief article is to update information in respect of the major design changes which have occurred since the Information Paper. I have also outlined those areas which were foreshadowed in the Information Paper but in respect of which no detailed draft legislation has yet been issued.

Changes since the April 1989 Information Paper

The draft legislation is broadly in line with the rules outlined in the April 1989 Information Paper. However, the following changes are of particular interest:

1. The conditions for qualification for the active income exemption have been relaxed in certain respects:
(i) The availability of the active income exemption has been made easier for Controlled Foreign Companies (CFCs) dealing in goods with unrelated parties. For instance, a CFC purchasing goods from an Australian party and selling them to an unrelated party may now qualify for the exemption. This obviously represents a significant benefit to Australian multinationals with distribution companies in tax-preferred jurisdictions.
(ii) Previously only a CFC that manufactured, created, produced, grew or extracted goods within the CFC's country of residence could have qualified for the active income exemption. This requirement has now been relaxed so that there is no longer a need for the goods to have originated in the CFC's country of residence; it is enough that the CFC is substantially adding value to the goods by being involved in the process of manufacture, creation, production, etc.
(iii) It was originally intended that all foreign exchange gains and losses of a CFC, other than those derived from dealings with unrelated non-Australian parties, would be treated as passive income for the purpose of applying the active income exemption. It is now accepted that those foreign exchange gains and losses not associated with the generation of "tainted" income will be regarded as active income for purposes of the exemption.

2. For foreign loss calculation and loss quarantining purposes, income is to be classified into 4 classes instead of 3 as originally proposed. The fourth class will continue the current treatment of interest income so that from 1 July 1990 interest income and losses will be required to be segregated from offshore banking income, modified passive income and other income. However, the 3 classes of income as originally proposed will remain for foreign tax credit purposes.

3. There have been changes to the foreign loss quarantining rules which may impact the funding/structuring of offshore investments.

Rules still to come

The draft legislation does not at this stage contain measures relating to the following matters:

- the treatment of branches of life offices;
- certain transitional provisions, including those relating to distributions and changes of residence designed to take advantage of the foreshadowed exemption of dividends received from comparable tax countries;
- the form of capital gains tax rollover relief for CFCs that wish to rearrange their affairs;
- the evidentiary requirement whereby documents not provided to the Commissioner upon request will not be available subsequently to be used as evidence to dispute an assessment; and
- the draft regulations listing the 60 or so "white-listed" countries along with various designated tax concessions. These regulations, along with measures on the above outstanding matters, will be available "as soon as practicable".

The Government is also in the process of eliminating a double tax problem arising from the interaction of the Capital Gains Tax and Accruals Rules. The problem would arise where the earnings of the CFC are attributed to an Australian shareholder who subsequently sells his interest in the CFC before the income is distributed as a dividend.

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Under the current provisions, there is no relief for the fact that the taxable capital gain would also reflect the retained earnings of the CFC previously subject to accruals taxation in the hands of the shareholder.

Apart from the above, the Government is pursuing its desire to introduce a Passive Investment Fund regime as originally outlined in the Information Paper. However, this regime will be applicable from the 1991/92 year of income, with the measures due to be released in draft form during the 1990 year for further consultation with interested parties.

IFA NEWS

INTERNATIONAL FISCAL ASSOCIATION

U.S./DUTCH JOINT MEETING IN AMSTERDAM

When: Thurs.-Fri., 23-24 August 1990 before the International Fiscal Association Congress opens in Stockholm on Sunday 26 August.

Location: In the "Koepelkerk" (Dome Church, an old building recently renovated as a Sonesta conference center) near the Central Railroad Station.

Hotels: A block of rooms has been reserved across the street in the Sonesta Hotel at:

Dfl. 250 (single) = $ 135*
Dfl. 290 (double) = $ 155*

* Exchange rate estimated at Dfl. 1.88 to the dollar.

Rooms are also available at "De Roode Leeuw" Hotel, Damrak 93, about a 5 minute walk:

Dfl. 165 (single) = $ 90
Dfl. 220 (double) = $ 120 room includes breakfast

Air fares: KLM would be

$ 618 to Amsterdam
$ 421 to Stockholm from Amsterdam
$ 1,039 when purchasing 2 round-trip tickets

Martinair, flying only Mondays NY-AMS could cut the $ 618 to ± $ 400.

Alternatively, $ 1,114 circle route NY-AMS-Stockholm entirely by KLM, or $ 707 to AMS via Pan Am, plus $ 16 U.S. tax (21 day advance reservation, 7 day minimum reservation), plus $ 440 tourist class AMS-Stockholm via SAS.

Registration fee: $ 100 or Dfl. 200 (includes lunches and dinner Thursday).

For more information, U.S. members should contact:

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U.S./DUTCH JOINT MEETING PROGRAM
23-24 August 1990: Thursday through lunch Friday, dinner party Thursday evening

Thurs., 23 August 1990:

Opening
Subject I: U.S.–Dutch Treaty Revision (including rules limiting those entitled to benefit and the likely future for the Act of the Kingdom with the Netherlands Antilles, including Aruba).
U.S. Speaker: Mary C. Bennett, Baker & McKenzie, Washington, D.C.; ex-Deputy International Tax Counsel
Dutch Speaker: Maarten Ellis, Loyens en Volkmaars, Rotterdam

Subject II: Europe 1992, including Harmonizing EEC Taxes
Dutch Speaker: Karel Kooyman, Unilever, Rotterdam
U.S. Speaker: Nicholas van der Kloot, Coopers & Lybrand, New York City

Subject III: Direct Investment into the U.S.
U.S. Speaker: Carl L. Estes II, Vinson & Elkins, Houston, Texas
Dutch Speaker: Fred de Hosson, Caron & Stevens, Amsterdam

EVENING DINNER PARTY (including accompanying persons)

Friday, 24 August 1990:

Subject IV: Portfolio Investment into the U.S.
Dutch Speaker: Marcel Romeyn, Moret Gudde Brinkman, Rotterdam
U.S. Speaker: Robert I. Stricof, Arthur Andersen & Co., New York City

Subject V: Investment in the Netherlands
U.S. Speaker: Erik J. Stapper, Stapper & Van Doren, New York City
Dutch Speaker: Frank van Brunschot, Stibbe en Blaisse, Amsterdam

IFA TAX SEMINAR

On 23 May 1990 the Canadian branch sponsored a tax seminar, entitled "Current International Tax Issues". The seminar was held at the Queen Elizabeth Hotel in Montreal, Canada. Topics included the "Legal and Tax Issues Respecting Immigration and Executive Transfers" (to and from Canada), "Canadian Fiscal Policy in the Context of Globalisation and European Integration" and "Taxation Aspects of Financing Techniques in Global Capital Markets".

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AUSTRALIAN BRANCH

The first meeting of the Australian branch was held on 5 June 1990 at the Ramada Renaissance Hotel in Sydney. The subject of the meeting was "Corporate Aspects of the Proposed Controlled Foreign Corporate Legislation".

The second and third (and annual general meeting) meetings will be held on 14 August 1990 and 20 November 1990, respectively. Both meetings will be held at the Ramada Renaissance Hotel.

DANISH BRANCH

The Danish branch celebrated its 25th anniversary on 26 May 1990. A booklet containing articles on Danish taxation and the association itself was published in honour of the occasion.

GERMAN BRANCH

Annual meeting

On 20 and 21 April 1990 the German Branch of IFA held its Annual Meeting in Bonn. During the meeting the subjects for the IFA Barcelona Congress in 1991 (the valuation of real property for taxation purposes and the protection of confidential tax matters) were discussed. However, the main topic of the meeting was the conditions under which the common economic development of the two Germanies was to take place.

Joint German-Italian Branch Meeting

On 28 and 29 May 1990 the German and Italian Branches of IFA met in Valmadrera (Italy) to discuss the following subjects:

- the New German–Italian tax treaty (signed but not yet ratified);
- the tax harmonization in the European Communities and the developments in the German Democratic Republic;
- taxes imposed to protect the environment.

The two-day programme was well attended and its success paves the way for future bilateral meetings.

INDIA BRANCH

A felicitation function was organized on 16 February 1990 to meet the newly-appointed Chief Justice of India, Mr. Sabysachi Mukharji. The function was attended by a number of justices of the Supreme Court and the Delhi High Court and eminent lawyers, accountants, economists, tax administrators and corporate managers.

An international tax seminar was held 19-20 April 1990. The seminar was organized jointly with the Indo-American Chamber of Commerce. The folllowing subjects were discussed:

- tax consequences of currency fluctuations in international transactions;
- current tax trends, with special reference to India, the United Kingdom and the United States;
- problems relating to the tax treatment of foreign technicians and other personnel in India; and
- India–United States double taxation agreement: implications and other tax treaty issues.

Speakers included Mr. Terry Browne, International Tax Specialist, Touche Ross International; Ms. Lynne Friend, Bass Group Taxation Controller, United Kingdom; Mr. Douglas Hartwick, First Secretary, Economics, U.S. Embassy, India; Mr. Ahmed Khan, Commissioner of Income Tax, Pakistan; Mr. P.K. Appachoo, Chief Commissioner of Income Tax, India; Mr. G.N. Gupta, Former Chairman, Central Board of Direct Taxes, Government of India; and Mr. O.P. Vaish, Chairman of the IFA India Branch.

SWISS BRANCH

On 7 June 1990 the Swiss Branch met in Zurich. The meeting was, inter alia, dedicated to the 1992 Congress in Mexico (Cancun) and the 1996 IFA Congress which will be held in Switzerland. Reporters were asked for the subjects to be treated during the Mexico Congress, i.e. (1) transfer pricing in the absence of comparable market prices and (2) income tax consequences of international acquisitions. A lecture was given on Swiss legislation and harmonization proposals and a panel discussion was held on new provisions with respect to the taxation of individual persons.

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NEW ZEALAND:

POLICY STATEMENT ON SEC. 99

On 1 February of this year New Zealand's Commissioner of Inland Revenue released an important policy statement on the application of Sec. 99 of the Income Tax Act 1976.[1] Sec. 99 is New Zealand's general anti-avoidance provision, the thrust of which is to render void for income tax purposes arrangements with the purpose or the effect of tax avoidance. In his statement the Commissioner indicates that his new policy will be to evaluate arrangements on the basis of whether they frustrate the underlying scheme and purpose of the charging provisions of the Income Tax Act.

The policy statement was accompanied by a brief notice setting the statement in context. This notice is also reproduced below.

SECTION 99 OF THE INCOME TAX ACT 1976 – STATEMENT OF INLAND REVENUE POLICY

This policy statement on section 99 represents a significant step forward for taxpayers, their tax advisers and for Inland Revenue.

The statement is the first comprehensive attempt for many years to indicate to taxpayers and their tax advisers how Inland Revenue sees section 99 and how it intends to apply the section.

Section 99 is often referred to as the "general anti-avoidance" section. It is designed to protect the tax revenue of the Government from tax avoidance devices but being enacted in a general form its application can give rise to uncertainty. Hence this policy statement which is designed to reduce that uncertainty.

There are three further points to note.

First, the statement takes into account the views expressed to me by the New Zealand Law Society and the New Zealand Society of Accountants but it does not purport to represent any agreement between those two bodies and Inland Revenue. Indeed there may be significant differences between tax experts inside and outside Inland Revenue on the subject but I have decided to issue the statement now to enable taxpayers and their advisers to gain the benefit of the reduced uncertainty which this policy does provide.

Secondly, I do not regard the statement as one which is not capable of further refinement and development.

Thirdly, and finally, it is in the end the Courts which decide whether section 99 has been correctly applied to a particular taxpayer and I would expect further refinement to the statement to result from that process.

POLICY STATEMENT ON SECTION 99

INTRODUCTION

The Commissioner has reviewed the policy in relation to the application of section 99 of the Income Tax Act 1976 (the Act). The purpose of this statement is to set out the new policy. The statement presents the Commissioner's view on section 99 – the need for the section, its function in terms of the Act, the impact and relevance of the recent legislative reforms and previous case law, the process of application, and some examples showing the effect of the new policy. It is not intended to be a detailed textual analysis of the provision. Rather it will provide guidance to both Departmental officers and taxpayers on the application of the section.

The focus of the Commissioner's new policy will be to evaluate arrangements in terms of whether they frustrate the underlying scheme and purpose of the relevant provisions of the Act.

This new policy will apply from the date of release of this statement to all cases, including those cases which are presently under review.

Section 99

Section 99 is the general anti-avoidance provision in the Act which renders void against the Commissioner any arrangement entered into for the purpose of avoiding tax.

Section 99 is designed to protect the Government's revenue from tax avoidance devices. To effectively achieve its objective the section is enacted in a general form, without reference to specific tax avoidance devices. This preserves flexibility to cope with new devices, but a consequence of this generality is a decree of uncertainty. This uncertainty is the cause of much of the criticism levelled at the section. This uncertainty can be remedied, to some extent, by outlining the Commissioner's opinion on section 99. The main points of this opinion are as follows –

- the Commissioner's view as to the function of the section;
- the effect on the recent reforms to the income tax system;
- the relevance of case law;
- the process undertaken when considering invoking section 99; and
- some specific examples demonstrating the effect of the new policy.

Function of Section

Section 99 is designed to protect the integrity of the tax system from tax avoidance devices implemented to frustrate it. It is not an independent charging section except insofar as section 99(3) provides for the reconstruction of an arrangement to counteract any tax advantage obtained, and

1. See "Section 99 Agreements purporting to alter incidence of tax to be void" on next page.

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SECTION 99 AGREEMENTS PURPORTING TO ALTER INCIDENCE OF TAX TO BE VOID

99(1) [Definitions] For the purposes of this section – "Arrangement" means any contract, agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect: "Liability" includes a potential or prospective liability in respect of future income:
"Tax avoidance" includes –
(a) Directly or indirectly altering the incidence of any income tax:
(b) Directly or indirectly relieving any person from liability to pay income tax:
(c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax.

99(2) [Void arrangements] Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly, –
(a) Its purpose of effect is tax avoidance; or
(b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, –
whether or not any person affected by that arrangement is a party thereto.

99(3) [Adjustment of income] Where an arrangement is void in accordance with subsection (2) of this section, the assessable income of any person affected by that arrangement shall be adjusted in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of the foregoing provisions of this subsection, the Commissioner may have regard to such income as, in his opinion, either –
(a) That person would have, or might be expected to have, or would in all likelihood have, derived if that arrangement had not been made or entered into; or
(b) That person would have derived if he had been entitled to the benefit of all income, or of such part thereof as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

99(4) [Deemed derivation of income] Where any income is included in the assessable income of any person pursuant to subsection (3) of this section, then, for the purposes of this Act, that income shall be deemed to have been derived by that person and shall be deemed not to have been derived by any other person.

99(5) [Sale of shares] Without limiting the generality of the foregoing provisions of this section, where, in any income year, any person sells or otherwise disposes of any shares in any company under an arrangement (being an arrangement of the kind referred to in subsection (2) of this section) under which that person receives, or is credited with, or there is dealt with on his behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive, as income by way of dividends in that income year, or in any subsequent income year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year.

99(6) [Discontinuance prevented] Where any arrangement has been made or entered into before the 1st day of October 1974 and the Commissioner is satisfied, in respect of that arrangement or, as the case may be, in respect of a part of that arrangement, that the terms or condition of that arrangement or, as the case may be, of that part (being legally binding terms or conditions which were agreed upon in writing before that date) prevent the discontinuance of that arrangement or, as the case may be, of that part, –
(a) Subsections (2) to (5) of this section shall not be applied with respect to that arrangement or, as the case may be, with respect to that part so long as that arrangement or, as the case may be, that part is so prevented from being discontinued and is continued strictly in accordance with the requirements of the aforementioned terms or conditions thereof; and
(b) So long as the said subsections (2) to (5) of this section are not applied with respect to that arrangement or, as the case may be, with respect to that part in accordance with paragraph (a) of this subsection, the section for which section 108 of the Land and Income Tax Act 1954 was substituted by section 9 of the Land and Income Tax Amendment Act (No. 2) 1974 shall, notwithstanding the repeal thereof by the said section 9, be deemed to remain in full force and effect in relation to that arrangement or, as the case may be, in relation to that part.

section 99(5) provides for the reconstruction of dividend stripping arrangements. It does not itself create a liability for income tax. Its function is to protect the liability for income tax established under other provisions of the Act. Section 99 supports the more specific provisions of the Act to prevent their frustration by those who would avoid their impact.

Impact of the Legislative Reforms

The recent legislative reforms have significantly altered the income tax system. The lowering of the tax rate, broadening of the tax base, introduction of new regimes in the areas of international tax, trusts, accruals and dividend imputation have made significant structural changes to the system. The reforms have reduced the availability of schemes which some taxpayers used to avoid their liability to income tax. Many of these schemes utilise legislative gaps in the Act and, in terms of the Commissioner's previous practice on section 99, the provision was applicable. In light of the reforms the Commissioner has reconsidered the application of section 99. As discussed above the section does not itself create a liability to income tax but is intended to protect the liability for income tax established under the other provisions of the Act. Accordingly it is considered more appropriate that legislative gaps be filled by Parliamentary action to amend the law rather than by invoking section 99. The role

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of section 99 is to support the other provisions of the Act where the underlying scheme and purpose of the Act and the specific provision under review has been frustrated.

The recent legislative reforms offer significant guidance in discerning the scheme and purpose of the Act and section 99 will actively be used to buttress the intent of the Act where that intent has been frustrated.

Relevance of Case Law

There are a number of interpretive guidelines, on section 99, of general application which have been judicially developed.

Some relate to particular factual situations. Cases involving alienation of income, transfer of income earning assets on a short term basis, payments to relatives and family trusts claimed as a deduction give clear guidelines on the application of section 99 in these situations.

In addition certain broad interpretive principles have also evolved. The Newton predication test, for example, is regarded as fundamental to the process of section 99 application. In *Newton v FC of T* [1958] AC 450 the test was set out by Lord Denning.

"In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax."

There was also the series of cases in the 1960's involving constructional arguments primarily designed to ascertain the scope and the application of the predecessor to section 99. For example whether the section applies only to sham transactions or has fiscal effect – effect, that is, as against the Commissioner or just between the parties to the arrangement.

CIR v Challenge Corporation [1986] 2 NZLR 556 is another example of the judicial development of section 99. In *Challenge* the taxpayer acquired a company (Perth) having no assets or debts but with a large deductible loss. After the acquisition, in compliance with s 191 of the Tax Act Perth gave notice of the transfer of its loss to the taxpayer's other subsidiaries, thereby reducing the group's assessable income. The Privy Council made it clear that s 99 is of general application and may apply notwithstanding that specific anti-avoidance provisions exist within a particular section.

All of these cases have added to the knowledge of what the section was intended to do and how it achieves this purpose. They will continue to assist both the Commissioner and taxpayers in ascertaining the boundaries of the provision.

Process of Application

While application of the section is not dependent on any discretionary decision by the Commissioner, the Commissioner recognises that it will be of considerable assistance to taxpayers if they know the process undertaken in considering the invocation of the section.

The Commissioner's approach requires a careful and thorough analysis of –
(a) the underlying scheme and purpose of the Act as a whole and of the specific provision under review;
(b) the arrangement to ascertain its purpose or effect;
(c) whether a fair and reasonable inference can be drawn that tax avoidance is one purpose of the arrangement (other than merely incidental);
(d) whether following this analysis it can be inferred that the arrangement frustrates the underlying scheme and purpose of the legislation.

These four steps are cumulative – that is, it is necessary to undertake each step before the decision is made as to whether section 99 is applicable.

The following is an explanation, in general terms, of the constituent elements of this process.

Scheme and Purpose

A succinct and practical guide to the "scheme and purpose" approach was given by Mr. Justice Richardson in his paper "Appellate Court Responsibilities and Tax Avoidance" delivered at Monash University in 1984. The approach was described as follows:

> The twin pillars on which our approach to statutes rests are the scheme of the legislation and purpose of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Act including the long title, analysing its structure and examining the relationship between the various provisions, and recognising any discernible themes and patterns and underlying policy considerations. It presupposes that in that way the study of the statute or of a group of sections may assist in the interpretation of a particular provision in its statutory context. It may provide a detailed guide to the intentions of the framers of the legislation and in so doing may cast light on the meaning of the provisions in question.

His Honour considered that the scheme and purpose approach may not furnish an answer to all the interpretation problems which may arise. However he was satisfied that the emphasis on trying to discern the scheme and purpose of the legislation is likely in many cases to lead to the resolution of interpretation problems in the tax field that best reflects the intention of Parliament as expressed in the statute. The Commissioner concurs with this view.

In trying to discern the scheme and purpose of the legislation primary regard must be had to the words of the legislation. It is Parliamentary intent, as expressed in the statute, which is crucial. The increased complexity of tax legislation has resulted in some instances of ambiguity leading to confusion as to the meaning of particular provisions which makes the ascertainment of the true Parliamentary intent difficult. The Government's consultative documents, the various consultative committee reports, Parliamentary discussion and debate, and Departmental interpretive guidelines may provide assistance in interpreting the legislation under review.

The Purpose or Effect of the Arrangement

The test to be applied in ascertaining the purpose or effect of an arrangement is objective. In short the word "purpose" means, not motive, but the effect which it is sought to achieve – the end in view. The word "effect" means the end accomplished or achieved. The whole set of words denotes concerted action to an end – the end of avoiding tax. This is the well-known passage from Lord Denning in the Newton case. The section is not concerned with the motives of taxpayers. It is not concerned with the desire to avoid tax. Rather the section is only concerned with the means employed to avoid tax. In the Newton case Lord Denning said –

> In applying the section you must, by the very words of it, look at the arrangement itself and see which is its effect – what it does – irrespective of the motives of the persons who made it. Williams J put it well when he said –
>
> 'The purpose of a contract agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms. Those terms may be oral or written or

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> may have to be inferred from the circumstances but, when they have been ascertained, their purpose must be what they effect.'

Inference

Having established the purpose of the arrangement as implemented by the taxpayer, it is necessary to effect a fair and balanced evaluation of that arrangement. The evaluation will be with a view to concluding whether one can predicate whether the arrangement was implemented in its particular way so as to achieve an income tax advantage.

That advantage may arise in one or more of a variety of ways. These include the reduction, avoidance, or postponement of income tax. They also include an alteration in the incidence of income tax, or relieving persons from income tax.

If there is an income tax advantage, it is necessary to identify whether or not that advantage is merely an incidental purpose or effect of the arrangement. In *CIR v Challenge Corporation,* Mr. Justice Woodhouse acknowledged that the meaning of this qualification is all important and stated:

> ... The issue as to whether or not a tax saving purpose or effect is "merely incidental" to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.
>
> ... The phrase "merely incidental purpose or effect" in the context of section 99 points to something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant. Many taxpayers when considering a course of action are likely to appreciate and welcome an opportunity provided by the Act for achieving some tax benefit as an aspect of it. But this should not bring the transaction or transactions almost automatically within the avoidance provisions of s 99. By itself conscious recognition and acceptance that a commercial transaction will be accompanied by a degree of tax relief is not the issue.
>
> ... In the end the breadth of the qualifying phrase and so the ambit of the section itself will be discovered as a matter of fact and degree on a case by case basis.
>
> ... When construing s 99 and the qualifying implications of the reference to "incidental purpose" the questions that need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the statute while in direct pursuit of tax benefits. To put the matter in another way, there is all the difference in the world between the prudent attention on one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it and its pursuit on the other hand simply to achieve a manufactured tax advantage.

In some circumstances, an evaluation having regard to the view expressed by Mr. Justice Woodhouse may conclude that the securing of a tax advantage is a non-incidental purpose or effect of the arrangement. In this case, it is necessary to consider whether that non-incidental tax advantage is one that constitutes tax avoidance as contemplated by section 99.

Frustration

This requires the synthesis of the other facets of the process. Section 99 is used to support the rest of the Act. Its function is to protect the liability for income tax established under other provisions of the Act. Accordingly the section will apply to void those arrangements where an evaluation of the arrangement results in the inference that a non-incidental purpose or effect is tax avoidance and the resulting tax advantage frustrates the intent of the Act.

The Commissioner considers that this new four-step approach to the application of section 99 gives the provision its proper status within the Act, enabling it to do its work in a balanced but effective way.

Pretence

Many tax avoidance arrangements involve an element of pretence. Section 99 will be applied to counter this. The Commissioner expects that the provision will be mainly applied to those taxpayers who follow a course of action to achieve a manufactured tax advantage which is essentially void of any economic reality. However, economic reality is not of itself the sole determinate of whether section 99 applies. The degree of economic reality associated with a given transaction will be contrasted to any artificiality, contrivance, or exploitation of the Act while in direct pursuit of tax benefits. This analysis will focus on determining whether the underlying scheme or purpose has been frustrated.

Invoking Section 99

The section may be applied in conjunction with other provisions of the Act but only where the merits of application have been properly considered. The process requires the careful and thorough analysis described above. This analysis will be undertaken independently from the consideration of the transaction in terms of the more specific provisions of the Act. Section 99 will not be used without this analysis having been undertaken. In other words Departmental Officers are not empowered to invoke section 99, or indicate that it is intended to invoke the section, without having completed the analysis.

Section 99 will be invoked by the Department against arrangements intended to frustrate the underlying scheme and purpose of the relevant provisions of the Act.

Rulings

The Department recognises as an important aspect of tax administration that the tax consequences of entering into any particular transaction be known with the greatest degree of certainty possible.

To achieve this objective the Department will do its best within its current resource constraints to provide timely, accurate and adequate advice on the possible application of section 99 to specific situations subject to the following conditions:

(a) the full facts and documentation (including proposed documentation) of the transaction and associated transactions must be disclosed;

(b) the names of the parties, including the parties to the associated transactions, must be disclosed;

(c) the taxpayer's full arguments as to –
(i) why section 99 does not apply; and
(ii) the purpose and effect of the transaction;

(d) any subsequent amendments to the proposals must be brought to the Department's attention and presented with an analysis of whether the amendments affect the ruling given;

(e) the ruling is not legally binding on the Commissioner but the Commissioner will normally follow his ruling unless the taxpayer has failed to comply with one or more of these conditions;

(f) the Commissioner may use the factual situation submitted to amend or supplement his general guidelines on the application of the section but this would be done in such a

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way as to preserve the confidentiality of the taxpayer concerned.

Requests for rulings on the application of section 99 should be made in the first instance to:–

Director (Taxpayer Services)
Head Office
P.O. Box 2198
Wellington

Examples of Application of Section 99

The Annex to this statement sets out some examples of the application of this new policy.

ANNEX TO POLICY STATEMENT

APPLICATION OF POLICY

The examples set out below illustrate how the Department will in practice apply the new policy described above. It is important to note that the following examples are indicative only of when section 99 is considered by the Department to apply in the specific circumstances as described in each example. The examples should not be viewed as delineating the line between when section 99 will or will not be applied by the Department.

It is assumed that the arrangements described below comply with the literal terms of the provisions of the Act concerned and that the transactions are legally valid.

Contents

1. Permanent transfer of income producing assets
2. International tax regime
3. Prepayment of interest (prior to accruals regime)
4. Section 160A: Amounts paid on shares in petroleum mining companies
5. Redeemable preference share financing
6. Valuation of trading stock
7. Dividend shipping
8. Dual resident company losses
9. Continued deductions

1. PERMANENT TRANSFER OF INCOME PRODUCING ASSETS

FACTS

YZ is an individual who derives income from salary and interest from a portfolio of interest bearing securities. YZ had some years ago established a discretionary trust for the benefit of YZ's family and had from time to time made settlements to the trust. YZ's income is at a level which attracts the highest marginal rate of tax. The income derived by the trustee during an income year is normally paid or applied to or for the benefit of the beneficiaries of the trust. The beneficiaries currently earn income at a level below the highest marginal rate of tax.

YZ recognises the opportunity to reduce YZ's liability to income tax on income that would otherwise be assessable to YZ and to reduce YZ's exposure to estate duty. In pursuit of this goal YZ transfers absolutely the portfolio of interest bearing securities to the family trust. YZ grants to the trust an interest free loan repayable on demand to effect the sale of the portfolio and forgives a portion of the debt over several years. The effect of this arrangement is that YZ is no longer subject to income tax on the interest income and YZ's estate has been considerably reduced. Assuming that the trustee pays or applies the income to or for the benefit of the beneficiaries during or within six months of end of the income year the overall effect is a reduction in the income tax paid.

INTERPRETATION

(a) Scheme and Purpose

A trust is an equitable obligation, binding on persons referred to as trustees to deal with the trust property over which they have control for the benefit of the beneficiaries of the trust.

A comprehensive scheme for the taxation of trustees and beneficiaries of trusts is contained in sections 226 to 233 of the Act. These provisions were substantially redrafted as a result of the Income Tax Amendment Act (No. 5) 1988. The new regime generally takes effect from the income year commencing 1 April 1988. The former regime drew a distinction between "specified" and "non specified" trusts. In broad terms, a non specified trust included trusts created by will or on intestacy and inter vivos trusts created before 19 July 1968.

Specified trusts were inter vivos trusts created on or after that date. The distinction was brought about by an amendment to the Land and Income Tax Act 1954. The policy behind the distinction was an effort to frustrate income splitting through the use of trusts by creating a harsher tax regime which would apply to specified trusts. For example, trustees of a non-specified trust were taxed at the normal individual rates after taking into account the $ 100 exemption. Whereas trustees of a specified trust were taxed at a minimum rate of 35c in the dollar.

The specified trust regime was designed to deter but not prohibit the use of trusts for income splitting purposes. As part of the introduction of the new trust regime, the distinction between specified and non specified trusts was removed.

The continued inclusion in the Act of a specific regime for the taxation of trusts and the existence of the former trust regime, although drawing a distinction between specified and non-specified trusts, clearly indicates that the Act contemplated and still contemplates the likelihood of permanent transfers of income producing assets to a trust for the benefit of its beneficiaries.

The inference that permanent transfers of income producing assets are consistent with the scheme of the Act is further reinforced by the presence of section 96 in the Act. Section 96 of the Act provides in general terms that where an assignment of income or income from settled property is for a period of less than seven years, and the assignor or settlor

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remains the owner or beneficial owner respectively of the income producing asset, or the property/corpus reverts to or otherwise remains under the control of the assignor/ settlor, then the income, notwithstanding the assignment or settlement, is deemed for income tax purposes still to be derived by the assignor or settlor.

By implication the Act contemplates as acceptable tax planning the permanent transfer of income producing assets without reservation, reversion or the right to control the disposition of the asset.

The possibility of tax savings arising from the permanent transfer of income producing assets is contemplated by the Act, in that it provides for the taxation of beneficiary income at the beneficiary's ordinary income tax rate.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement it has several purposes: to reduce YZ's potential estate duty liability, the setting aside of income earning assets for the benefit of YZ's family, and the minimisation of income tax.

(c) Inference

The taxpayer in this case has chosen to transfer the portfolio of investments to a trust, subject to the provisions of the Act as they apply to trusts. Such a transfer would have been influenced by domestic and economical factors which may have included a wish to secure income tax savings. A reduction in taxation has occurred.

Although the tax savings may be significant, it is a natural consequence of the disposition of the assets to the trust. The inference to be drawn is that the tax saving is an incidental purpose or effect of the arrangement.

(d) Frustration

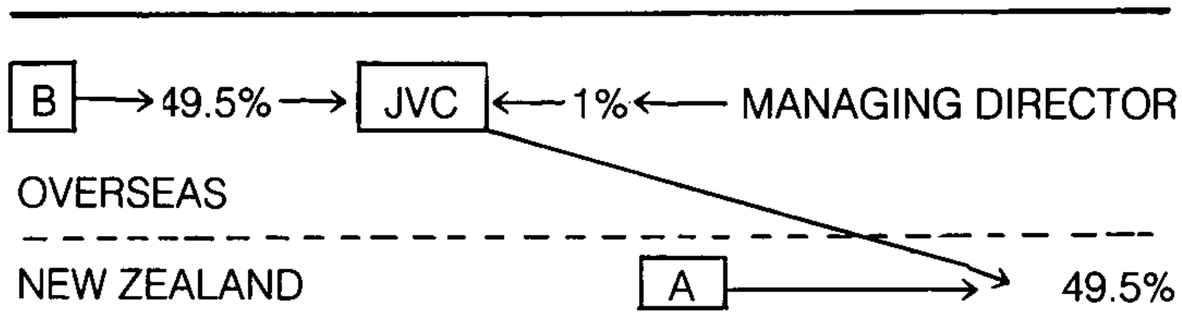
The Department does not consider that the scheme and purpose of the Act has been frustrated in the above circumstances. If a taxpayer permanently disposes of income producing property to another taxpaying entity so as to reduce the taxpayer's burden of taxation the Act contemplates that the new owner will be liable for the tax on that income. The incidence of the tax and the burden of tax falls precisely as the Act intends, namely, upon the new owner.

The Department would accept the above arrangement as acceptable tax and estate planning and would not apply section 99 to the arrangement.

2. INTERNATIONAL TAX REGIME

FACTS

A is a new Zealand resident and B is a non-resident. A and B are involved in a joint venture operation. A joint venture company is incorporated in Panama with the following share structure. The joint venturers each hold 49.5% and a non-resident Managing Director holds the remaining 1%. The Managing Director's shares carry limited voting rights. Additionally, the shares provide for limited entitlement to participate in the distribution of profits or the value of net assets on a winding up (or other distribution). The share structure adopted is not a requirement of the law of Panama, New Zealand, or the country in which B is resident. The Managing Director is neither a "nominee" or "associated person" of resident A, as those terms are defined in sections 245A and 245B of the Act.



INTERPRETATION

(a) Scheme and Purpose

One of the primary objectives of the international tax regime is to prevent the deferral/avoidance by New Zealand residents of New Zealand income tax on foreign sourced income earned through non-resident companies.

The Controlled Foreign Company (CFC) regime was enacted as part of a trilogy of measures to ensure that foreign income derived by New Zealand residents is subject to New Zealand tax as it is earned. The CFC regime only applies where five or fewer New Zealand residents have a 50% or greater control interest in a foreign company.

The control tests contained in section 245C are the cornerstone of the CFC regime. Recognising the importance of this section, the legislature have included a specific anti-avoidance provision in section 245C(9). In general terms the provision provides that where two residents enter into an arrangement whereby any control interests in a foreign company are held by any other person or persons, where the arrangement has the purpose or a purpose of defeating the effect of section 245C, then the control interests are deemed to be held by those persons equally.

(b) The Purpose of the Arrangement

An objective evaluation of the arrangement is required to establish whether resident A effectively holds a 50% control interest in the joint venture. For example, the Managing Director may hold 0.5% of his shareholding on behalf of resident A in a manner intended to frustrate the control test requirements of section 245C.

(c) Inference

It cannot be automatically inferred that the structure like that outline was designed to avoid the effect of the CFC regime. There may be a number of non tax related reasons for adopting the arrangements, such as accommodating the commercial or tax needs of the non-resident joint venturer.

However, having considered all the relevant factors it may be that the only proper inference which can be drawn from the arrangement and surrounding circumstances is that it was implemented in this particular way so as to avoid tax.

Once it has been identified that the arrangement provides for tax benefits, an evaluation must be made as to whether they are a more than merely incidental consideration in the implementation of the arrangement.

(d) Frustration

The control interest requirements of section 245C are designed to ensure that the CFC regime applies to those New Zealand residents who control a foreign company. If the reality is that resident A owns a 50% interest in the joint venture operation, the Department will apply section 99 to the arrangement, on the basis that the 1% holding by the Managing Director is an attempt to circumvent the provisions of section 245C. This is notwithstanding that the

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specific anti-avoidance provision in section 245C(9) has no application because the arrangement is not entered into between two or more New Zealand residents.

The Department considers that section 99 can still apply notwithstanding that a specific anti-avoidance provision has been avoided. This is clear from the Privy Council decision in *Challenge*. The facts of the Challenge case were that Challenge acquired the shares in a tax loss company for the sole purpose of grouping those losses against Challenge's assessable income.

One of Challenge's arguments was that as section 191 of the Act contained its own specific anti-avoidance provision and that as Challenge had not temporarily acquired the shares in Perth and were not therefore within the ambit of the activities proscribed by section 191(1)(c)(i), then section 99 could not apply.

Section 191(1)(c)(i) provided, in general terms, that in determining whether the requisite proportions had been met at the end of the year for the purposes of the tax grouping provisions, the Commissioner could disregard any temporary alteration in shareholding or constitution of a company.

The taxpayer's submissions on this point were firmly rejected by the majority of the Privy Council in the Challenge case. To reiterate, the Department considers that the existence of a specific anti-avoidance provision within a section, e.g. the export incentive provisions, will not bar the application of section 99. Similarly, section 99 operates side by side with sections such as section 96, which have an anti-avoidance function.

In this example the mere fact that resident A has settled for less than a 50% interest in the joint venture company does not in itself create a presumption that the intention of the legislation has been frustrated. A detailed analysis must be undertaken as to the true capacity in which the shares owned by the Managing Director are held, in order to determine if they are held on behalf of resident A.

Section 99 will not have application, where that section has been expressly excluded from operation, e.g. section 336Y of the Act excludes section 99 from application in the context of fringe benefit tax.

3A. PREPAYMENT OF INTEREST (PRIOR TO ACCRUALS REGIME)

FACTS

For the purposes of this example, the transaction occurs prior to the introduction of sections 64B to 64M of the Act (the "accruals regime"). PI Ltd need to borrow $ 100,000 to finance their assessable income earning activity. The capital is to be fully employed in the production of PI Ltd's assessable income earning process. Bank Ltd offer two alternative funding proposals.

Proposal one, a five year loan of $ 100,000 at 10% simple interest per annum (the current market interest rate for loans of this term). For years one to four, interest of $ 10,000 is payable annually in arrears. At the end of five years PI Ltd is required to pay $ 110,000 to Bank Ltd, being interest of $ 10,000 and principal of $ 100,0000.

Proposal two, a five year loan of $ 100,000 with interest required to be prepaid. The loan agreement also provides that there is no right of refund of the prepaid interest in the event of the loan being repaid early. The prepaid interest is calculated as the present value of the future stream of interest payments of $ 10,000, that is, the interest payable in arrears in proposal one. Applying a 10% discount rate, the prepayment amounts to $ 37,907. At the end of five years, PI Ltd is required to repay the principal of $ 100,000 to Bank Ltd.

PI Ltd selects proposal two because it can obtain a tax deduction in terms of section 106(1)(h)(i) at the time of payment of the interest in year one. PI Ltd funds the interest payment out of existing cash resources.

INTERPRETATION

(a) Scheme and Purpose

The statutory scheme in relation to the tax deductibility of interest has not been conclusively resolved. However, it is the Department's policy that in order to qualify for a deduction in terms of section 106(1)(h)(i) the following criteria must be met:

(i) The taxpayer's purpose in borrowing the capital is relevant at the threshold stage of considering whether the statutory nexus has in fact been met: *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5146, 5154.

(ii) The terms of section 104 must be satisfied as well as section 106.

(iii) Interest is a prohibited deduction unless it comes within the exceptions contained in section 106(1)(h)(i), (ia), (ii).

(iv) The paragraphs of section 106(1) provide cumulative proscriptions i.e. is the interest deduction prohibited by the other provisions of section 106(1) e.g. section 106(1)(j).

Aspects of the Department's policy were recently confirmed by Barber J in Taxation Review Authority Case No. 83/33. His Honour held that a taxpayer must cumulatively satisfy sections 104 and 106(1)(h) to qualify for an interest deduction. Specifically, in terms of this example, the Department considers that provided the tests as prescribed in section 106(1)(h)(i) are satisfied then the interest will be deductible for tax purposes. In other words, where the terms of section 106(1)(h)(i) have been met then that will be sufficient to satisfy section 104. In the circumstances section 104 is not considered to impose a more stringent test than section 106(1)(h)(i).

The issue is largely academic in regard to interest tax deductions post 1 April 1985 because of the close similarity between sections 104 and 106(1)(h).

Prior to 1 April 1985 section 106(1)(h) provided for a deduction for interest where:

(i) It was payable on capital employed in the production of assessable income; or

(ii) It was payable by one group company in respect of money borrowed to acquire shares in another group company.

With effect from 1 April 1985 the section was significantly redrafted. The Income Tax Amendment Act 1987, inserted a proviso to section 106(1)(h) to the effect that accrual expenditure is deemed to be "interest payable". The Income Tax Amendment Act (No. 2) 1987, replaced the former section 106(1)(h)(i) as it existed prior to 1 April 1985 and introduced new subparagraphs (i) and (ia) in similar form to section 104.

Commencing from 1 April 1985, section 106(1)(h) provides for the deductibility of interest in the following terms, where:

(i) It is payable in gaining or producing the assessable income for any income year; or

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(ia) It is necessarily payable in carrying on a business for the purpose of gaining or producing the assessable income for any income year; or

(ii) It is payable by one company included in a group of companies in respect of money borrowed to acquire shares in another company included in that group of companies:

Provided that for the purposes of this paragraph expenditure deemed to be incurred pursuant to sections 64B to 64M of this Act shall be deemed to be interest payable.

Prepaid interest loans entered into between 1 April 1985 and 31 July 1986 (the earliest implementation date for the accruals regime) are dealt with in terms of the new section 106(1)(h)(i), (ia), and (ii). However, the proviso is inoperative as prepaid interest schemes entered into before 31 July 1986 will not be subject to the accruals regime.

In this example the capital is fully employed in the assessable income earning process so that sections 106(1)(j) or 106(1)(a) have no application.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement its principle purpose is to provide PI Ltd with funds and to do so in a tax effective manner.

(c) Inference

The inference to be drawn from the facts of this case is that PI Ltd primarily required further working capital. The tax avoidance purpose is considered to be merely incidental.

(d) Frustration

The Department considers that the scheme and purpose of section 104 and section 106(1)(h)(i) has not been frustrated in the circumstances described above. More specifically, the Act did not prior to the introduction of the accruals regime prohibit the deductibility for tax purposes of interest paid in advance.

Additionally, the transaction is not artificial, the borrower has incurred real interest expenditure calculated by discounting to present value interest payable in arrears at the market interest rate. The prepaid interest is deductible in these circumstances.

The Department considers that section 99 would not apply to this arrangement because the scheme and purpose of section 104 and section 106(1)(h)(i) has not been frustrated and the taxpayer has been involved in genuine commitments and expenditure.

3B. PREPAYMENT OF INTEREST (PRIOR TO ACCRUALS REGIME)

FACTS

The transaction occurs prior to the introduction of sections 64B to 64M of the Act (the "accruals regime"). PI Ltd is a company which has substantial assessable income for the income year ending 31 March 1985. Bank Ltd is a financial institution whose activities include borrowing and lending money.

PI Ltd enters into the following tax saving arrangement. On 29 March 1985 Bank Ltd advances $ 750,000 for 3 years to PI Ltd. The terms of the loan require an upfront payment of interest of $ 287,675 (17.5% annual compounding) payable one day after the drawdown of the loan. Although it is not a term of the loan agreement that Bank Ltd or PI Ltd can make early repayment of principal, it is expected and anticipated that the loan will be repaid at a discounted value of $ 462,325 shortly after drawdown. A fee of $ 30,000 is payable by PI Ltd for this loan facility.

PI Ltd deposits the $ 750,000 received on drawdown on call at 18% per annum.

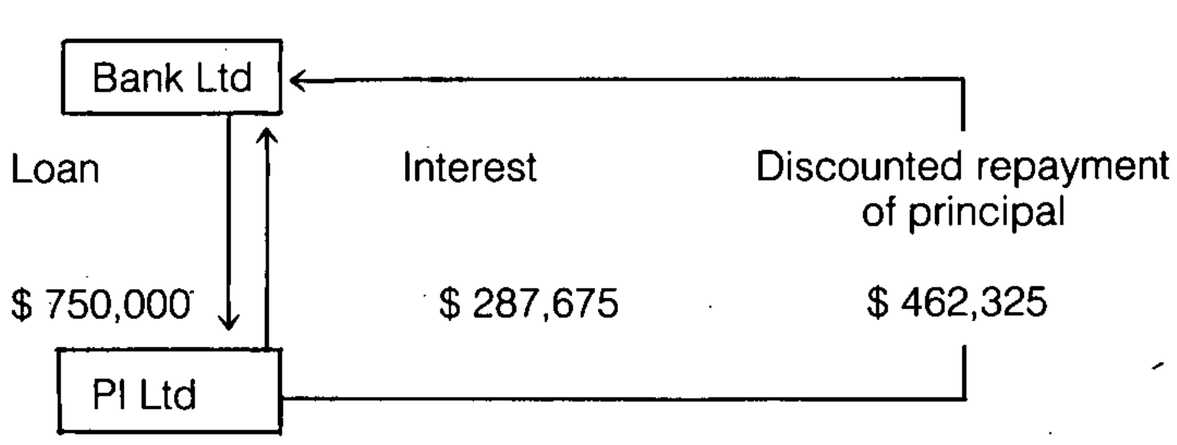
On 30 March 1985 PI Ltd recalls the sum of $ 287,675 and uses this to make the upfront payment of interest of $ 287,675 to Bank Ltd. PI Ltd claims an interest deduction in terms of section 106(1)(h)(i) of $ 287,675 for the income year ending 31 March 1985.

On 31 March 1985 PI Ltd recalls the $ 462,325 remaining on call and uses this to fund the discounted repayment of principal of $ 462,325. The "gain" to PI Ltd of $ 287,675 (i.e. the gain arising from the discharge by PI Ltd of its debt of $ 750,000 by a payment of $ 462,325) is treated as capital and consequently non assessable.

Interest is credited daily on the outstanding balance and the investment earns PI Ltd $ 598 of assessable income for the year ending 31 March 1985.

Bank Ltd return the interest of $ 287,675 as assessable income for the year ending 31 March 1985. The net tax effect to Bank Ltd of this arrangement is nil (ignoring the facility fee), the loss on loan of $ 287,675 (arising from the acceptance of a payment of $ 462,325 from PI Ltd in discharge of the debt of $ 750,000 owed to Bank Ltd) being set off against the assessable interest income.

The arrangement can be illustrated as follows:



Temporary investment

INTERPRETATION

(a) Scheme and Purpose

The statutory scheme in relation to the tax deductibility of interest is set out in example 3A above.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement its sole purpose is the avoidance of income tax. It is considered that the income earning purpose is inconsequential to the tax avoidance purpose.

(c) Inference

The only inference that can be drawn from this arrangement and surrounding circumstances is that it was implemented in this particular way to avoid tax. The arrangement is economically neutral to all parties except for the interest deduction and loan facility fee.

(d) Frustration

The Department considers that the interest is not deductible in terms of sections 104 and 106 as the deduction does not satisfy the statutory test for deductibility in so far as the nexus to assessable income has not been established. On the

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contrary the only purpose of this arrangement is the avoidance of tax.

This arrangement is clearly intended to frustrate the scheme and purpose of the Act as it relates to the tax deductibility of interest and the Department would apply section 99 to this arrangement.

The following dictum from Lord Templeman in the Challenge (PC) case is binding authority that such arrangements constitute tax avoidance:

> In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering the reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.

4. SECTION 160A: AMOUNTS PAID ON SHARES IN PETROLEUM MINING COMPANIES

FACTS

P is a petroleum mining company in terms of section 214B of the Act. In order to continue its petroleum mining operations in New Zealand, it decides to raise further capital by way of an issue of ordinary shares to the public.

E, a New Zealand resident individual considers that the shares will rise in the short term after the public issue. On the basis of this expectation, E borrows to subscribe to the shares and concurrently enters into a sale agreement with non-resident purchaser L. The sale agreement provides that the sale to L is to occur two weeks after acquisition of the shares by E, at the then prevailing market rate.

Pursuant to this plan, E subscribes to the shares in P on 25 July 1986 and claims a one third deduction against E's assessable income pursuant to section 160A of the Act.

INTERPRETATION

(a) Scheme and Purpose

The Income Tax Amendment Act 1979 introduced into the Act a new taxation regime for petroleum mining companies. The regime provided for taxation incentives to petroleum mining companies, e.g. section 214B(5) provides for the deduction of exploration expenditure (this term being defined to include what would otherwise be considered to be capital expenditure); and to investors in petroleum mining companies, e.g. section 160A. This section allows a New Zealand resident shareholder to claim a deduction of one-third of the amount paid as subscriptions or calls on petroleum mining shares, subject to the following limitations:

(a) The money is used by the company in the exploring or searching for petroleum in New Zealand.

(b) The shares are ordinary shares in the company.

(c) The deduction being disallowed if the petroleum mining company does not use the money for the prescribed purposes within a reasonable time.

The section 160A deduction only applies to payments made on or before 30 September 1986 pursuant to calls made on or before 31 July 1986.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement, it is entered into for the purpose of deriving a taxable profit. An incidental consequence of the arrangement is the availability to E of the section 160A deduction.

(c) Inference

The inference to be drawn from the arrangement is that the tax consequences are merely incidental to E's profit making objective.

(d) Frustration

The Department considers that the plan falls within the underlying policy considerations for the provision; being to encourage capital contributions to companies whose business is the mining of petroleum in New Zealand. Additionally, the plan is neither artificial nor unreal.

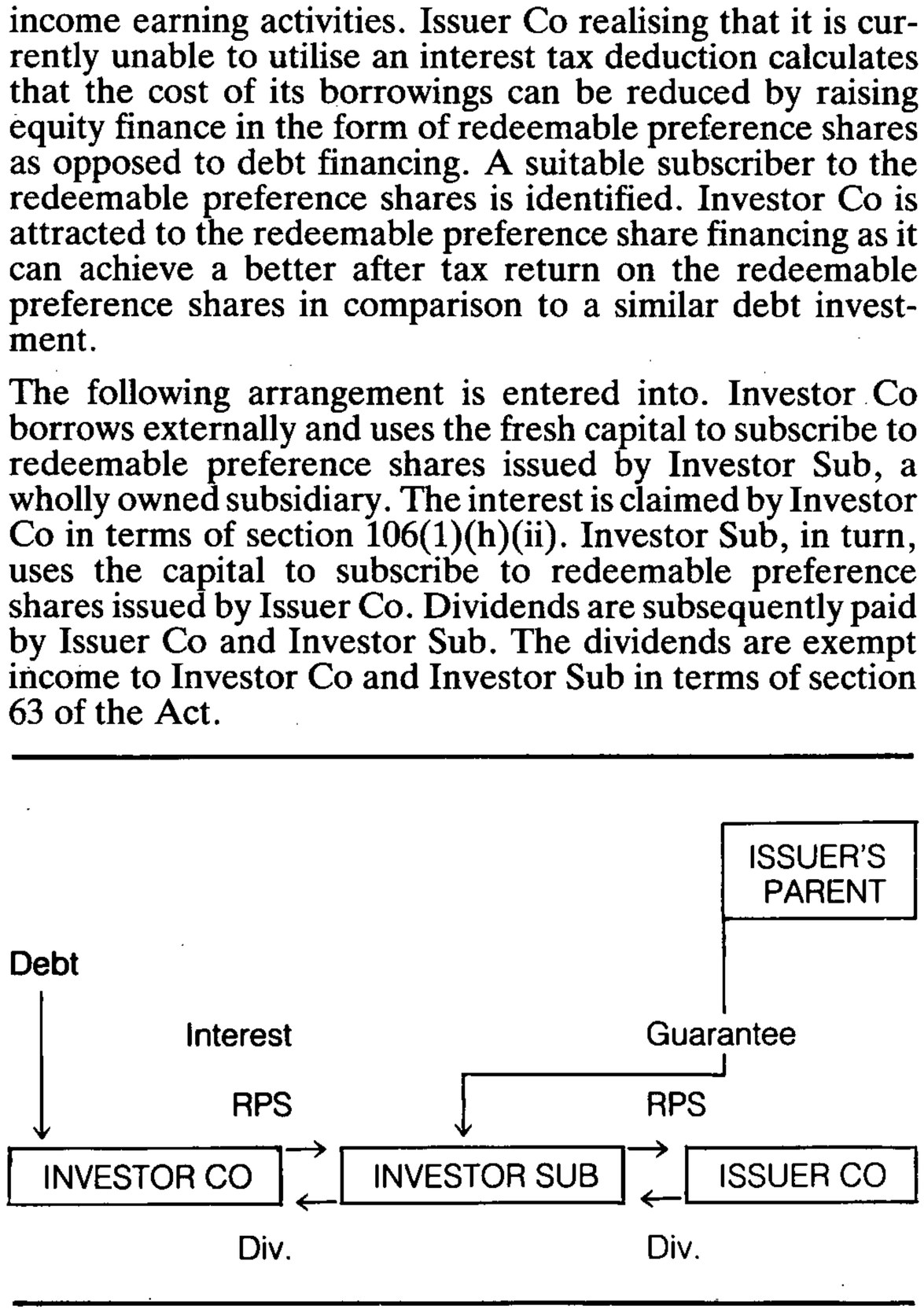
The Department considers that section 99 would not apply to this arrangement because the scheme and purpose of section 160A has not been frustrated, more specifically, the section does not specify any period of time that a resident shareholder must hold the petroleum mining company shares in order to qualify for the deduction. The taxpayer has also been involved in genuine commitments and expenditure.

5. REDEEMABLE PREFERENCE SHARE FINANCING

FACTS

Issue Co is a company which is currently in a tax loss situation which is expected to subsist in the foreseeable future. Issuer Co needs to raise further finance to fund its assessable income earning activities. Issuer Co realising that it is currently unable to utilise an interest tax deduction calculates that the cost of its borrowings can be reduced by raising equity finance in the form of redeemable preference shares as opposed to debt financing. A suitable subscriber to the redeemable preference shares is identified. Investor Co is attracted to the redeemable preference share financing as it can achieve a better after tax return on the redeemable preference shares in comparison to a similar debt investment.

The following arrangement is entered into. Investor Co borrows externally and uses the fresh capital to subscribe to redeemable preference shares issued by Investor Sub, a wholly owned subsidiary. The interest is claimed by Investor Co in terms of section 106(1)(h)(ii). Investor Sub, in turn, uses the capital to subscribe to redeemable preference shares issued by Issuer Co. Dividends are subsequently paid by Issuer Co and Investor Sub. The dividends are exempt income to Investor Co and Investor Sub in terms of section 63 of the Act.



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Additionally, Investor Co requires security in respect of the redemption of the redeemable preference shares. Accordingly, another company in Issuer Co's group, e.g. Issuer's parent company, guarantees Issuer Co's obligations to redeem the redeemable preference shares. Investor Sub allows Investor Co to pledge this guarantee as security for the debt raised from its own lender.

INTERPRETATION

(a) Scheme and Purpose

The Act marks a line between the taxation treatment of debt and equity investments. Sections 64B to 64M (the "accruals regime") provides for a comprehensive regime for the taxation of financial arrangements (a term which expressly includes a "debt instrument"). The accruals regime was not intended to effect the taxation treatment of equity instruments. This intent is reflected in the legislation, where in general terms shares are an "excepted financial arrangement", as that term is defined in section 64B(1) of the Act.

Equity investments have in general terms always been treated differently to debt investments for tax purposes, e.g. interest is deductible but dividends are not. This difference has recently been further accentuated by the introduction of a full imputation system.

Additionally, the Act has previously contained provisions which deemed certain debt instruments to be taxed as equity, e.g. section 192 dealing with floating rate debentures and certain equity instruments to be treated as debt, e.g. section 194 dealing with deductions for dividends on specified preference shares. As far as possible these deeming provisions have been refined or removed. Section 192 was further clarified to ensure that floating rate debentures that were to be treated as equity were those where there was a direct relationship between the company's profits and the debenture payment. Secondly, section 192(3) expanded the exemption from treatment as equity where the interest on the debenture is calculated in terms of indices independent of the company's performance.

The deduction for dividends on section 194 specified preference shares has been removed for post accruals regime issues.

The intent of these amendments has been to ensure the delineation between debt and equity instruments for tax purposes is maintained as far as possible, without undermining the integrity of the tax system, e.g. the tax treatment of debentures issued in substitution for shares was retained (section 195) and accordingly to tax financial instruments according to their true legal form.

By drawing and recently reinforcing the distinction between debt and equity instruments for tax purposes, the scheme of the Act is clear in its intent to provide for taxpayers a choice of raising or investing in capital by way of debt or equity instrument.

The interest deduction is claimed in terms of section 106(1)(h)(ii) which provides for a tax deduction for interest on money borrowed to acquire shares in another group company.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement its purpose is to raise finance and to do so in the most tax efficient manner.

(c) Inference

The inference to be reached on evaluating the arrangement is that the tax considerations are merely incidental to the purpose of fund raising.

(d) Frustration

The scheme of the Act contemplates that taxpayers may raise finance through either the debt or equity market. The scheme of the Act has not been frustrated when a taxpayer simply selects an option that the Act clearly contemplates that the taxpayer might choose.

Section 106(1)(h)(ii) provides a special deduction outside the general scheme of the Act, which has its own nexus, not between expenditure and assessable income, but between expenditure and the acquisition of shares in a group company. Investor Co has incurred genuine expenditure and both Investor Co and Investor Sub are members of the same group of companies. The terms of section 106(1)(h)(ii) are therefore satisfied.

The Department considers that section 99 would not apply to this arrangement because the scheme and purpose of the relevant provisions of the Act have not been frustrated and Investor Co is involved in genuine commitments and expenditure.

6. VALUATION OF TRADING STOCK

FACTS

J Company is in the business of importing and selling computers. For the income year ending 31 March 1988, the corporate tax rate was 48 cents per dollar reducing to 28 cents per dollar for the income year ending 31 March 1989.

J Company ordinarily adopts the cost price alternative for valuing its closing stock for tax purposes. J company realises that it can achieve a tax saving by reducing its assessable income for the income year ending 31 March 1988 via the use of the trading stock valuation options contained in section 85(4).

In pursuit of this goal, J Company elects in terms of section 85(4) to value its closing stock of computers at replacement price. J Company evaluates the other options but this valuation represents the lower of the three permissible alternatives of cost price, market selling value and replacement price.

J Company accepts the risk of an increase in assessable income for the year ended 31 March 1989 (primarily because of the reduced value of the trading stock adopted in the previous year) because of the reduction of the corporate rate to 28 cents per dollar.

INTERPRETATION

(a) Scheme and Purpose

Section 85 of the Act provides for a comprehensive regime for bringing to account trading stock for tax purposes. In particular, section 85(4) provides a taxpayer with three different options for valuing trading stock at year end, i.e. cost price, market selling value, or replacement price. In addition section 85(4A) provides for a different regime for livestock, not used in a dealing operation. Section 85(6) requires a taxpayer to include in assessable income the value of the trading stock at the end of the income year. Section 85 provides for certain valuation options which are unique to the Income Tax Act, i.e. they do not reflect any external business norm. Specifically, the tax options can be usefully contrasted to options available for accounting purposes. Statement of Standard Accounting Practice No. 4 (SSAP 4)

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"Accounting for Inventories", provides that inventories should be valued at the lower of cost and net realisable value, whereas the tax options are cost price, market selling value, and replacement price. The only similarity that the tax options have with accounting standards is the option to value trading stock at cost price. Secondly, it is important to note SSAP 4 requires the adoption of the lower of the two values specified, whereas section 85(4) provides for a choice of options irrespective of their comparative value.

Section 85, by providing for options for valuing stock which are not commercially available, i.e. at market selling value or replacement price and the provision of an unqualified choice as to which option to adopt, creates a unique tax norm.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement, its purpose is to reduce J Company's liability to tax.

(c) Inference

The prima facie inference to be drawn from the arrangement is that it was implemented in this particular way to avoid tax. The expression "tax avoidance" is defined in section 99(1) and includes "reducing or postponing any liability to tax".

(d) Frustration

Section 85 creates trading stock valuation options which are unique to the Act, against which there is no external commercial yardstick that they can be judged. The Department does not consider it as tax avoidance for taxpayers to adopt an option created by the Tax Act and which exists only for the purposes of the Act.

Section 85 is clearly intended to provide taxpayers with an unfettered choice as to how to value their trading stock at year end for tax purposes. The ability to achieve the type of tax saving described above is clearly contemplated by section 85.

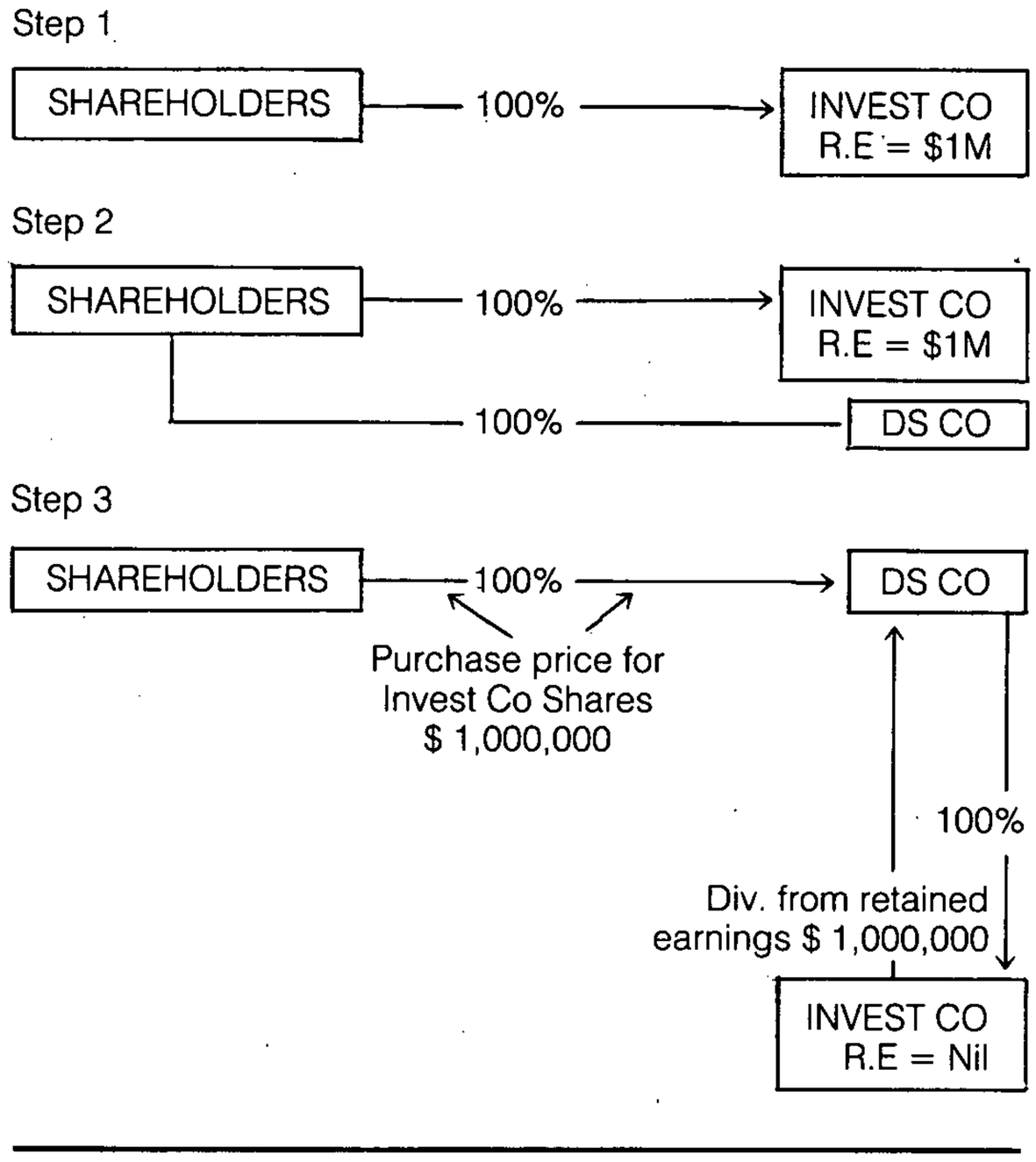
The Department considers that section 99 would not apply to this transaction because the scheme and purpose of section 85 has not been frustrated.

7. DIVIDEND STRIPPING

FACTS

Invest Co is an investment company with a substantial portfolio of interest bearing investments and retained earnings. The shareholders of Invest Co wish to have the retained earnings distributed to them in a tax free form. In accordance with a plan, the shareholders of Invest Co arrange for the incorporation of DS Co and subscribe to all of the share capital. The shareholders in DS Co cause DS Co to acquire all their shares in Invest Co for a consideration equal to the Invest Co retained earnings of $ 1,000,000. DS Co funds the purchase of the shares by causing Invest Co to pay a dividend out of and equivalent to Invest Co's retained earnings.

The effect is that the original shareholders of Invest Co have had distributed to them the retained earnings of Invest Co in a tax free form whilst still retaining effective control of Invest Co.



INTERPRETATION

(a) Scheme and Purpose

Section 99(5) is a specific provision included in the Act which deals with dividend stripping arrangements. In general terms the section provides that where the Commissioner considers that any consideration received by a taxpayer as a result of the sale of shares, is in substitution for a dividend that would otherwise have been received, the Commissioner may deem such consideration to be a dividend.

A precondition for the application of section 99(5) is that the arrangement satisfy the criteria of section 99(2). As a result the normal sale of shares (not having a tax avoidance purpose) will not be caught by the section.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement, it has been entered into solely to convert assessable dividend income into a non assessable receipt. The purpose of the arrangement is tax avoidance.

(c) Inference

The inference to be drawn from the arrangement is that it is entered into solely to avoid tax.

(d) Frustration

The Department considers that section 99(5) of the Act applies to this arrangement and would treat the consideration received by the shareholders of Invest Co for the sale of their shares in Invest Co to DS Co as an assessable dividend. Section 99(5) is clear in its intent to defeat arrangements intended to recharacterise assessable dividends into non taxable receipts.

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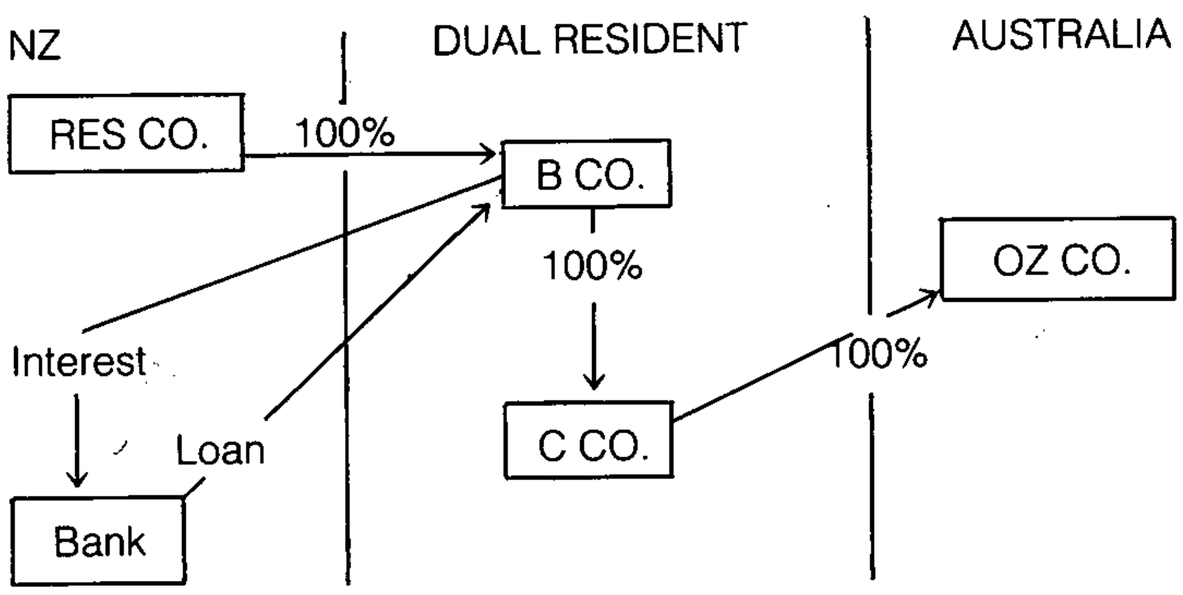
8. DUAL RESIDENT COMPANY LOSSES

FACTS

Res Co is a company resident in New Zealand. It has a subsidiary company, B Co, which in turn has a subsidiary company, C Co. Both B Co and C Co have been intentionally established so that they are residents of both Australia and New Zealand for income tax purposes. C Co has a wholly owned subsidiary in Australia, Oz Co. In order to finance investments by the group, dual resident company B Co, borrows to subscribe to shares issued by dual resident company, C Co. The interest deduction results in a tax loss in the dual resident company for New Zealand income tax purposes which is able to be grouped against assessable income derived by Res Co. Due to the dual resident status of B Co, the loss is also able to be grouped against the assessable income of Australian company, Oz Co. This results in the dual resident's tax loss being able to be utilised twice, once in each tax jurisdiction.

C Co advances funds to Oz Co and other associated group companies.

Section 191 was amended in 1987 by the insertion of section 191 (7E) and in 1988 by the insertion of section 191 (7F). In general terms, the effect of these provisions is to quarantine dual resident company and non dual resident company losses from New Zealand group company assessable income. The following interpretation applies to losses incurred by dual resident companies prior to the introduction of section 191 (7E) and 191 (7F).



INTERPRETATION

(a) Scheme and Purpose

The Act as it was structured prior to the introduction of section 191 (7E) and 191 (7F) did not contemplate or address the problem of dual resident company losses.

As no comprehensive scheme existed for the treatment of dual resident company losses, the analysis of the arrangement must proceed on the basis of analysing the scheme and purpose of the relevant taxing provisions affecting the different steps making up the arrangement.

The arrangement described above generally relies on an interest tax deduction in terms of section 106(1)(h)(ii) for its effectiveness. This section provides for a deduction outside the general scheme of the Act, which has its own nexus, not between expenditure and assessable income, but between expenditure and the acquisition of shares in a group company.

Section 191 of the Act provides for a comprehensive scheme for the offset of losses within groups of companies. The method by which losses may be offset depends on whether the group is characterised as a "group of companies" or "specified group". In general terms, a company is a part of a group of companies where there is a 66⅔% commonality of shareholding. Companies are a part of a specified group where the shareholders hold all the paid up capital in all the companies in the same proportions. A group of companies may transfer losses by subvention payment, whereas a specified group may choose between a subvention payment or notice of election. There are a multiplicity of tests which must be satisfied before a taxpayer can avail himself of the grouping provisions.

Section 191 creates a unique concept in a tax group, against which there is no external commercial yardstick. In other words, a tax group of companies is created by the Income Tax Act and exists only for the purposes of the Income Tax Act.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement it has several purposes: the financing of group company investments, the obtaining of a deduction in New Zealand and Australia for the incurring of a single expense, and to enable the dual resident company losses to be grouped against Res Co's income. The latter purpose would prima facie amount to "tax avoidance" as that expression is defined in section 99, being to relieve "any person from liability to pay income tax".

(c) Inference

The inference to be drawn from this arrangement and surrounding circumstances is that the tax deductibility of the interest by B Co and the subsequent grouping of B Co's losses against Res Co's assessable income is merely incidental to the purpose of funding the groups investment activity.

(d) Frustration

The Department has identified several multinational companies which have utilised the dual resident structure described above. The Department does not consider that the scheme of the Act as it was prior to the introduction of sections 191 (7E) and 191 (7F) has been frustrated in these circumstances.

The Department does not consider that section 99 applies to the above arrangement for the following reasons:

(a) The terms of section 106(1)(h)(ii) have clearly been satisfied by this arrangement.

(b) The scheme of section 191 has not been frustrated by this arrangement. Through section 191 the Act creates a tax group which exists only for the purpose of the grouping of tax losses. The Department does not consider that an arrangement can constitute tax avoidance where a taxpayer has simply satisfied the statutory form which the Act has purposely created. Although Res Co has been relieved to some extent of its liability to tax; that is one of the purposes of every offset of loss by one company against the profits of another; indeed it may be concluded that it is the only reason for the presence of section 191.

(c) The Department considers that the mere ability to utilise losses in two separate tax jurisdictions is not of itself sufficient to trigger the operation of section 99. *Europa Oil (NZ) Ltd v CIR* [1976] 1 NZLR 546, 556, remains good law on this point; section 99 is not concerned with the fiscal consequences of the disputed arrangement in another tax jurisdiction. Section 99 is

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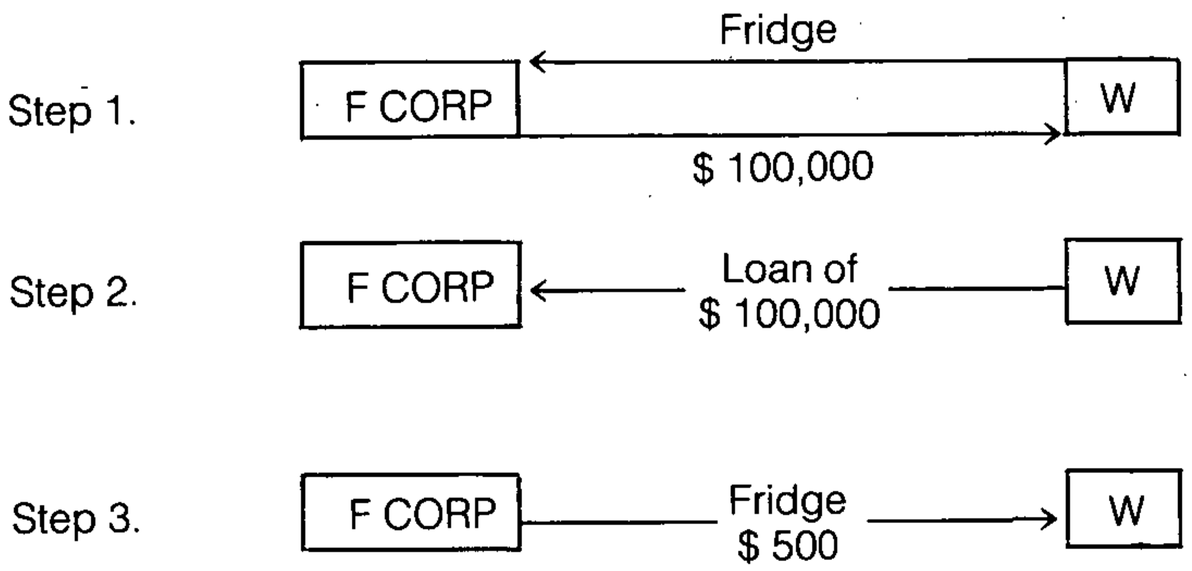
only concerned with the avoidance of New Zealand income tax.

9. CONTRIVED DEDUCTIONS

FACTS

F Corp is a company operating a business with substantial assessable income. The two major shareholders are a husband and wife, H and W respectively. F Corp enters into the following tax saving arrangement. F Corp acquire a household fridge from W for $ 100,000. The fridge is only worth $ 400. The purchase price is immediately lent back by W to F Corp on an interest free repayable on demand basis. The fridge is used by F Corp to store refreshments for entertaining clients. Two weeks after the purchase, F Corp sell the fridge to H for $ 500. F Corp claim the loss on disposal of $ 99,500 against its assessable income.



INTERPRETATION

(a) Scheme and Purpose

The Income Tax Act provides a code in relation to deductibility. Section 101 provides that no deductions are available otherwise than in terms of the Act. Section 104, the general deductibility provision of the Act, provides for a deduction for any expenditure or loss incurred, or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. Expenditure otherwise deductible in terms of section 104 may be restricted by the provisions of section 106, e.g. section 106(1)(a) prohibits deductions for capital expenditure. Section 108 provides the test for deductibility for depreciation.

(b) The Purpose of the Arrangement

On an objective evaluation of the arrangement it has been implemented in this way for the sole purpose of avoiding income tax.

(c) Inference

The only inference which can be drawn from the arrangement and surrounding circumstances is that it was implemented in this particular way to avoid tax.

(d) Frustration

The basis for deductibility of losses of this nature is unclear, the alternatives are section 104 or section 108.

Where the claim is made in terms of section 104 the Department considers that the loss is not deductible as the arrangement has been entered into for the sole purpose of avoiding tax and thus lacks the nexus to assessable income. It is also considered by the Department that losses incurred in the above circumstances clearly fall outside the scheme of section 104.

Where the claim is in terms of section 108 the Commissioner would similarly disallow the deduction on the basis that it lacks the nexus to assessable income.

The Department would also challenge the deduction on the basis that it amounts to capital expenditure in terms of section 106(1)(a).

Additionally, the Department would also invoke section 99 as the sole purpose of the arrangement is the avoidance of tax. The arrangement is artificial and is intended to frustrate the scheme and purpose of section [99 of the] Act.

As from 1 October 1988 the excess over the market value of the fridge, i.e. $ 99,600 is deemed to be a dividend to W in terms of section 4(1)(d) of the Act.

If an arrangement as described above were entered into by a taxpayer, the Department would give serious consideration to treating the arrangement as tax evasion.

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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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Greg Delany:

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Dr. Arjunan Subramaniam:

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Ian Harris:

HONG KONG: BUDGET 1990/1991: SOME WORRYING TRENDS 343

This article reviews the salient features of the 1990/1991 Budget which, the author asserts, is neither "predictable nor boring".

J.V.M. Sarma:

INDIA: 1990-91 BUDGET AND THE NEW CORPORATE TAX PROPOSALS: AN EVALUATION 347

The 1990-91 Budget contains many features that intimate an overhaul of the corporate tax system in India. The Finance Minister's proposals aim to simplify the tax structure by removing the numerous tax incentives which are in the form of deductions from the taxable profit base and instead granting a general reduction in the statutory tax rate. This article examines the effect of these proposed changes both on the long-term growth of the corporate sector and on the revenue yield.

John Fisher:

AN AUSTRIALIAN COURT'S REVIEW OF THE AUSTRALIA–SWITZERLAND DOUBLE TAXATION AGREEMENT 350

The Australian judiciary has rarely been called upon to interpret the provisions of a double taxation agreement. However, in the recent case of Thiel v. Federal Commissioner of Taxation *the court considered the meaning of the term "enterprise" as contained in the Australia–Switzerland agreement. In addition, the court reviewed the principles for interpreting tax treaties in general and the extent to which the court should have regard to external materials in interpreting a treaty.*

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Prof. Ben J.M. Terra:

International: Elimination des frontières fiscales dans la CE: Récents développements sur la TVA 311

Le Conseil Economique et Financier a adopté le 9 octobre 1989 les "conclusions" sur l'élimination des frontières fiscales. En commençant par le "White Paper" de 1985, le Professeur Terra revoit toutes les propositions portant sur la suppression des frontières fiscales et les conclusions adoptées durant les réunions de l'ECOFIN. Il donne en conclusion un aperçu de la situation actuelle.

Greg Delany:

Singapour: Les encouragements aux investissements 321

Tout laisse à penser que le gouvernement de Singapour continue à

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Prof. Ben J.M. Terra:

International: Die Aufhebung der Steuergrenzen innerhalb der EG: Neuere Entwicklungen auf dem Gebiet der Mehrwertsteuer 311

Am 9. Oktober 1989 hat der EG-Ministerrat des Wirtschafts- und Finanzausschusses „Schlussfolgerungen" zur Beseitigung der Steuergrenzen angenommen.
Ausgehend vom „White Paper" von 1985, gibt Prof. Terra einen Überblick über alle Vorschläge, die im Hinblick auf die Beseitigung der Steuergrenzen gemacht wurden und über die jeweiligen Schlussfolgerungen, die während der Treffen des Wirtschafts- und Finanzausschusses übernommen wurden. Prof. Terra beschliesst mit einer kenntnisreichen und einsichtigen Analyse der gegenwärtigen Situation.

Greg Delany:

Singapur: Steueranreize 321

Es deutet alles darauf hin, dass die Regierung Singapurs sich

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se soucier du développement de l'économie. L'une des méthodes ayant donné entière satisfaction pour remplir ces engagements est celle du recours aux avantages fiscaux pour les sociétés et les personnes physiques. Cet article met l'accent sur les différents avantages prévus en faveur des investissements à Singapour.

Veerinderjeet Singh:

Malaisie: Le système fiscal 325
L'auteur résume les points les plus importants du système fiscal malais applicable aux personnes physiques et aux sociétés. Une rapide description des différents avantages fiscaux prévus par la Loi sur la Promotion des Investissements de 1990 (telle qu'elle a été amendée) est également présentée dans cet article.

Dr. Arjunan Subramaniam:

Malaisie: Présentation des avantages fiscaux 334
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Ian Harris:

Hong Kong: Budget 1990/991: Quelques tendances inquiétantes . 343
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J.V.M. Sarma:

Inde: Budget 1990-91 et propositions d'un nouvel impôt sur les sociétés: Évaluation 347
Le budget 1990-91 présente de nombreuses dispositions qui sous-entendent une révision du système de l'impôt sur les sociétés en Inde. Les propositions du Ministre des Finances tendent à simplifier la structure fiscale en supprimant les nombreux avantages fiscaux sous forme de déductions à la base du bénéfice imposable et en les remplaçant par une réduction générale du taux de l'impôt. Cet article analyse les effets de ces propositions de modifications en fonction d'une part de l'évolution à long terme du secteur social et d'autre part en matière de revenus.

John Fisher:

Réexamen de la convention de double imposition australo–suisse par un tribunal australien 350
Il est peu habituel que l'on demande à la magistrature australienne d'interpréter des dispositions d'une convention de double imposition. Dans une affaire récente, *Thiel contre Federal Commission of Taxation*, la cour a toutefois analysé la signification du terme "entreprise" tel qu'il est contenu dans la convention australo–suisse. Elle a réexaminé à cette occasion les principes d'interprétation des conventions fiscales en général et dans quelle mesure un tribunal devrait tenir compte de circonstances extérieures dans l'interprétation d'une convention.

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weiterhin der Entwicklung der Wirtschaft verpflichtet fühlt. Eine sehr erfolgreiche Methode bei der Erfüllung dieser Aufgabe ist das Anbieten verschiedener Steueranreize und zwar sowohl für Körperschaften als auch für Individuen.

Veerinderjeet Singh:

Malaysia: Das Besteuerungssystem 325
Der Autor gibt einen Überblick über die wichtigsten Merkmale des malaiischen Personen- und Körperschaftsteuersystems. Desweiteren wird eine kurze Beschreibung der verschiedenen Steueranreize gegeben, die nach dem „Promotion of Investments (Amendment) Act 1990" gewährt werden.

Dr. Arjunan Subramaniam:

Malaysia: Ein Umriss der Steueranreize 334
Das 1986 in Kraft getretene Gesetz zur Förderung von Investitionen wurde im Februar 1990 geändert. Der Autor untersucht die wichtigsten Merkmale dieser Gesetzgebung einschliesslich des Pionierstatus (pioneer status), der Freibeträge für die Steuer auf Investitionen und der Anpassung der Freibeträge für die Industrie, des Ausfuhrfreibetrages für landwirtschaftliche Erzeugnisse und für Industrieprodukte und die Abzüge zur Exportförderung.

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Jefferson P. VanderWolk:

Besteuerung von Gewinnen aus internationaler Tätigkeit in Hong Kong: neue Entscheidungen 340
Unterliegen Gewinne von Unternehmen, die in Hong Kong angesiedelt und im internationalen Bereich tätig sind, der Gewinnsteuer in Hong Kong? Seit einigen Jahren beschäftigt dieses Problem – insbesondere im Hinblick auf die Frage, ob die Gewinne aus Hong Kong stammen – Unternehmen in Hong Kong mit Offshore-Aktivitäten. Neuere Entscheidungen hierzu haben die bereits unsichere Rechtslage auf diesem Gebiet weiter erschüttert und machen einmal mehr die Notwendigkeit einer sorgfältigen Planung internationaler Geschäfte, in die Hong Kong verwickelt ist, deutlich.

Ian Harris:

Hong Kong: Haushalt 1990/1991: Einige beunruhigende Trends 343
Der Artikel gibt einen Überblick über die wichtigsten Punkte des Haushaltes 1990/1991, der nach Auffassung des Autors weder „vorhersagbar noch langweilig ist".

J.V.M. Sarma:

Indien: Das Haushaltsbudget für 1990-91 und die neuen Vorschläge zur Körperschaftsteuerreform: Eine Auswertung 347
Das Haushaltsbudget für 1990-91 deutet auf eine Überholung des Körperschaftsteuersystems in Indien hin. Die Vorschläge des Finanzministers zielen darauf ab die Besteuerungsstruktur durch die Abschaffung zahlreicher Steueranreize in Form von Abzügen von der Bemessungsgrundlage zu vereinfachen und an deren Stelle eine allgemeine Absenkung des Steuersatzes treten zu lassen. Der Artikel untersucht die Auswirkungen dieser Vorschläge sowohl im Hinblick auf das langfristige Wachstum des Körperschaftsteuer- als auch des Einkommensteuersektors.

John Fisher:

Überprüfung des Doppelbesteuerungsabkommens Australien–Schweiz durch ein australisches Gericht 350
Nur höchst selten wird das australische Gerichtswesen angerufen, um Bestimmungen eines Doppelbesteuerungsabkommens zu interpretieren. In dem erst kürzlich entschiedenen Fall „Thiel gegen Federal Commissioner of Taxation" hatte das Gericht jedoch Gelegenheit, Überlegungen zur Bedeutung des Begriffes „Unternehmen", wie er im Doppelbesteuerungsabkommen Australien–Schweiz benutzt wird, anzustellen. Zusätzlich überdachte das Gericht die Prinzipien zur Interpretation von Doppelbesteuerungsabkommen im allgemeinen und die weitere Frage, inwieweit externe Umstände bei der Interpretation des Abkommens berücksichtigt werden können.

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INTERNATIONAL:

The Elimination of Tax Borders within the EC: Recent Developments Regarding VAT

Prof. Dr. Ben J.M. Terra and Julie Kajus*

I. INTRODUCTION

On 9 October 1989, after laborious discussions, the ECOFIN Council (the Economic and Financial Council of Ministers of the EC) on the elimination of tax frontiers – finally – adopted "conclusions". The spokesman of the Council affirmed that the Twelve have reached a "decisive phase on the road to elimination of tax borders". The first reports on the guidelines agreed upon were rather confusing: "the Commission's proposal to introduce the origin principle is rejected in favour of the destination principle, collection of the VAT in the country of consumption will be continued, intra-company transactions will remain taxed," etc.

On 13 November, the Finance Ministers confirmed their agreement reached the previous month. These orientations, however, were not complete, since there had been no agreement on the rapprochement of the VAT rates nor on the 'traveller' franchise. During the meeting on 18 December, the Council, meeting for the last time under the French presidency, reached, in principle, agreement on the 'harmonization of taxation'.

On 8 May 1990, the Commission presented an amendment to the proposal for a Council Directive supplementing the common system of VAT and amending the Sixth VAT Directive. The amendment is largely based on the agreement reached by the ECOFIN Council.

This article overviews all proposals regarding the removal of tax frontiers and the conclusions adopted during the ECOFIN meetings. The recent proposal by the Commission is also analyzed.

II. THE PROPOSALS: AN OVERVIEW

A. General

On 29 June 1985, the Commission published a White Paper for the European Council with the aim of working out in more detail a programme and timetable to "achieve a single large market by 1992 thereby creating a more favourable environment for stimulating enterprise, competition and trade". The White Paper is not intended to cover all possible issues which affect the integration of the economies of the member states of the European Community. It focuses on the internal market and the measures which are directly necessary to achieve a single integrated market embracing the 320 million people of the enlarged Community. The measures that need to be taken have been classified in the White paper under 3 headings:

- Part I: the removal of physical barriers;
- Part II: the removal of technical barriers;
- Part III: the removal of tax barriers.

The detailed timetable for implementing the measures is found in the Annex to the White Paper.

1. *The removal of physical barriers*

The customs offices at borders are the most obvious examples of physical barriers. Barriers, immigration control, passports and the occasional searching of personal luggage are to the ordinary citizen the clearest manifestation of the continued division of the Community. These barriers are equally important to trade and industry, commerce and business. The Commission's objective is to simplify existing procedures and ultimately to abolish internal frontier controls in their entirety. The Commission recognizes, however, that certain national protective measures do not in all their aspects fall within the scope of the Treaty, e.g. measures against terrorism and the illicit trade in drugs. If the objective of abolishing all internal frontier controls is to be achieved, alternative means of protection will need to be found. Obvious examples, in the Commission's opinion, are improving controls at the external frontiers of the Community, using spot checks at the internal frontiers and inland, and further enhancing cooperation between the national authorities concerned. The considerations which apply to goods and individuals are discussed separately.

a. The control of goods

The principles of proportionality and nondiscrimination have hitherto been central to the attempt to make internal frontier formalities more flexible and to simplify the free movement of goods. These principles will continue to apply in the future. Initially, the Commission intends greater flexibility at the frontiers by, for instance, avoiding duplication of controls on both sides of the frontier ("banalisation").

The shift from the alleviation to the elimination of internal frontier controls, however, is a major step and requires a qualitatively different approach. The Commission distinguishes between measures in commercial and economic policy, health control, transport checks and the collection of statistics.

(1) *Commercial and economic policy*
The Commission takes the view that it is not an unreasonable aim to achieve abolition of national and regional quotas by 1992.

(2) *Health*
Internal frontier posts are often used for making veterinary

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and plant health checks. The Commission intends initially that these controls (and the issuing of certificates) will have to be made exclusively at the place of departure. Subsequently, by aligning national standards to common standards for veterinary and plant health, the role of certificates should be drastically reduced. Specific restrictions should then only be necessary in emergencies such as epidemics.

(3) *Transport*
It is intended, inter alia, to abolish quotas and to introduce common safety standards.

(4) *Statistics*
Modern methods of data collection, including sampling techniques, can ensure that accurate and comprehensive trade statistics are compiled without the need for frontier formalities.

b. Individual travellers

The formalities affecting individual travellers are, firstly, police checks relating to the person's identity. Secondly, tax checks are carried out with regard to the importation of personal effects (see below). The Commission intends, in the short term, to seek a commitment from the member states that they will not introduce new or more stringent controls or formalities affecting individuals at internal frontiers. An attempt will be made to strengthen controls at external frontiers and enhance cooperation between the relevant national authorities. Proposals will also be drawn up concerning policy with regard to the issuing of visas and the granting of asylum, and the approximation of arms and drugs legislation.

2. *The removal of technical barriers*

The Commission states that the elimination of border controls, important as it is, does not in itself create a genuine common market. Goods and people moving within the Community should not encounter obstacles within the member states as opposed to encountering them at the border. Examples of technical barriers are the various requirements imposed by each member state on imported products with regard to health and safety or with a view to consumer protection. Only when these barriers have been removed will the Community be in a position to create the large economic and industrial market which will enable companies to achieve economies of scale and improve their competitive position.

The Commission's own strategy is aimed more at mutual recognition and equivalence of standards than at harmonization. The approximation of the member states' laws will, however, be continued. The Commission is trying to limit this harmonization to the establishment of basic requirements.

The White Paper goes on to discuss public procurement, free movement of labour and the professions, a common market for services, capital movement, the creation of suitable conditions for industrial cooperation (including a certain degree of harmonization of direct taxes) and the application of Community law.

The majority of complaints about infringement of Community law relate to Arts. 30 through 36 of the EEC Treaty (quantitative restrictions and measures having equivalent effect). Because of a lack of resources, the Commission can only settle less than half of these cases. The Commission will have to take more systematic action by publishing general communications setting out the legal situation for the whole of an economic sector.

If the above policy options are realized, the customs' main task will still be to supervise the remaining operation of the indirect taxation system applying in the member state concerned. For the customs, therefore, the problem of abolishing physical controls coincides largely with the removal of tax barriers.

3. *The removal of tax barriers*

After summarizing the historical development of the VAT directives, the draft directives and the excise (draft) directives, the Commission states that the harmonization of indirect taxation has always been regarded as an essential and integral part of achieving a true common market. However, in recent years momentum has been lost. If, the Commission continues, goods and services and people are to move freely from one member state to the other "in just the same way as they can within a member state", it is essential that frontier controls are abolished. Given the relationship between prices and levels of taxation (i.e. of VAT and excise duties), it must be considered whether it would be practically possible, in the absence of border controls, for member states to charge significantly different levels of indirect taxation. A distinction is made between commercial traffic and the individual traveller.

The starting point of the Commission for commercial traffic is the proposal for the Fourteenth VAT Directive and the system of postponed accounting which shifts the accounting procedures for VAT frontiers to inland tax offices. In view of the experience gained in the Benelux, the Commission thinks there are no convincing reasons why the Directive has not yet been adopted by the Council. Adoption of the Directive will not, however, result in the complete abolition of frontier controls. The Commission therefore advocates the setting up of a Community Clearing House System to ensure that VAT collected in the exporting member state and deducted in the importing member state is reimbursed to the latter.

The Commission sees problems in the present widely divergent rates and coverage of VAT which would expose the proposed system to heavy and systematic fraud and evasion. It would be all too easy for traders in high rate member states to obtain supplies from low rate member states and omit them from their records. The clearing house system would even less be able to provide a solution for the small trader not registered for VAT. These traders could legitimately shop across the border, and would do so, according to the Commission, where significant differences in taxation and corresponding differences in prices existed. The Commission concludes that there is no means of removing the frontier controls (and thus the frontiers) if there are significant tax and corresponding price differences between the member states.

In addition, the normal commercial transactions with regard to excise duties (removal from the bonded warehouse, transit, delivery to a bonded warehouse in the member state of destination) require frontier controls. The first simplification proposed by the Commission is that the Council should adopt the directives on common structures for excises which are already before it; a further streamlining could be achieved by linking national systems of excise suspension. The present wide differences in excise taxation would, however (if they persisted), lead to fraud and evasion. The conclusion is that a considerable adjustment is needed in excise coverage and, hence in the numbers of duties and rates.

For the individual traveller, the Commission's analysis con-

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centrates, as regards both VAT and excise duties, on the fact that differences in price levels result in considerable price differences. They create a powerful incentive for people living in high rate countries to cross the border and shop in low tax countries. The existence of travellers' allowances, their modest amounts and the disproportionate difficulty in obtaining agreement to limited increases all demonstrate, according to the Commission, that it would be impossible to dismantle tax frontiers unless there were a considerable measure of approximation of indirect taxation.

In the Commission's opinion, complete harmonization, which has come to imply absolute identity in every aspect, is not essential and for that reason we should use the term approximation. Next the Commission refers to the situation in the United States where there are no tax frontiers as such, and differences of up to 5% in tax rates are acceptable even between neighbouring states. On this basis, the Commission argues that if a target rate is introduced by the Community, the margin either side of that rate should be +/– 2½%. Purely as an illustration, this would mean that, if the norm for the standard rate were 16½%, actual rates adopted by member states could be in the range of 14 to 19%. In the case of excises, the indicative range of +/– 2½% would be less significant, as excises frequently account for a large proportion of the retail price. The Commission admits that further study is needed and confines itself in the White Paper to a general discussion of the broad picture. A survey of total revenue from indirect taxation as a percentage of GDP shows that for most member states the total yield differs little from the Community average (10.68%).

According to the Commission, approximation, looked at in this way, presents a budgetary problem that could be managed by most member states and it would not seriously disturb the existing relationship between direct and indirect taxation. The problem, therefore, is not so much the total yield of indirect taxation but the composition of that yield, namely the division between VAT and excises. Given adequate time, flexibility and political will, approximation will cause no more difficulty than many member states have encountered in determining their domestic tax policy.

The approximation of VAT focuses on 3 areas: (1) the common base, (2) the number of rates and (3) the level of the rates (particularly of the standard rate). The Commission recommends that the current draft directives be adopted with respect to the common base. It also announces further proposals. As far as the number of rates is concerned, the Commission finds that despite the present predominance of multiple rate systems, there are strong arguments in favour of a single rate. The Commission also argues that the draft directives on the common structures should be adopted for excises. Subsequently, VAT and excises should be treated together when proposals for common rates are drawn up.[1]

The Commission recognizes that the approximation of indirect taxation will give rise to considerable problems for some member states and that as a consequence it may be necessary to provide for derogations, although these should be kept to a minimum.

B. The progress – 1987

Since publication of the White Paper the Commission has made various reports to the Council and the European Parliament on the progress, thus far, towards completing the internal market. Although it is admitted that the progress is slower than the Commission would like to have seen, most proposals as foreseen in the White Paper have been presented to the Council. However, the Council is lagging behind in adopting the proposed measures. It is apparent that the Council will come under increasing pressure to accelerate the adoption of the proposals; herein will lie the ultimate test of the willingness of the member states to meet the deadline of (the end of) 1992.

In August 1987, the Commission issued a series of proposals concerning the measures in the field of indirect taxation as a follow-up to the chapter on tax barriers in the White Paper. Confining ourselves to the harmonization of the VAT, we will now discuss these proposals.

1. *Harmonization of VAT*

In the summer of 1987 the Commission of the EC issued a global communication, a working document and proposals for 7 directives presenting a blueprint of the indirect tax aspects of completion of the internal market.[2]

The White Paper demonstrated that in order to abolish fiscal frontiers there must be a considerable measure of approximation of indirect taxes. In its global communication the Commission proposes 4 major changes in the present system of indirect taxation within the Community.

First, the Commission proposes an approximation of the VAT and the main excise duties. Second, the Commission proposes to eliminate the distinction made at present between supplies within a member state and supplies to another member state. For intra-Community trade the existing system of relieving goods from tax upon exportation and of imposing tax upon importation will be abolished. Third, a revised VAT clearing mechanism is proposed. Fourth, for VAT purposes the Commission proposes to change the place of taxable transactions regarding the services.

2. *Approximation of VAT rates*

Although considerable progress has been made towards the creation of a common VAT base, notably by adoption of the Sixth Directive, further measures are necessary to abolish fiscal frontiers. The proposals of the Commission on approximation of VAT rates and the rate structure are related to (1) the number of rates, (2) the coverage of the distinct rates and (3) the rate levels.

The Commission refers to the existing situation in the member states with regard to the number of rates. Ten out of the 12 member states apply more than one rate. Although in theory, a VAT system with only one rate is the simplest and most efficient structure, it is clear that such an approach

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1. This is due to the fact that high VAT yields often exist side by side with low excise yields, and vice versa.
2. Completion of the internal market: approximation of indirect tax rates and harmonization of indirect tax structure; Global communication from the Commission. Com(87) 320 final; Completing the internal market – the introduction of a VAT clearing mechanism for intra-community sales. Working document from the Commission. Com(87) 323 final; Proposal for a Council Directive completing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates – Com(87) 321 final; Proposal for a Council directive completing and amending Directive 77/388/EEC – Removal of fiscal frontiers – Com(87) 322 final; Proposal for a Council directive instituting a process of convergence of rates of value added tax and excise duties. Com(87) 324 final; and 4 proposals on the approximation of cigarette taxes, of manufactured tobacco other than cigarettes, of excise duties on mineral oils and of excise duties on alcoholic beverages and other products containing alcohol. Com(87) 325 through 328. [hereinafter referred to as the 1987-proposals.] The Commission's proposals are largely based on the strategy provided for in the White Paper.

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would have disruptive consequences for all but 2 member states and is unlikely to be acceptable as a whole. The choice is between a 3 rate (reduced, standard and increased) and a 2 rate (reduced, standard) system. Clearly, a 3 rate system creates more complications for national administrations and taxpayers alike. In the member states applying increased rates they differ widely; their abolition will not create undue financial problems since they are only applied to a relatively small proportion of the tax base. For this reason the Commission prefers a 2 rate system.

Regarding the coverage of the rates, the reduced rate should, in conformity with existing practices in the Community, apply to items of basic necessity; mainly foodstuffs with the exception of alcoholic drinks, energy products for heating and lighting, supplies of water, pharmaceutical products, books, newspapers and periodicals and passenger transport.

The Commission deems it necessary to narrow the differences in the spread of rate between certain limits in order to avoid intolerable tax-induced price differences between (in particular adjacent) member states. For the standard rate the Commission proposes a range of between 14 and 20% (under these parameters 7 member states would currently fall within this range); for the reduced rate a range between 4 and 9%.

To prevent any further increase in the existing differences between national systems of indirect taxation, the Commission proposes the prohibition of any divergence in the number or level of VAT rates applied by the member states at present, while at the same time allowing and even encouraging, convergence towards the number and level of VAT rates as between the member states.

3. *Intra-community supplies of goods*

Under the present system of the Sixth Directive a distinction is made between supplies of goods which are dispatched or transported and other supplies. In the case where the goods are not dispatched or transported, the place of the taxable transaction is where the goods are at the moment of the supply. In case where the goods are dispatched or transported, either by the supplier himself or by the person to whom they are supplied or by a third person, the place of the taxable transaction is where the goods are at the time when the dispatch or transport to the person to whom they are supplied begins. In case of exportation, the VAT will be remitted or the delivery will be subject to zero-rating. Upon importation into another member state VAT will be charged.

The Commission does not propose to change the place of supply, but rather the tax treatment. Instead of remittance or zero-rating, the VAT rate applicable in the member state of departure of the goods will be charged. "Importation" into another member state will no longer be a taxable event. The foreign VAT can simply be deducted in the member state of destination (provided the goods are used for taxed transactions) in the same way as the national input-VAT. Between the member state of departure that has collected the VAT and the member state of destination that grants deductions, the amounts of VAT should be cleared.

4. *The clearing mechanism*

The clearing system as proposed in the White Paper was designed to operate on the basis of bilateral flows between member states. In its new proposals the Commission has come to the conclusion that this is not necessary and that it can operate simply on the basis of money owed to or from a central account. Into this account – serviced by the Commission and operated exclusively in terms of the ECU – net exporting countries will be required to pay and net importing countries will receive payments from the account.

Under the proposed system member states will provide a monthly statement indicating its total VAT input and output figures for intra-Community trade (without being dependent on bilateral clearing or on a yearly balancing of the VAT accounts). The monthly payments by the member states, and consequential payments to and from the clearing account, are part of an ongoing process, never representing a fiscal balancing of the VAT accounts. There will be no need for traders to include separate input tax figures for purchases in each member state; they simply have to fill in 2 extra boxes on their normal declaration indicating the output and input VAT on intra-Community trade as a whole. Each member state will aggregate and convert the information received from the traders declarations into ECU before transmitting its monthly statement to the Commission's services. A noteworthy feature of the system, according to the Commission, is that the clearing account will show a surplus, approximately equal to the VAT charged on intra-Community sales to VAT-exempt businesses and other entities, since they are not entitled to deduction. Nevertheless the member state of departure of the goods shall report and pay the VAT into the central account.[3]

5. *Services*

From the outset of VAT in the Community, services were not accompanied by border tax adjustments. The place of supply is, according to the Sixth Directive, generally the place where the supplier of a service has a fixed establishment from which the service is supplied. Certain services, however, are linked to the customer's country within the Community provided he is an entrepreneur. In these cases the VAT of the customer's country has to be charged. With regard to transportation, the place of supply is where they physically are carried out, having regard to the distances covered.

The Commission proposes to amend the Sixth Directive in order to treat intra-Community services similar to the supply of goods. It is unnecessary to link certain supplies to the customer's country, since under the proposed clearing system tax charged in the supplier's country will be deductible in the customer's country.

The territorial application of transportation has also been reformulated; the fiscal charge is linked solely to the country of departure. As it turned out these proposals were considered too bold and radical. In May 1989 the Commission offered new, more moderate, proposals.

C. Further progress – May 1989

After having made an inventory of all objections raised by the member states, new proposals were submitted in May 1989.[4]

The Commission reiterates its objectives:
- the VAT and excise duty rates should be approximated;
- the tax frontiers are incompatible with a genuine single market.

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3. This may be different when Member States decide to treat the use of purchased goods by exempt businesses and other entities as taxed self-supplies. The foreign VAT will then be deductible – thus not resulting in a surplus of the central account – and the national VAT rate will be applied!
4. Com(89) 260.

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Nevertheless, a more pragmatic approach is suggested based on a threefold strategy, regarding (1) a transitional phase, (2) the VAT and (3) excise duties.

1. *The transitional phase*

A transitional period lasting until the end of 1992 should be introduced. Proposals will be made to simplify Community transit procedures by abolishing the transit advice note. Furthermore, the Commission intends to propose in 3 stages an increase of the travellers allowances, by quadrupling the value of the VAT allowances and doubling the specific quantitative allowances for excisable products. It is hoped that this will accelerate the alignment of fiscal conditions between the member states.

2. *VAT*

An alternative to the Commission's proposal for 2 rate bands is suggested. Only a minimum rate is suggested for the standard rate, i.e. not lower than 14%. Regarding the reduced rate, the Commission considered that the proposed band (4-9%) best meets the needs of the situation. Finally, with regard to zero-rated products it is admitted that, in the framework of a final compromise, member states, who so wish, could be authorized to maintain zero-rating for a very limited number of products currently subject to the zero rate.

A differentiated approach is suggested for the clearing house mechanism, whereby a system of clearing, or, rather, refunds is envisaged for residual transactions only, between taxable persons, the significant proportion of the transaction having been dealt with without use of the clearing mechanism.

The Commission is prepared to propose that mail order (distance) selling should be taxed under the conditions applicable in the country of destination of the goods. For the sales of cars it is suggested that in order to charge VAT in the purchaser's country, the place of supply would be defined as the place of registration.

With regard to purchases of institutional non-taxable persons (bodies governed by public law and those treated as such) and exempt taxable persons (banks, insurance companies, etc.), it is suggested that purchases in another member state should give rise to, in the country in which these operators are established, a self-supply procedure which would be taxable under the conditions applicable at the place of supply; or that a differential tax should be instituted which would be equal to the difference between the VAT paid on purchase and the VAT which would have been chargeable on similar goods and services in the country of destination.

Finally, intra-Community sales between approved members of a group could take place without VAT being applied. These transactions within the same group form a substantial part of intra-Community transactions.

The measures suggested above would result in a small percentage of residual transactions still to be dealt with in a clearing mechanism. It is suggested that a macro-economic approach to the clearing operation regarding these residual transactions should be acceptable. An essential condition of such a system would be the maintenance of a high quality statistical system in the Community, the principle of which has been proposed by the Commission.[5]

3. *Excises*

The Commission considers that flexibility is necessary with respect to excises. Uniform rates are no longer deemed necessary. Differentiated minimum rates on alcohol and tobacco should be compulsory by the end of the transitional period. Measures to prevent fraud could take the form of tax stamps (bands, permits, etc.).

Concerning mineral oils, attention should be paid to the risks of distortion of competition. For this reason the Commission proposes that either single rates or rate bands should be applied to the different products, without rejecting *a priori* the fixing of minimum rates in certain circumstances.

During the meeting in Madrid in June 1989, the revised Commission proposals found no favour in the eyes of the ECOFIN Council; the Council asked the ad hoc Working Party to propose a solution for the Council meeting on 9 October 1989.

D. The Lemierre report

In the so-called Lemierre report (Conclusions of the Presidency of the ad hoc Working Party on the Abolition of Fiscal Frontiers), it is stated that the introduction of a taxation system in the country of origin is still desirable, but presupposes conditions which cannot be met before 1 January 1993.

Three requirements were set by all delegations for meeting the conditions for an agreement on the removal of tax frontiers:

(1) exempting intra-Community trade between taxable persons from customs formalities and reducing administrative burdens on undertakings;[6]
(2) ensuring freedom of movement and purchase for individuals while obviating excessive risks of distortion of competition;
(3) ensuring the administrative monitoring and control of operations to secure correct application of taxes.

Even if these requirements are met, the present arrangements should be continued, "whereby tax would be applied in the country of destination to purchases by taxable persons, coupled with approximation of the rates and special arrangements for purchases of registered vehicles and for mail-order purchases and "tele-shopping" by private individuals and purchases by bodies not subject to VAT, or exempt from it..."

III. THE ECOFIN CONCLUSIONS

The following is the text of the conclusions adopted by the Council of 9 October 1989 on the elimination of tax frontiers.

> After examining the report made by the President of the ad hoc group, in compliance with the mandate given by the Council on 19 June 1989, the Council considers that the creation of a system of taxation in the country of origin, as proposed by the Commission, presupposes the fulfillment of conditions that cannot be met before 1 January 1993. Also, in order to achieve the effective elimination of borders by this

5. Com(89) 810 final, as amended in Com (90) 177.
6. All delegations felt that it would be very difficult to determine adequate legal criteria for eligibility under an arrangement where intra-Community sales between undertakings linked within one group would be effected with VAT suspended. The use of a single (trade) document and the periodical production of a summary list of the transactions carried out by sending and receiving undertakings is considered the most effective solution for control.

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date for companies and individuals, while respecting the economic neutrality of the common system of value added tax, the Council finds it necessary to continue, for a limited period of time, to collect the VAT in the State of consumption.

The planned solution must:
- ensure a lightening of the charges currently borne by companies and administrations;
- avoid distortions of competition without hindering free movement.

The first guide-lines agreed by the Council on VAT for application on 1 January 1993 are as follows:

1. transactions carried out by liable persons and exempted or non-liable bodies, will be taxed in the country of destination at the rate and under the conditions of this country;
2. for the great majority of delegations, the elimination of limits on purchases made by travellers linked to an alignment of rates will allow the establishment of freedom of movement and of purchases by individuals while warding off major risks of distortion of competition. The particular situations of certain member states will be the subject of specific arrangements;
3. purchases of registered motor-cars and, with the reservation of an in-depth examination, long distance purchases by individuals will be subject to VAT in the country of destination and at this country's rate in order to ensure the neutrality of the common VAT system;
4. companies' obligations will be simplified: all formalities connected to border crossings will be eliminated. Only the tax obligation of declaring intra-Community trade transactions a posteriori will remain, also allowing statistical follow-up on trade;
5. administrative follow-up and control of transactions will be ensured via strengthened administrative cooperation and exchanges of information among member states on VAT matters..

In the light of the Commission's and delegation's observations, the ad hoc group is responsible for continuing to examine the terms of application of this plan and the questions relative to excise duties and the budget consequences for member states. The ad hoc group will pay particular attention to the proper functioning of the proposed system and to the need for effective control measures to reduce the risks of fraud without creating distortions of competition and without hindering free movement. The ad hoc group will also examine the particular questions linked to the elimination of limits on purchases by travellers as well as the question of harmonization of rates, which should be resolved as soon as possible. The ad hoc group will submit its overall conclusions to the ECOFIN Council of 13 November 1989.

The following is a translation of the text of the official communiqué:

Conclusions of the Council of 13 November 1989 and the elimination of tax frontiers.
Following its mandate from the Madrid European Council, the ECOFIN Council considers that the tax mechanism to be established by 1 January 1993 has now been agreed upon. The initial guide-lines adopted by the Council on 9 October, and the overall conclusions of the Ad Hoc group, led the Council to retain the following solutions which will confirm the undertakings of the Single Act for companies and individuals.

1. The proposed mechanisms and arrangements will make it easier at a later date to switch to a unified taxation scheme in the country of origin, which remains the medium term objective.

   For a limited period, the smooth functioning of the VAT regime, in the case of operations between different member states carried out by individuals liable for VAT, must be ensured through the taxation of the recipient in the country of destination at rates and conditions prevalent in that country.

   Exonerated or non-liable organizations which purchase goods for a certain amount in other member states will be treated similarly.

2. The burden currently imposed on companies and administrations will be lightened through the elimination of formalities preceding the movement of the goods or those related to crossing borders. For tax purposes, enterprises will have to make all information allowing their intra-Community operations to be identified available to the administration. They will provide a periodical declaration, which should be as simple as possible, of these operations for statistical and tax purposes. The content of the obligations imposed in this framework will be specified in a Commission proposal, notably concerning the need for exchanges of information between administrations for tax inspection and the needs of statistical recording.

3. An action plan for inspection must effectively prevent the risks of fraud. It will be based primarily on the use of company declarations by national administrations, on the regular exchange of information and on the communication of relevant papers established by the administration. This permanent administrative cooperation should not raise any obstacles as a result of national legislation. It will complete existing procedures of mutual assistance.

4. The special treatment of certain categories of operations will allow competition distortion to be avoided without hindering free movement. Purchases of vehicles in another member state will be subject to VAT in the country of destination and at that country's rate. For long distance deliveries intended for an individual or a body that is tax-exempt or non tax liable and established in another member state, the seller or his representative will discharge the tax of the country of destination when the amount of sales of this type exceeds a certain threshold that has to be set.

4, bis. The concrete terms for implementation of the above principles (points 1 to 4) must be examined carefully so as to assure that for each Member State
- the costs currently incumbent on enterprises and administrations are reduced,
- distortions of competitions are avoided without hindering the free movement of goods.

5. The Council agrees to re-examine the alignment of VAT rates at a forthcoming session.

6. Goods subject to excise duties will move free of tax between warehousemen that are authorized by the administrations of the member states. Adapted provisions will allow buyers not having the status of warehouseman to buy from sellers in other member states, the excise being discharged in the State of consumption.

   The new Commission proposals concerning excise duties will be examined by the Council in order to reach the necessary degree of alignment for 1 January 1993 so as to avoid the distortion of competition and risk of fraud.

7. Quantitative limits and ad valorem on travellers' purchases will be removed on 1 January 1993 in conjunction with a sufficient alignment of VAT and excise rates.
   These provisions concern purchases exclusively intended for the personal consumption of travellers.
   The particular situation in Denmark, Ireland and Greece can be subject to specific arrangements on Commission proposal in the general framework of harmonization of rates.*

* The Danish delegation did not accept the text of point 7.

The Council is asking the Commission to submit the appropriate proposals to translate into Community legislation the orientations that result from the present conclusions.
The dynamic effects of the elimination of borders will, by themselves, create in parallel the most favourable conditions to this evolution. The elimination of purchase limits for indi-

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viduals will indeed necessarily lead to the continuation of rate alignment.

The budgetary consequences will be able to be borne more easily due to the extra growth resulting from the unification of the internal market; likewise the convergence of economies will eradicate the problem of compensation caused by the allocation of the product of the tax to the country of consumption.

The Council and the Commission therefore agree that an overall review will take place by 31 December 1996 at the latest so as to determine the terms and deadlines for definitive unification of the common VAT system at the outcome of a transitory period.

The meeting of December 18 complemented what already had been decided in principle on 13 November 1989. The Twelve agreed to not increase the present differences in VAT rates and to not undertake movements leading to normal rates to below 14% or above 20%. The details of the future tax regime will be finalized before the end of 1991. The United Kingdom reaffirmed the importance it attaches to its zero rating. Although it will take difficult negotiations before all the details are finalized, the basic aims – abolition of the tax frontiers, a lowering of the tax burden for industry, exemptions for tourists (Denmark still has a reservation on this) – seem to have been reached.

IV. RECENT PROPOSALS OF THE COMMISSION

On 8 May 1990, the Commission presented new proposals largely based on the agreement reached by the ECOFIN Council.

In addition to a proposal for a regulation concerning administrative cooperation in the field of indirect taxation[7] and an amended proposal for a Council Regulation on the statistics relating to trading of goods between member states,[8] "transitional arrangements" were proposed "with a view to establishment of the internal market".[9] This discussion is confined to the latter.

The proposal is an amendment to the proposal of 1987 (see above), which aims at completing and amending the Sixth VAT Directive.[10]

The starting point of the new proposal is the stipulation of a transitional period which will last until 31 December 1996 at the latest. Following the transitional period (1 January 1993 until 31 December 1996), the definitive taxation arrangements have to be introduced according to the proposals of 1987 and 1989 (see above). Thus, on 1 January 1997 all purchases will be taxed in the country of purchase; the tax charged in another member state will be deductible in the member state of destination and the clearing operation between member states will be based on a macro-economic approach.

A. The transitional period

Starting on 1 January 1993, purchases by private individuals will, as a general rule, be taxed exclusively in the country of purchase. There are, however, 2 exceptions to this rule during the transitional period: purchases from mail order companies and purchases of new cars.

The purchases by taxable persons (taxed or exempt) and by non-taxable persons within the meaning of Art. 4, para. 5 of the Sixth VAT Directive (hereinafter referred to as "public bodies") fall under a special regime, based on taxation in the country of destination and an exemption with the right to deduction in the country of purchase.

The concepts of "exportation" and "importation" have been abandoned with respect to intra-Community trade; therefore new concepts (with similar results) have been introduced – namely "exemption for acquisition transaction" and "acquisition".

For the sake of clarity, the proposals are dealt with under 4 headings: (1) mail order sales; (2) exemptions of intra-Community transactions; (3) taxable acquisition transactions and (4) miscellaneous provisions.

B. Mail order sales

The medium-term objective continues to be the move to a system of charging tax in the country of purchase on all transactions, including those by taxable persons. As from 1 January 1993, non-taxable persons must be free to purchase in the member state of their choice against rates applicable in that member state, without being confronted with frontier formalities. An exception is made for mail order sales and for sales of private vehicles, both of which fall under a special arrangement (see below).

The general rule is that mail order sales shall be deemed to take place at the time the consignment or means of transport reaches the purchaser. In other words, cross frontier mail order sales are taxed at the rate of (and the tax is payable to) the member state of destination. The provision is not applicable to mail order undertakings with a yearly turnover in cross frontier mail order sales not exceeding 1 million ECUs. However, these undertakings may opt for application of the general rule, an option which is valid for 2 successive years. It should be noted that this special mail order scheme is only applicable to sales to a non-taxable person "or a taxable person whose activity is fully exempt, who does not qualify for the arrangements provided for in the second indent at b", i.e. a fully exempt business which purchases less than 35,000 ECUs during a calender year in other member states, unless this business has opted for taxation of its acquisition in the country of destination.

C. Exemptions

Since the concept of exportation, and as its consequence, an exemption with a right to deduction can no longer be used for intra-Community transactions, new provisions are necessary to define the conditions for an exemption in the country of departure. A distinction is made between the status of the person carrying out the exempted transaction and the type of transaction and the status of the acquirer.

1. *Status of the person carrying out the exempted transaction*

As a general rule, supplies of goods to another member state are exempt if the supply in question is carried out by a totally or partially taxable person. In addition, the supplies of services directly connected to these supplies and the services carried out by intermediaries, fall under the exemption. Small and medium-sized undertakings (falling under the exemption of Art. 24 of the Sixth Directive) and flat-rate farmers (benefiting from the scheme in Art. 25) are explicitly excluded from the general rule. Exemptions to the general rule are to be found in the type of the transaction and the status of the acquirer.

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7. COM (90) 183 final.
8. COM (90) 177.
9. COM (90) 182.
10. COM (87) 322 final.

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A question that may be raised concerns the treatment of transactions between closely related enterprises. The general rule is that supplies of goods will be exempted; within the context of the Sixth Directive a supply of goods is a supply effected for consideration. Does this mean that transactions between, for example, subsidiary A and B, when B processes goods on behalf of A or serves as a storage facility or a distribution centre, are not taxed, except for the services rendered for a consideration?

In our view this seems to be a logical consequence. This means, however, compared to the present situation, that no tax is due upon importation (to be replaced by acquisition), resulting in a considerable loss, especially to those member states, in which a certain time elapses before the tax, paid upon importation, can be deducted or is refunded. It seems that via a back door the Commission has re-introduced the suspension of VAT on 'sales' between undertakings linked within one group, a concept that the ECOFIN Council unanimously rejected in December 1989.

2. *Type of transaction and status of the acquirer*

The general rule of exemption of transactions to another member state depends on the status of the acquirer. He must be either a totally or partially taxable person or an institutional non-taxable person (a public body) or a totally exempt person, whose annual acquisitions exceed 35,000 ECUs (unless the public body or totally exempt person has opted for taxed acquisitions).

As mentioned above, the general rule is that all supplies of goods and services directly connected with these transactions are exempted provided the acquirer has a certain status. This rule is expanded with respect to the supply of private vehicles, where supplies are exempted regardless of the status of the acquirer. Thus, when the purchaser is a private person or a public body or a totally exempt person, the supply from another member state of a (new) private vehicle is exempted. Private vehicles mean cars (including motorcycles), other than used vehicles which are part of the dealer's stock. Utility vehicles are excluded as are private cars other than those referred to above; the delivery of these vehicles falls under the general rule and is exempted if the acquirer has the status described above.

Consequently, the purchase of a used car by a private person is taxed solely in the country of purchase. So long as the rates vary substantially one may expect a lively trade in "hardly-used" cars. In this context a more accurate definition of a used car (e.g. used for more than 90 days) seems to be useful.

With regard to services directly relating to the exempted supplies, it should be noted that the place of departure will become the place of taxation of transport services. According to the explanatory notes the transitional arrangement reduces the scope of this new rule in that it re-introduces the exemption of transport services directly related to the exempted supplies These services do, however, form part of the taxable amount for the acquisition (see below).

D. Acquisitions

As the direct counterpart of supplies of goods which are exempted in the country of departure, the corresponding acquisitions are taxable in the country of destination.

Taxable events are:
(1) the acquisition of a new vehicle, regardless of the status of the acquirer;
(2) the acquisition of property by a wholly or partially taxable person, including purchases from mail order businesses;
(3) the acquisition of property by a fully exempt person or a public body, provided the total amount of the annual purchases exceeds 35,000 ECUs unless the option for taxation of the acquisition in the country of destination has been exercised. The taxable acquisition includes purchases from a mail order business.

From the foregoing it follows that no acquisition occurs when:
(a) supplies are made within the framework of a mail order business (with a turnover below 1 million ECUs) other than those referred to under (2) and (3) above;
(b) supplies of goods are made to private persons, including the supply of a used car;
(c) supplies of goods are made to a taxable person whose business is fully exempt or to a public body, provided the amount of total annual purchases does not exceed 35,000 ECU, unless the above option has been exercised. These supplies include used cars.

Two instances of *fictitious* acquisitions are introduced. The following will be treated as an acquisition made for a consideration:
(1) the application (by a fully exempt taxable person or by a public body) for the purpose of his business in the member state of arrival of property taken into the framework of his business in the Member Sate of departure;
(2) the application by a taxable person of property taken into the framework of his business in the member state of departure, where such property does not give the right to full or partial deduction in the member state of arrival.

In both cases the proposal prescribes that the member state of arrival shall take whatever measures are necessary to avoid double taxation.

E. Miscellaneous

The integrated approach of the Commission proposing measures for the transition period and for the final system as from 31 December 1996, has resulted in a patchwork of provisions. Sometimes a new provision is proposed and at the same time the old provision is re-introduced for the transition period. In this section we will only discuss provisions that are applicable during the transition period. Art. 2, secs. d through k, of the proposal provides for measures necessary to support the envisaged transitional system; Art. 3, paras. 1 and 2 provides that certain directives shall cease to have effect on 31 December 1993.

1. *Supportive provisions*

a. Taxable amount

Art. 2, sec. d deals with the taxable amount for the acquisition and includes the subsidiary costs – if they are not already included – relating to the acquisition. These incidental expenses are generally exempted with a right to deduction in the country of departure (commission, packing, transport) unless they relate to services which are exempted under Art. 13 of the Sixth Directive, such as insurance. A new Art. 4 of the proposal replaces the reference to the method of valuation for customs purposes for determining the taxable amount expressed in a currency other than that of the member state of arrival.

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b. Liability to the tax

Art. 2, sec. e deals with the liability to the tax in respect of acquisition transactions. The tax payable upon acquisition is treated in the same way as the tax payable in respect of goods supplied under domestic arrangements.

c. Place of supply of services

According to Art. 1, point 5 of the proposal (of 1987), the removal of fiscal frontiers makes it unnecessary to link the supply of services listed in Art. 9, para. 2(e) of the Sixth Directive to the customer's country. Under the proposed system (after 1996), tax in the suppliers' country will be deductible in the customer's country. However, based on Art. 2, sec. f, the present situation with regard to the supply of various intangible services will be maintained during the transitional period.

d. Option for banking and financial activities

Art. 2, sec. g seems to be the result of the strong lobbying of interest groups. At least for the duration of the transitional period, the right of option may be granted for taxation of banking and financial services, exempted by virtue of Art. 13Bd. It remains to be seen how many member states will actually grant a right of option.

e. In any case exempted

Art. 2, sec. h prescribes an exemption for acquisition of goods, the supply or import of which would in any case be exempted within the country (e.g. the diplomatic exemptions). According to the explanatory notes the exemptions of Art. 15, paras. 4 to 9 of the Sixth Directive (the exemptions with regard to fueling and provisioning of vessels and aircraft), will be looked at in greater detail at a later date.

f. Re-exportation

Art. 2, sec. i provides for an exemption of acquisitions, importations and supplies and of related services, which are to be exported to another member state or a third country in the same state or after processing. In this provision (based on Art. 16, para. 2 of the Sixth Directive), the exemption of acquisitions is added for the duration of the transitional period. It is remarkable that the term "exportation" is also used for transactions to other member states, although the explanatory notes emphasize that the term "exportation" no longer applies to trade within the Community.

g. Deductions

Art. 2, sec. j provides that the rules in force in relation to deductions also apply to VAT which is due or paid in respect of acquisitions. It is emphasized that during the transitional period there is no right to deduction within a member state for VAT payable or paid in another member state. Thus the deduction, based on a Community-wide dimension, will not become operative before 1997.

h. Obligations under the internal system

Finally, Art. 2, sec. k, points 1 through 10 deal with the obligations of persons liable for payment. It replaces Art. 22 of the Sixth Directive. The most important change is the obligation to state on the invoice the VAT registration number of the taxable person making the supply of goods and the VAT registration number of the person acquiring them.

2. *Directives ceasing to have effect*

A new Art. 3 in the proposal prescribes that the Directives 83/183/EEC and 74/651/EEC shall cease to have effect on 31 December 1992. As far as the intra-Community relations are concerned the Directives 69/169/EEC, 83/181/EEC and 85/362/EEC shall cease to have effect on 31 December 1992.

C. The system after 1996

The transitional tax system proposed by the Commission will expire on 31 December 1996. It will be replaced by a new permanent tax system where purchases are taxed in the country of purchase with a right of deduction of VAT within a member state for VAT payable or paid in another member state. The amounts of deducted foreign VAT will be cleared between the member states, presumably in accordance with the outlines sketched in Document COM(89) 260. In that proposal, a system of clearing, or, rather, refunds is envisaged for residual transactions between taxable persons, based on a macro-economic approach. A significant proportion of the transactions is dealt with without the use of the clearing mechanism such as mail order sales, the sales of cars and sales between approved members of a group.

V. CONCLUSION

Since an analysis of the details of the proposal falls beyond the scope of this article, we refer to our analysis in the June and July 1989 issues of the *International VAT Monitor*. Two aspects of the proposal are commented upon: the treatment of the single taxable person and the approach in general by the Commission.

A remarkable paragraph in the Lemierre report (see above) deals with intra-Community sales between undertakings linked within one group. "All delegations" felt that it would be very difficult to determine adequate legal criteria for eligibility under such an arrangement and that suspension of VAT would lead to distortions. Apparently 5 delegations (United Kingdom, France, Netherlands, Germany and Denmark) were not aware that such arrangements are applied in their country.

According to Art. 4, para. 4 of the Sixth Directive, member states may treat as a single taxable person, persons who, while legally independent, are closely bound to one another by financial, economic and organizational links. At a national level this concept does not cause "distortions" and it is suggested here that the national experiences offer a sufficient base to determine legal criteria for a Community concept of a single taxable person. (Or is it feared that such a concept even further necessitates harmonization?)

The concept of a Community-wide single taxable person is not the only provision necessary for a (residual) clearing system based on a macro-economic approach after 1996. In our view, during the transition period, provisions are also necessary with regard to cross border transactions between undertakings linked within one group. Under the proposed regime all transactions which do not take place for a consideration, will not be exempted nor followed by a taxable acquisition. In the country of departure, the goods fall under the internal rules with regard to deduction; supervising these transactions from a tax administration point of view in the country of destination becomes rather illusory since no taxable acquisition will be reported. This brings us to the approach in general of the Commission.

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It should first be noted that in the proposal reference is made to the origin principle; in our view this is incorrect. Based on that principle products are taxed and the tax benefits the revenue of the country where the goods are (finally) produced regardless of where they are eventually consumed. On the other hand, the destination principle taxes goods where they are consumed, regardless of where they are originally produced. The VAT, particularly when it extends to the retail stage, does not fit neatly into the principle of origin. If one wants to apply the origin principle so that no border tax adjustments would be necessary, difficulties arise with regard to imported products. These problems are caused by the inevitable deduction of the input tax.[11]

The proposal aims at charging the tax, after 31 December 1996, in the country where products are purchased, "the country of origin", but with an adjustment in the country of destination, thus applying the destination principle to its fullest extent.

The introduction of a new taxable event, "acquisition", does not improve the transparency of the VAT treatment of intra-Community transactions. It requires strenuous mental gymnastics to understand the complicated mail order scheme or the fictitious acquisitions. From this perspective, obviously, the Commission's proposal for the final tax arrangements is most attractive, since all purchases are dealt with in an identical way: purchases for internal consumption (or production) and purchases by taxable persons or individuals residing in another member state are taxed identically. If, nevertheless, this system should be rejected – for a limited period of time – it should be obvious, in our view, that solutions should be sought which at present are offered for *internal* transactions.

According to Art. 5, para. 7 of the Sixth Directive, member states may treat as supplies made for consideration the application by a taxable person for the purpose of his business of goods purchased or imported in the course of such business, where the VAT on such goods, had they been acquired from another taxable person, would not wholly be deductible. This possibility to create an internal levy could be extended to all cases in which a taxable person, with or without a right to full deduction, applies goods introduced from another member state (where these goods have been obtained zero-rated), resulting in an obligation to register for VAT purposes.

Such an internal levy is most attractive because a new chargeable event is unnecessary; additionally, various risks can be avoided, such as lack of information and control on transactions performed without consideration.

In the final analysis we consider the proposals with regard to the transition period a kowtow to the ECOFIN Council; they do not deserve serious consideration in public policy discussions. The best solution seems to be to introduce the final tax arrangements as proposed for 1997 starting on 1 January 1993. One prerequisite for such a solution already exists, namely poor proposals for a transition period. What is now required is the political will.

11. The natural result would be an allocation of the tax in proportion to the value added in each country concerned based on the so called restricted origin principle.

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SINGAPORE:

INVESTMENT INCENTIVES

Greg Delany

After rapidly recovering from an economic downturn several years ago, the Singapore economy is booming. Pro-business government policies, a highly trained and motivated work force, and a location at the cross roads of international trade routes in Asia have made Singapore the choice location for many international businesses. An excellent infrastructure, including one of the world's finest airports, have also contributed to the ease of doing business in Singapore.

By all appearances, the Singapore government continues to be committed to the development of the economy. One method which has been very successful in fulfilling this commitment is the use of various corporate and individual tax incentives. As a recent example, in order to encourage population growth in Singapore the government introduced generous procreation incentives. Each day en route to the office we can observe the effect of these incentives on birth rates in Singapore.

I. CORPORATE INCOME TAX INCENTIVES

Various corporate income tax incentives are available under the Economic Expansion Incentives Act ("the Incentives Act"). In practice, the granting of incentives and the conditions attached under the Incentives Act are at the Finance Minister's discretion, based on the recommendations of the Economic Development Board (EDB). Applications for such incentives are made in writing to the EDB. Incentives granted may be revoked by the Finance Minister if the conditions agreed upon are not met.

The corporate income tax incentives which are currently available include the following:

- pioneer industry/service incentives
- post-pioneer incentives
- investment allowances
- export of services incentives
- approved operation headquarters
- treasury and finance center incentives

A. Pioneer industry/service incentives

To obtain this benefit, a company must be approved by the Finance Minister as a "pioneer" enterprise, based on the merits of the project, e.g. the nature of the product, investment level, skills and technology, etc. Pertinent points for consideration are:

- Most enterprises can be considered for pioneer status except when the products concerned are already manufactured locally without a tax incentive. A service company may also apply for pioneer status if it is involved in one of the following qualifying activities: any engineering or technical service, including laboratory, consultancy, and research and development activities; computer-based information or production of any industrial design; and such other services or activities as may be prescribed.
- Pioneer certificates may be issued to more than one company manufacturing the same product.
- Specialized enterprises manufacturing new and desirable products may be considered for pioneer status even if the amount of their fixed investment is small (e.g. less than S$1 million).
- Longer periods of pioneer status may be available for projects involving a large investment, a higher level of skills, advanced technology, and long gestation periods.

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Mr. Delany wishes to express his gratitude to Mr. Pok Soy Yoong, Singapore tax partner of Ernst & Young, for his contribution to the article.

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An approved pioneer enterprise is entitled to full tax exemption for 5 to 10 years from the time it commences commercial production. Should the company incur losses during that period, the losses can be carried forward and offset against future profits. Tax adjustments and capital allowances (i.e. tax depreciation) are taken into account in determining the amount of tax-exempt profits.

Pioneer status has been granted to a wide range of projects with favourable development prospects. Both R&D organizations and computer software companies have recently merited such status. In addition, existing companies undertaking expansion, companies without pioneer status, or pioneer companies seeking additional concessions may apply for other incentives based on expansion plans, export performance or upgrading of local skills and technology.

To ensure the benefits of the pioneer incentive are not inadvertently dissipated, several ground rules should be observed.

1. Fixing the production day

The pioneer period starts from the "production day". This date is determined jointly by the company and the EDB and is taken to be the day the company commences production of the pioneer product in marketable quantities.

A company likely to have a long gestation period for its pioneer product should postpone the production day as much as it can. An earlier production day will mean the tax incentive period will commence at a time when the company has yet to become profitable. With coordination and planning between the marketing and production departments, the benefits of the incentive could be considerable enhanced.

2. Separate trade

A "separate trade" refers to that part of the business not covered by the pioneer incentive.

When a pioneer company is involved in a separate trade, a number of tax rules may come into play and result in a significant reduction in the level of the profits exempted from tax. This will in turn reduce the amount of tax-exempt dividends that may be distributed to the shareholders.

Firstly, if the separate trade suffers losses, those losses are combined with the pioneer profits, effectively reducing them. Also, those losses will no longer be available for deduction against the taxable profits of the separate trade in subsequent years. To avoid this negative result, the company should demonstrate to the Inland Revenue Department that the losses of the separate trade were not incurred for the purpose of obtaining a tax advantage (for example, through the arbitrary allocation of expenses between the pioneer and separate activities), so they need not be set off against the pioneer profits.

Another pitfall to watch out for is the abatement provision. The law states that if there is a separate trade which results in tax adjusted profits of less than 5% of the turnover of the separate trade, such profits must be adjusted to the equivalent of 5% of the turnover. At the same time, the pioneer profits will need to be reduced by the same amount. This effectively results in tax being payable on the pioneer profits deemed as income of the separate trade.

The problems related to the issue of separate trade can come about in one of two ways. A company may decide to diversify its operations in a small way after commencing the pioneer trade. Alternatively, the pioneer trade may be undertaken by a company already carrying on non-pioneer business.

The obvious solution to the separate trade problems is to house the separate trade in a different company. However, this only needs to be done if the separate trade is expected to make tax-adjusted profits of less than 5% of its turnover or in fact, losses. In other words, corrective action need only be taken if the separate trade is of a high volume and low margin nature. If the company anticipates problems with the abatement provisions, it may also apply to the Minister to consider a reduction in the deemed profit margin of the separate trade to a level lower than 5% of turnover.

3. Group structure

A common mistake in group situations is to place an intermediate holding company between the pioneer company and the ultimate holding company. The pioneer company is able to distribute its tax exempt profits to the intermediate holding company which may in turn redistribute them as tax-exempt dividends to the ultimate holding company. Unfortunately, the ultimate holding company will not be able to pass on the dividends tax-free to the shareholders. In order to avoid this consequence, careful planning of the group structure is needed before applying for the pioneer incentive.

4. Maximizing the benefits

The conventional thinking on non-pioneer operations is to focus on maximizing the tax deductibility of expenses. For pioneer companies, the conventional thinking is not always appropriate. The tax deductibility of expenses is not the primary concern; cost to the company is. An example of this is the decision whether to acquire company or privately registered cars for business use. A non-pioneer company would opt for company registered cars in order to maximize the tax deductions. A pioneer company, however, may prefer privately registered cars because they cost less to the company and the expenses disallowed for tax purposes will increase the amount of the tax-exempt pioneer profits.

It will be seen from the foregoing that a successful application for the pioneer incentive does not necessarily ensure that the full benefits of the incentive will accrue to the company. The pioneer company should always be on the lookout for those pitfalls which it must avoid.

B. Post-pioneer incentives

To encourage pioneer companies to remain in Singapore and continue to expand and invest, post-pioneer profits may be taxed at a concessionary rate (not less than 10%), as the Finance Minister may specify, for a maximum period of 10 years[1]. This incentive is available to existing pioneer companies or export enterprises immediately following their pioneer status on or after 1 April 1986.

C. Investment allowances

These allowances are available as an alternative to pioneer status and the export incentive for manufacturing and related service enterprises. Depending upon the expected results of operations, this incentive may be preferable to pioneer status. Projects that qualify include the following:

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1. The 10-year period is a 1990 budget proposal; until this proposal is passed the period is 5 years.

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- technical and engineering services, such as laboratory services or aircraft servicing;
- automation and upgrading of assembly operations;
- new manufacturing and related servicing projects;
- desirable expansion/diversification projects undertaken by existing companies;
- projects for the promotion of the tourist industry (other than a hotel);
- small but desirable new projects with a fixed investment of less than S$1 million.

For approved projects, tax-exempt profits are limited to specified percentages (up to 50%) of the actual fixed investment in factory buildings (excluding land) and new productive equipment. The investment allowance percentage varies according to the nature of the project and the amount of assets involved.

The investment allowance for any accounting year is the specified percentage of qualifying fixed investment made during that year, and it may be set off against the taxpayer's chargeable income from all sources for that year. If there is insufficient chargeable income for that year, the investment allowance may be carried forward indefinitely until it is fully utilized. This is particularly beneficial to long gestation projects that may not generate profits early enough to benefit greatly from a fixed period tax holiday.

Companies currently enjoying corporate tax exemption or reduction under the Incentives Tax Act will not be eligible for investment allowance with respect to investments made during their tax relief period.

D. Export of services incentives

A company that will engage in the exportation of qualifying services may apply for export incentives. "Qualifying services" are any of the following activities undertaken in relation to an overseas project for a person who is not resident in Singapore and who has no permanent establishment in Singapore:

- technical services, including construction, distribution, design and engineering services;
- consultancy, management, supervisory, or advisory services relating to any technical matter or to any trade or business;
- fabrication of machinery and equipment and procurement of materials, components, and equipment;
- data processing, programming, computer software development, telecommunications and other computer services;
- professional services, including accounting, legal, medical, and architectural services;
- educational and training services;
- any other services that may be prescribed.

The export incentives scheme provides for 90% of the export income in excess of a predetermined base amount to be exempt from tax. The tax relief period is 5 years.

E. Tax exempt dividend income

Where incentives granted under the Incentives Act exempt income from tax, the company is able to distribute dividends that will be tax-exempt in the hands of shareholders (except for holders of preference shares).

1. Incentives for approved operational headquarters

To encourage multinationals to set up operational headquarters in Singapore for the purpose of providing management and other headquarters-related services to network companies in the region, income arising from the provision of qualifying services to overseas companies in the network can be subject to a reduced rate of 10% for a period of 5 to 10 years. The net income can be passed on to the shareholders without additional tax.

In additional, foreign-source dividend income can be exempt from tax for a period of 10 years and will not be subject to tax when it is subsequently distributed to shareholders.

Interest derived from loans raised through financial institutions in Singapore and extended to the overseas companies in the network can be subject to a reduced tax rate of 10% for a period of 5 to 10 years. This concession also applies to royalties received from companies in the network in respect of R&D work carried out from Singapore.

At the end of its award period, an operational headquarters may apply for renewal of these incentives.

F. Treasury and Finance Center (TFC) Incentive

Recognizing that multinational companies with worldwide business and financial activities have found it increasingly necessary to establish specialist treasury divisions to control their treasury and risk management functions, a new tax incentive was proposed in 1990 for the establishment of Treasury and Finance Centers in Singapore. Under this incentive, income arising from trading in foreign exchange, offshore investments and the provision of financial services to related companies will be taxed at a concessionary rate of 10% as from the year of assessment 1991. This new incentive complements existing incentives for fund management.

The qualifying criteria for the new incentive have not yet been defined but are likely to include matters such as minimum turnover level, a proven track record outside of Singapore, a minimum capital base for the operations in Singapore, and a commitment to utilize to a substantial degree the Singapore banking system and related financial institutions. The period of tenure of the new incentive, i.e. whether indefinite or for a limited time frame of, say, 5 to 10 years, remains to be clarified.

This incentive will be especially helpful to multinationals who want to relocate their regional treasury and risk management functions to Singapore but who may not find it easy to meet the full range of requirements needed for operational headquarters status.

II. INDIVIDUAL INCOME TAX INCENTIVES

Individual tax rates in Singapore are reasonable by world standards. In addition, a number of tax incentives are readily available for individuals assigned to Singapore. The combination of the reasonable rates and the incentives typically results in an effective tax rate in the range of 15% to 20%. The main incentives are:

A. Exemption of income earned outside Singapore

In many cases, income earned outside Singapore and not remitted to Singapore is exempt from tax. This exemption applies to both compensation income and unearned income such as dividends and interest.

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B. Exemption from contribution to Singapore social security system

Individuals covered by similar plans in their home countries are eligible for exemption from participation in the Singapore system.

C. Reduced taxation of housing

Employer provided housing is taxed based on an imputed amount equal to 10% of Singapore employment income or actual rent paid, whichever is less. Since rents of S$ 3,000 to S$ 4,000 per month are not uncommon, this incentive can be particularly valuable.

D. Reduced taxation of home leave airfare

Only 20% of the cost of home leave airfare is taxable.

All of these incentives are relatively simple to secure.

This article has highlighted the incentives available for investment in Singapore. In our experience, the ease of doing business in Singapore combined with these incentives makes Singapore a location that must be considered when deciding where to establish operations in Asia.

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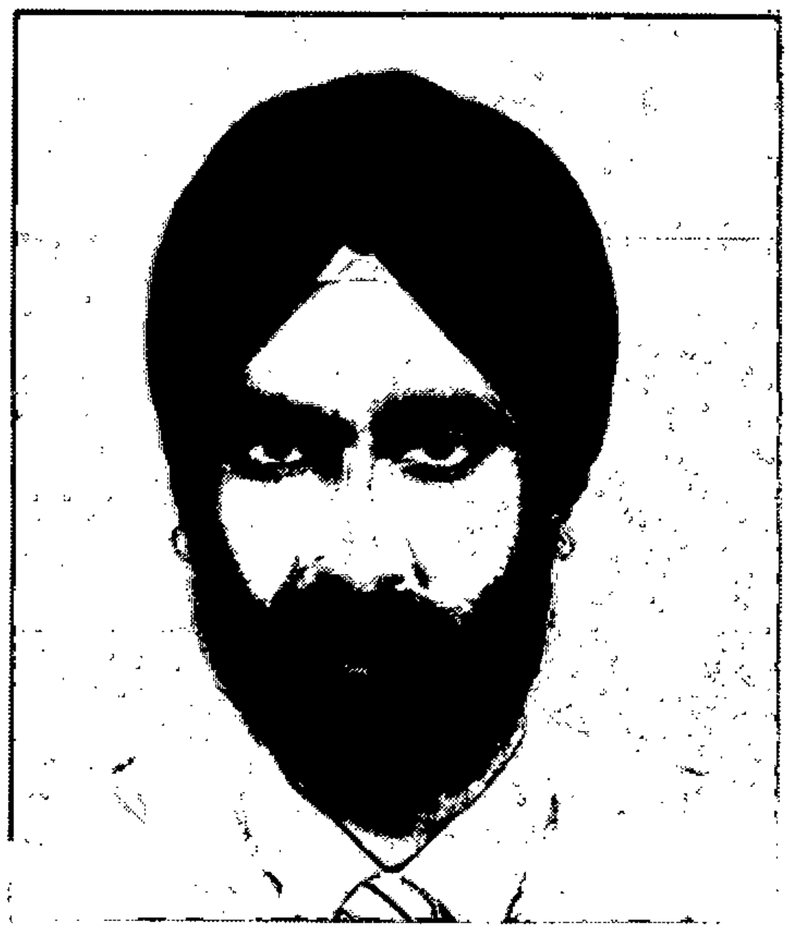
MALAYSIA:

The Tax System

Veerinderjeet Singh



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I. INTRODUCTION

Taxation is one of the economic tools that the Government employs to regulate the economy. The major objectives of implementing tax policies are to encourage economic growth by granting fiscal incentives and to finance various development programmes. About 68% of the Federal Government's revenue for 1989 is expected to come from taxes; direct taxes will account for about 33% of the total revenue. Direct taxes include income tax, estate duty, real property gains tax and stamp duty; these taxes are the main subject of this article. Indirect taxes, which include import duties, surtax, export duties, excise duty, sales tax and service tax, account for around 35% of the total revenue.

Income tax was first introduced into the Federation of Malaya (as Malaysia was then known) in 1947 through the Income Tax Ordinance 1947. In addition, the tax system in the state of Sabah was governed by the Sabah Income Tax Ordinance 1956, whereas that in the state of Sarawak was governed by the Sarawak Inland Revenue Ordinance 1960.[1] These 3 separate taxation laws were subsequently repealed following the formation of Malaysia. The Income Tax Act 1967 (the Act) took effect from 1 January 1968 throughout the whole of Malaysia and is the current legislation governing income tax in Malaysia.

The Malaysian Treasury (the Ministry of Finance) is responsible for all policies relating to taxation whilst the Inland Revenue Department (IRD) is responsible for the enforcement of the tax laws relating to:

- Income tax and excess profits tax
- Development tax
- Real property gains tax
- Estate duty
- Stamp duty
- Petroleum income tax
- Promotion of investments

The Royal Customs and Excise Department is responsible for the enforcement of legislation relating to indirect taxation.

Changes in the tax laws can be introduced by the Government at any time to regulate and control the economy. However, changes are normally proposed in the annual Budget, generally announced in late October. A bill containing the proposed changes will be debated in the Dewan Rakyat (House of Representatives) and the Dewan Negara (Senate). The bill will eventually be gazetted as an Act when it receives royal assent from the King.

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1. The states of Sabah and Sarawak are located in the northern part of the island of Borneo.

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II. TYPES OF DIRECT TAXES

A. Income tax

Income tax is chargeable upon the income of any person (individuals and companies) accruing in or derived from Malaysia or received by a resident person in Malaysia from outside Malaysia.

Income tax is dealt with in detail later in this article.

B. Excess profits tax (EPT)

The EPT is an additional tax which is levied on a person whose chargeable income exceeds M$ 300,000 (in respect of individuals).[2] It is levied at a flat rate of 5%.

The following types of income are specifically exempt from EPT:
- dividend income derived from Malaysia and received by corporate shareholders;
- income of a non-resident person for technical services and certain rental payments under Sec. 4A of the Act which deals with "special classes of income"; and
- income from petroleum operations carried on by a petroleum company.

C. Supplementary income taxes

Prior to the year of assessment 1986, development tax, timber profit tax and tin profit tax were chargeable under the Supplementary Income Tax Act 1967. The timber profit tax and the tin profit tax were abolished with effect from the year of assessment 1986. Presently, only the development tax is chargeable under the Supplementary Income Tax Act 1967.

Development tax is chargeable on the income of a person from all his development sources. The rate for companies and individuals has been reduced from 5% to 4% with effect from the year of assessment 1990.[3] A development source means a source consisting of a business or the letting of property situated in Malaysia, including royalties from patents, copyrights, etc. registered in Malaysia. Development tax is, accordingly, not levied on dividends or interest.

D. Petroleum income tax

The petroleum income tax is chargeable at the rate of 45% on the income from petroleum operations under the Petroleum Income Tax Act 1967. Apart from this tax, no other taxes are imposed on income from petroleum operations.

E. Real property gains tax (RPGT)

RPGT is charged under the Real Property Gains Tax Act 1976, which came into effect on 7 November 1975. It is a tax on gains arising from the disposal of any interest, option or other right in or over land situated in Malaysia. Every method, scheme or arrangement by which the ownership of an asset is transferred from one person to another constitutes an acquisition and a disposal of the asset for RPGT purposes.

The rate of tax ranges from a maximum of 20% for assets disposed of within 2 years of acquisition to a minimum rate of 5% for assets disposed in the fifth year following acquisition. Assets sold after the fifth year are not subject to tax except for disposals by companies, which continue to be subject to tax at 5%.

With effect from 21 October 1988, the gain on the disposal of shares held in a real property company is also subject to RPGT.[4] A real property company is a controlled company which owns real property or shares (or both) in another real property company, the value of which is not less than 75% of the value of its total tangible assets.

F. Stamp duty

The Stamp Duty Ordinance 1949 levies 2 types of duties, namely, "fixed duties" and "ad valorem" duties. Fixed duties are those imposed without any relation to the consideration or amount expressed in an instrument, while ad valorem duties are those levied in relation to the value of the consideration disclosed in an instrument. The First Schedule to the Stamp Duty Ordinance 1949 lists the instruments that are subject to the fixed and ad valorem rates of duty. The scope of instruments chargeable is comprehensive.

G. Estate duty

Estate duty is, in general, chargeable under the Estate Duty Enactment 1941, on the value of all property which passes or is deemed to pass on the death of an individual.[5] All property (whether movable or immovable) situated in Malaysia is liable to estate duty irrespective of the domicile of the deceased. Movable property situated within Malaysia or anywhere abroad and immovable property situated in Malaysia are liable to estate duty if the deceased died domiciled in Malaysia.

Estate duty is assessed by reference to the aggregate open market value of dutiable property at the date of death. Where a person dies domiciled in Malaysia, estate duty will be levied only on the value of the estate in excess of M$ 2 million. For a person who dies domiciled outside Malaysia, estate duty will be levied on the value of the estate in excess of M$ 400,000. The rate of estate duty in both cases ranges from 5% to 10%.

III. INCOME TAX

A. Scope of charge

A person resident in Malaysia is liable to income tax on income accruing in or derived from Malaysia or received in Malaysia from outside Malaysia. This rule does not apply to a resident person carrying on banking, insurance or air/sea transport operations. In such cases, the resident person carrying on such operations is liable to tax on world-wide income, even though the income is not received in Malaysia.

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2. The EPT on companies was abolished with effect from year of assessment 1988.
3. The 1990 Budget contains a proposal to phase out the development tax altogether at the rate of 1% per year until 1994.
4. Until October 1988, the Share (Land Based Company) Transfer Tax Act 1984 regulated such transactions. When this law was repealed, an amendment was introduced to the RPGTA to include shares in real property companies as chargeable assets, thus precluding individuals from using companies to acquire land and then dispose of the shares in the companies.
5. For example, a gift made within 7 years of death is deemed to be property passing on death.

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A non-resident person is liable to income tax on the income accruing in or derived from Malaysia but is not taxed on income arising from sources outside Malaysia which is brought into Malaysia.

Tax is imposed on a person's "income", a word not defined in the Act. As there are no fixed rules that apply to determine a receipt of income, income is defined in its ordinary sense. In certain instances, case law will offer guidance.

B. Classes of income

The Act sets out the main classes of income upon which tax is chargeable. The following items are taxable under the general rules:

(i) gains or profits from a business;[6]
(ii) gains or profits from employment;
(iii) dividends, interest or discounts;
(iv) rents, royalties or premiums;
(v) pensions, annuities or other periodic payments not falling under any of the above;
(vi) gains or profits not falling under any of the above.

Tax is also chargeable on special classes of income under Sec. 4A of the Act. Certain types of income which might not be otherwise taxable are brought into the tax net:

(i) amounts received by a non-resident for services rendered in connection with the use of property or rights belonging to, or the installation or operation of any equipment purchased from, that non-resident;
(ii) amounts received by a non-resident 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; or
(iii) rent or other payments (excluding film rentals subject to film rental tax) to a non-resident under any agreement or arrangement for the use of any movable property.

C. Basis of taxation

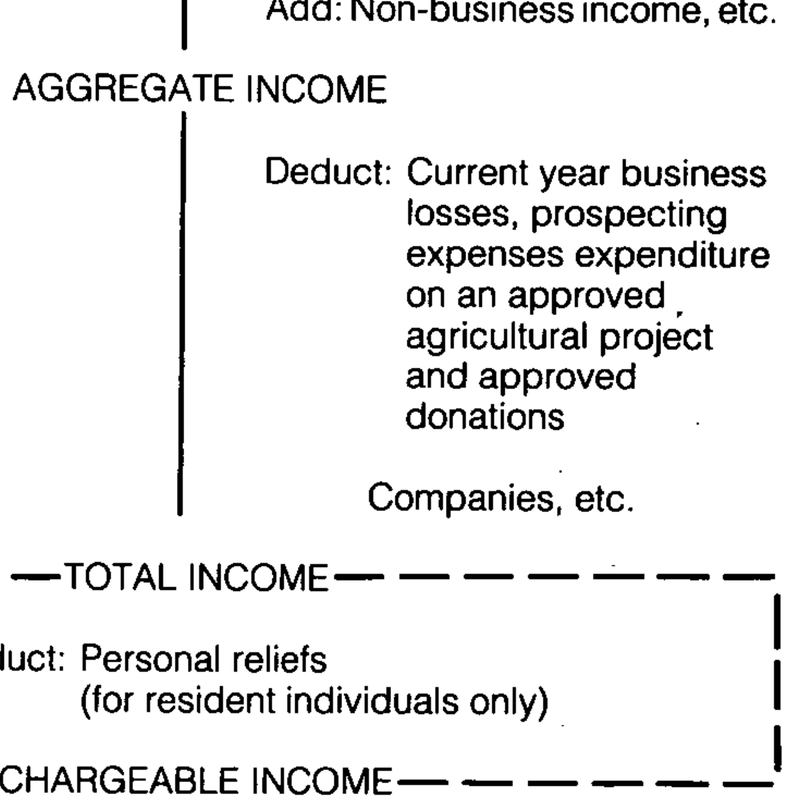
Malaysia has a "preceding year" basis of assessment. The chargeable income of a person for a year of assessment is ascertained by reference to the income for the basis year immediately preceding that year of assessment.

The basis year for a year of assessment is the calendar year immediately preceding that year of assessment. This means that a basis year is always the 12 months prior to 31 December. A year of assessment runs from 1 January to 31 December annually. Therefore, the year of assessment 1990 refers to the 12 months from 1 January 1990 to 31 December 1990. The basis year for the year of assessment 1990 is the 12 months from 1 January 1989 to 31 December 1989.

The Act recognizes that business organizations may have accounting year ends which do not end on 31 December, and consequently allows the accounting year to be the basis period for income derived from a business source. Essentially, the basis period is the accounting period which ends in the basis year for a year of assessment. The basis of assessment in respect of income from non-business sources (for example, employment income, interest, rentals, dividends, etc.) will be the preceding calendar year. Therefore, if a sole proprietor carrying on a retail business prepares accounts annually to 31 August, then the 12 months prior to 31 August 1989 will form the basis period for the year of assessment 1990. If the sole proprietor also receives interest income, the basis of assessment will be on the strict preceding calendar year basis, that is, interest income received in the period 1 January 1989 to 31 December 1989 will be assessable for the year of assessment 1990.

D. Ascertainment of chargeable income

The various stages in ascertaining chargeable income of a taxpayer can be illustrated as follows:



The various terms used in the diagram are explained as follows:

1. Adjusted income

The adjusted income of a taxpayer for a basis period or basis year for a year of assessment refers to the income from each source after deducting allowable expenses from gross income. The deduction of expenses from gross income derived from a business as well as any other source is governed by the general provision in Sec. 33(1) of the Act, which states that all outgoings and expenses wholly and exclusively incurred during the basis period/year in the production of gross income are deductible.

It should be noted that certain expenses are specifically disallowed in the Act; for example, domestic or private expenses, amounts paid to unapproved pension, provident or other similar schemes or funds, expenditure on which capital allowances are available, lease rentals on motor vehicles in excess of M$ 25,000, entertainment expenses (other than those categories which are specifically allowed), leave passages granted to employees and payments to non-

6. The term "business" includes profession, vocation and trade and every manufacture, adventure or concern in the nature of trade.

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residents on which withholding taxes have not been deducted.

2. Statutory income

Statutory income is arrived at after adding balancing charges and deducting capital allowances. This calculation is only applicable to business sources where plant and machinery is utilized in the carrying on of business activities. For non-business sources of income, statutory income is the same as adjusted income.

Capital allowances are allowed on qualifying assets based on the rates stipulated either in the Act or in separate rules. Such allowances take the place of depreciation which is not deductible. Balancing adjustments must be made if plant and machinery on which capital allowances have been allowed is subsequently disposed of. If the sale proceeds exceed the tax written down value (that is, qualifying expenditure less capital allowances granted), the excess is termed a balancing charge and is taxable. Such a charge is restricted to the total amount of capital allowances previously granted on that asset. Where the tax written down value exceeds the sale proceeds, a balancing allowance results which is allowed as a deduction in arriving at statutory income.

3. Aggregate income

This refers to the aggregate of statutory income from all sources after deducting unutilized business losses brought forward (against statutory income from all business sources). Another item which is also added in arriving at aggregate income is recoveries of prospecting expenditure which had previously been allowed as a deduction.

4. Total income

Total income is arrived at by deducting business losses for the basis period, prospecting expenditure, expenditure on an approved agricultural project and donations to the government, local authorities or approved institutions.

5. Chargeable income

In the case of an individual, the chargeable income for any year of assessment means the remainder of the total income for that year after deducting personal reliefs to which the individual is entitled. Personal reliefs are only available to an individual resident in Malaysia.

Generally, in cases other than that of individuals, the chargeable income is the same as the total income.

E. Tax rates

Income tax is assessed on the chargeable income of a person. The tax rate structure is composed of both graduated rates and fixed rates.

Income tax at the rate of 35% is charged on:
(1) a company;
(2) a person (other than a company) not resident for the relevant year;
(3) a trust body;
(4) an executor of an estate of a deceased individual who was domiciled outside Malaysia at the time of his death; and
(5) a receiver appointed by a court in Malaysia.

The chargeable income of an insurer carrying on an inward re-insurance business or an offshore insurance business is subject to income tax at the rate of 5%. Resident individuals and any other person not mentioned above is subject to income tax at graduated rates ranging from 5% to 40%. The tax rates applicable to the chargeable income of a co-operative society also range from 5% to 40%.

A non-resident deriving interest income from Malaysia is subject to a 20% tax rate on the gross amount of interest whereas royalty income, special classes of income and remuneration or other income for services performed in Malaysia by a public entertainer is subject to a 15% tax rate. On the other hand, income tax at 5% is deducted on interest received from specified financial institutions in Malaysia by a resident individual.

It should be noted that together with other taxes on income, that is, the development tax and excess profits tax, the maximum tax rate for companies is 39%, whereas for a resident individual it is 49%.

IV. PERSONAL TAXATION

A. Resident status

The resident status of an individual is determined by Sec. 7 of the Act. An individual is resident in Malaysia if:
(1) he is in Malaysia in the basis year for a period or periods amounting in total to 182 days or more; or
(2) he is in Malaysia in the basis year for less than 182 days and that period is linked by or to another period of 182 or more consecutive days throughout which he is in Malaysia in the basis year for the year of assessment either immediately before or after that particular year of assessment. Temporary absences from Malaysia are disregarded if they are due to service matters, attending conferences, seminars or study abroad connected with service in Malaysia, ill-health of the individual or a member of his immediate family, or social visits not exceeding 14 days in aggregate;
(3) he is in Malaysia for a period or periods totalling 90 days or more in a basis year and he was either resident in Malaysia or in Malaysia for 90 days or more in any 3 out of the 4 immediately preceding basis years; or
(4) he is a resident for the basis year of the following year of assessment and was resident for each of the 3 basis years for the 3 immediately preceding years of assessment.

B. Employment income

Gross employment income includes wages, salary, remuneration, leave pay, fees, commissions, bonuses, gratuities, perquisites or allowances (whether in money or otherwise) and benefits or amenities in respect of having or exercising the employment. The value of living accommodation provided to an employee is also taxable.

Certain common benefits and allowances may or may not be taxable, as discussed below:

1. Leave passage

Leave passage provided for the taxpayer and members of his immediate family is exempt from tax. However, the exemption is restricted to one trip per year to any place outside Malaysia and 3 trips per year for travel within Malaysia.

2. Medical and dental benefits

The cost borne by the employer for medical and dental care incurred by the employee and members of his family is exempt from tax.

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3. Housing accommodation

The value of living accommodation provided by an employer is subject to tax by the employee on either the actual rental value of the accommodation or 30% of the employee's taxable cash remuneration, whichever is lower. However, the payment of a cash rental allowance is taxable in full by the employee.

If the employee is required to entertain at home, an entertainment rebate may be claimed against the rental value. The amount of the entertainment rebate granted varies because the Internal Revenue Department (IRD) considers each individual case on its own merits.

The value of household furnishings and appliances provided by the employer is also assessable based on guidelines issued by the tax authorities.

4. Hotel accommodation

The taxable value of hotel accommodations provided by the employer is 3% of the employee's taxable cash remuneration. The cost of food, if borne by the employer, is taxed in full.

5. Household utilities

All actual payments for utilities borne by the employer are assessable on the employee enjoying the benefit.

6. Household domestic servants

The cost of employing household domestic servants borne by the employer also constitute a taxable benefit on the employee.

7. Company car

The provision of a company car gives rise to a taxable benefit with regard to the private use of the car. However, the value of the benefit attributed to the use of the car is assessed according to guidelines issued by the tax authorities.

8. Travelling and entertainment allowances

Travelling and entertainment allowances are assessable. However, that portion of an allowance which could be shown to the IRD as having been incurred in connection with and in the exercise of the employment are excluded.

9. Share option scheme

The difference between the market price of shares at the time of granting the option and the option price is the taxable benefit to the employee who has subscribed for shares in a share option scheme operated for the benefit of employees.

C. Personal reliefs

The personal reliefs available to a resident individual are as follows:

1. Personal allowance

This amounts to M$ 5,000, consisting of M$ 4,000 as an allowance for the individual and M$ 1,000 as relief for dependent relatives. The allowance for dependent relatives is automatic and hence every taxable individual is entitled to a M$ 5,000 personal allowance.[7]

2. Wife allowance

If the wife lives with the taxpayer in the relevant basis year, the allowance is M$ 2,000. The allowance is proportionately reduced if the spouses separate in the basis year.[8]

Alimony paid by the taxpayer to a former wife may be deducted up to a maximum of M$ 2,000. However, where an individual is married and paying alimony to his former wife, the maximum relief remains at M$ 2,000.

3. Child allowance

Child allowance on a graduated scale is granted as follows:

First child	M$ 650
Second child	750
Third child	800
Fourth child	800
Fifth child	800

A maximum of up to 4 times the amount of the normal allowance will be granted for a child over 16 years of age who receives full-time education in a university or college outside Malaysia and Singapore. A deduction of M$ 400 is also granted for a child over 16 years of age who is mentally or physically handicapped.

4. Life insurance premiums and contributions to approved schemes and funds

A relief is allowed in respect of annual premiums paid on insurance on the life of the taxpayer or his wife which secures a capital sum on death, and annual contributions to an approved provident fund or scheme.

The deduction in respect of the premiums paid on life insurance is limited to 7% of the capital sum assured. The relief for these premiums and contributions is limited to M$ 3,500.

5. Tax rebates

The rebate granted to a resident individual is as follows:
Taxpayer – M$ 60
Wife – M$ 30

The rebate is granted only when chargeable income of the taxpayer does not exceed M$ 10,000.

In addition, a rebate for *zakat, fitrah* or other Islamic religious dues which are obligatory under any written law is also granted when such payments are evidenced by a receipt issued by an appropriate religious authority established under any written law.

The above rebates are granted against the income tax chargeable.

D. Separate assessment on wife's income

A wife may elect for her income from the exercise of an employment, a profession or a pension on optional retirement to be assessed in her own name and not aggregated with her husband in respect of any year of assessment. However, separate assessment is not permitted if the wife is employed in a business carried on by her husband, or in a business in which her husband is a partner, or in a business which is carried on by a company controlled by her or by her husband or by both of them.

7. This includes a wife who is assessed separately on income from her employment or profession.
8. The allowance is not granted if the wife is assessed separately on the income from her employment or profession.

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E. Exemptions

Certain types of income are exempt from tax under the Act. These exemptions include:

- employment income of a non-resident individual from the exercise of employment in Malaysia for a period or periods which do not exceed 60 days in a calendar year;
- retirement gratuities if the retirement is due to ill health or if it takes place after age 55, or upon reaching the compulsory age of retirement from employment, and in either case, the employment must have been for a period of at least 10 years with the same employer;
- compensation for loss of employment due to ill health;
- payments of M$ 4,000 for each completed year of service with the employer in respect of compensation for loss of employment or in consideration of any restrictive covenant restricting an employee from taking up any other employment of a similar kind.

V. BUSINESS AND CORPORATE TAXATION

A. Resident status

Sec. 8 of the Act provides that a company is resident in Malaysia for a particular year if at any time during that year the management and control of its business or of any one of its businesses is exercised in Malaysia. Management and control generally refers to the place where the Board of Directors meets to make decisions.

B. Deductions and capital allowances

As mentioned earlier, companies deriving income from Malaysia are subject to a 35% income tax rate and a 4% development tax on rental and business income. A resident individual with business income is subject to income tax at graduated rates, the development tax of 4% and the excess profits tax of 5% if the chargeable income exceeds M$ 300,000.

Business expenses wholly and exclusively incurred in the production of income are deductible from gross income. Certain expenses are specifically disallowed, for example, entertainment expenses subject to certain limited exceptions, payments to non-residents from which withholding tax was not deducted, capital expenditure, etc.

Depreciation is not an allowable deduction but capital allowances on qualifying plant and machinery are granted in lieu thereof at various specified rates. Capital allowances are also granted on certain industrial buildings, e.g. a factory. Such capital allowances are only granted if the taxpayer makes a claim.

C. Losses and unabsorbed capital allowances

An adjusted loss incurred in a business for a particular year of assessment is deducted in arriving at total income for that year of assessment. In other words, current year losses can be set off against all sources of income in the current year of assessment. However, if the current year losses cannot be fully deducted due to insufficient aggregate income, the unabsorbed portion may be carried forward indefinitely and utilized only against the statutory income from all business sources in subsequent years. The statutory income of a business need not arise from the same source as that of the adjusted loss. It should, however, be noted that non-business losses can neither be deducted from aggregate income nor be carried forward.

Capital allowances are deducted from the adjusted income of a business source in arriving at the statutory income. In the event of an adjusted loss or a shortfall of adjusted income, the excess capital allowances claimed can be carried forward to be utilized against the adjusted income of the same business source in subsequent years. No time limit is imposed on the carry-forward of unabsorbed capital allowances. However, in the event that a business source ceases, the unabsorbed capital allowances will be permanently lost.

D. Dividends

Malaysia follows the imputation system in respect of company taxation, that is, tax paid by a company is imputed to the shareholders. In other words, the tax paid by the company is taken as advance tax paid by the shareholders in respect of the dividends received. When a shareholder receives a dividend from a company, the gross dividend is included in computing the total income of the shareholder. If the shareholder is not liable to income tax, the full amount of the tax credit attached to the dividend is refunded to the shareholder. If the shareholder is taxable, the tax credit will be set off against the tax chargeable on that shareholder.

Where a company which is resident for the basis year for a year of assessment pays, credits or distributes a dividend in that basis year, that dividend is deemed to be derived from Malaysia. A company paying Malaysia dividends may deduct tax therefrom at the appropriate income tax rate applicable to the company, i.e. currently 35%. Therefore, only the net amount will be paid to the shareholders (for example, where a company proposes a gross dividend of M$ 100,000, only M$ 65,000 will be paid to the shareholders). If a company fails to comply with this provision (that is, it pays a dividend without deduction of tax), the dividend paid to the shareholder will be deemed to be a net dividend and it will be grossed up. For example, if a dividend of M$ 52,000 is paid by the company without deducting tax, M$ 52,000 will be deemed to be the net dividend and the gross amount will be M$ 80,000. Therefore, the tax deemed to have been deducted will be M$ 28,000.

An annual statement must be provided to the IRD setting forth the amount of income tax which the company has deducted from dividends paid. This information is provided in the company's tax return. A comparison is then made between the total tax deducted from dividends paid to shareholders during the basis year, that is, the calendar year and the income tax payable or paid by the company for past years and the income tax chargeable for the basis period for the current year of assessment. Where the tax deducted does not exceed the income tax paid (including the unutilized balance brought forward from the previous years), the excess may be carried forward for future franking of dividends. There is no time period within which this balance must be utilized. On the other hand, where the tax deducted exceeds the income tax paid or chargeable, the deficit shall be a debt due to the Government for which a requisition or demand for payment will be served on the company.

The following illustration highlights the operation of the tax credit account:

	Case 1 M$	Case 2 M$
Taxable profits	100,000	100,000
Income tax at 35%	35,000	35,000

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Dividends paid

Case 1	Gross	M$ 60,000		
	Tax	(21,000)	39,000	
Case 2	Gross	M$ 150,000		
	Tax	(52,000)		97,000

Tax credit account

Balance brought forward	10,000	10,000
Add: Income tax chargeable	35,000	35,000
	45,000	45,000
Less: Amount utilized for franking dividends	21,000	52,000
Balance c/f to next year/(deficit)	24,000	(7,500)

Under case 1, the company has a credit balance of M$ 24,000 for carry-forward to the next year. As the tax on the dividend in case 2 exceeds the tax credits, the deficit of M$ 7,500 is a debt due to the Government. When the debt is paid, the deficit will be wiped off and the balance carried forward will be nil.

It should be noted that the amount of income tax chargeable for a particular year of assessment that is taken into consideration for purposes of the tax credit account of the company should be net of any double taxation relief granted for that year of assessment.

VI. TAX ADMINISTRATION

Under the Act, every person who is chargeable to income tax is required to file a return of his income with the IRD. It is this filing requirement that sets the wheel of the administrative machinery into motion.

A. Returns

If a person who is chargeable to income tax does not receive a return form[9] by 31 March for a particular year of assessment, the IRD must be notified by 14 April so that a return form can be issued. The income reported in the 1990 return would be that in respect of 1989. The return forms must be filed within 30 days from the date of issue. In practice, however, an extension of time is allowed to submit the completed tax return.

B. Assessments

After the tax return has been examined, a notice of assessment is issued stating the amount of income chargeable to tax and the amount of tax payable. There are provisions in the Act which allow the IRD to issue additional assessments as well as advance assessments in certain situations. The IRD may reject a return and determine on its own the amount of chargeable income and make an assessment accordingly.

C. Collections

1. Notice of assessment

The amount of tax stated in the notice of assessment must be paid to the IRD within 30 days after the notice of assessment is served, whether or not any objection or appeal has been made. The IRD may, in its discretion, extend the time limit within which the payment must be made. In practice, when an objection is filed to an assessment, the IRD is normally willing to consider withholding collection of a reasonable amount of the tax that is disputed. This depends, of course, on the merits of each individual case.

2. Employer withholding

Tax is deducted from the salaries of employees by the employer in accordance with directives issued by the IRD. The tax deducted in 1990 is in respect of the tax on income earned in 1989. In the case of expatriates, the deduction of tax is made out of income of the current year, that is, on a Pay-As-You-Earn (PAYE) basis. In the states of Sabah and Sarawak, employee deductions are also made on a PAYE basis.

3. Payment of tax due

With effect from 1 January 1989, every person is required to settle tax through an instalment scheme as directed by the IRD. Employees have already been subjected to this requirement from the year of assessment 1987. Therefore, all taxable persons with an estimated tax liability exceeding M$ 500 are now on an instalment scheme whereby tax is being paid in instalments from the beginning of the year instead of being paid after the notice of assessment has been issued.

A penalty of 10% of the tax due will be charged if the tax due is not paid by the due date. If any of the outstanding tax and penalty remains unpaid after 60 days of the date of imposition of the 10% penalty, an additional penalty of 5%, based on the outstanding tax and penalty, will be imposed. If the tax still remains outstanding, civil proceedings for the recovery of the tax due will be instituted by the IRD.

4. Payments to non-residents

Malaysia has a fairly comprehensive withholding tax system on payments to non-residents. Withholding taxes are charged on the following types of payments:

(1) interest which is paid or credited to a non-resident and which is not attributable to a place of business of the non-resident in Malaysia. The rate of tax is currently 20%, which may be reduced by the terms of a double taxation agreement between Malaysia and the country of residence of the non-resident;
(2) royalties paid or credited to a non-resident which are not attributable to a place of business of the non-resident in Malaysia. The 15% rate of tax may be reduced by the terms of a double taxation agreement;
(3) contract payments paid to non-resident contractors. The rate of tax is 15% of the service portion of the contract payment in respect of the tax liability of the non-resident contractor and 5% on the service portion

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9. The various types of return forms are as follows:

Individual	: Form B (Residents with business income) Form BE (Residents without business income) Form M (non-residents)
Companies	: Form C
Co-operative societies	: Form C1
Partnerships	: Form P
Trusts, Estates, Trade Associations, etc.	: Form T
Employers	: Form E

In addition to the above forms, every employer is required to submit Form E at the beginning of a year where a listing of employees and their remuneration for the preceding year is reported to the IRD.

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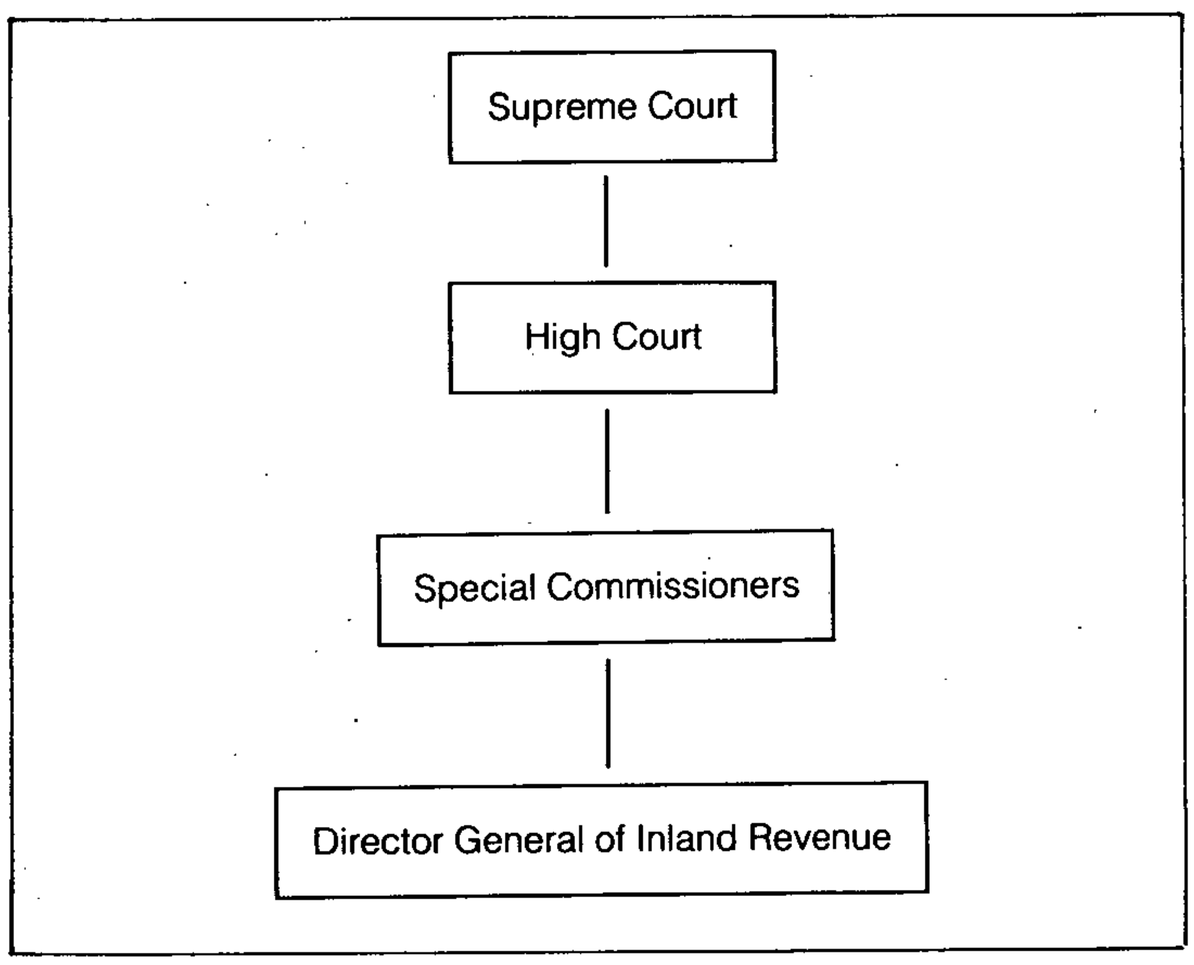
in respect of the employees of the non-resident contractor;

(4) special classes of income derived from Malaysia where the payer of such amounts to a non-resident would have to withhold tax at 15% of the gross amount of such payments. These special classes of income include fees paid for services in connection with the installation of plant and machinery, technical advice in connection with any industrial, commercial or scientific venture, project or scheme and rent or other payments in respect of movable property.

D. Objections and the appeal process

If a taxpayer disagrees with the amount of tax payable in the notice of assessment, a written notice of objection must be lodged with the IRD within 30 days of the date of service of the notice of assessment. The grounds for notice of objection must be set forth in the objection. If a valid objection against an assessment is not lodged within the 30-day statutory period, the notice of assessment will become final and conclusive. An objection against a notice of assessment does not mean that the tax assessed need not be paid (but see above).

If the dispute cannot be resolved by the taxpayer and the IRD, the appeal may be referred to the Special Commissioners of Income Tax. A person may within 6 months from the date of his written notice of objection request the IRD to forward the appeal to the Special Commissioners. The IRD must then refer the appeal to the Commissioners within 3 months after receiving such a request.



E. Penalties

To ensure the smooth functioning of the administrative machinery, penalties are imposed on various types of offences. The penalty provisions can be categorized into 3 broad groups: offences against the Act; filing of incorrect returns and providing incorrect information; and fraud and willful default.

VII. TAX INCENTIVES[10]

Broadly, tax incentives are available in the Act and in the Promotion of Investments Act 1986, as amended most recently by the Promotion of Investments (Amendment) Act 1990 (PIA); the major incentives are contained in the PIA.[11]

A. Promotion of Investments Act 1986 incentives

Tax incentives under the PIA are only available to companies resident in Malaysia. The types of incentives are as follows:

1. Pioneer status

Pioneer status is granted for a period of 5 years if a company is involved in a promoted activity or is producing a promoted product. This status can be extended by an additional 5 years if certain criteria are met. Companies which are granted pioneer status will enjoy a complete exemption from tax on the profits generated by the pioneer business during the tax relief period. Dividends paid out of the tax-exempt profits will also be exempt from tax in the hands of shareholders.

2. Investment tax allowance

An investment tax allowance is granted at a specific rate not exceeding 100% of capital expenditure on a project which is listed as a promoted activity or which involves production of a promoted product. The amount of the investment tax allowance will be deducted from adjusted income and the amount deducted will be credited to a tax-exempt account for which tax-exempt dividends can be declared to shareholders.

3. Industrial adjustment allowance

An industrial adjustment provides for an allowance of up to 100% of the qualifying expenditure incurred within a period of 5 years by a manufacturing company which undertakes an approved industrial adjustment programme. The amount of the adjusted income equal to the allowance is exempt from tax and may be distributed to shareholders as tax-exempt dividends.

4. Hotels

Hotels can be deemed to be industrial buildings under certain conditions, meaning that an industrial building allowance is available on capital expenditure incurred on construction of a hotel.

5. Abatements of adjusted income

Abatements of adjusted income are granted in respect of a location in a promoted industrial area, small-scale companies, compliance with Government policy on capital participation or employment in industry, exports and purchases from small-scale companies.

The abatements are confined to manufacturing companies resident in Malaysia and the amount of adjusted income that has been abated will be credited to a tax-exempt account from which tax-exempt dividends can be declared to shareholders.

6. Export allowance

An export allowance is only available to companies export-

10. It should be noted that some of the tax incentives are mutually exclusive and that amendments are made from time to time to meet changing needs.

11. For a discussion of these incentives, see Arjunan Subramaniam, "An Outline of Tax Incentives", in this issue at 234.

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ing agricultural produce and to trading companies exporting locally manufactured products.

7. Double deduction for expenses

A double deduction for expenses incurred on the promotion of exports is available.

8. Double deduction on expenditure

A double deduction on expenditure incurred by hotel and tour operators on overseas promotions was proposed in the recent 1990 Budget.

B. Income Tax Act 1967 incentives

The incentives available in the Act itself are generally classified as follows:

- a reinvestment allowance of 40% of capital expenditure incurred on an expansion project by a manufacturing concern is available; for small-scale companies, the rate is 50%;
- a tax exemption on the profits derived by a resident person from the carrying on of the business of transporting passengers or cargo by sea;
- a special income tax rate of 5% on profits from offshore insurance and inward re-insurance;
- double deductions in respect of:
  - (i) expenses incurred on approved research and development;
  - (ii) export credit insurance premiums;
  - (iii) insurance premiums on the import of cargo;
  - (iv) interest payable on loans obtained under the Special Loan Scheme;
  - (v) remuneration paid to disabled persons;
  - (vi) remuneration paid to employees employed and trained under an approved training scheme in the construction industry;
  - (vii) expenses incurred on approved training in the manufacturing sector; and
  - (viii) expenses incurred on training approved by the Minister of Culture and Tourism in order to upgrade the level of skills and professionalism in the tourist industry (this was proposed in the 1990 Budget);
  - (ix) freight charges incurred by manufacturers in Sabah and Sarawak exporting rattan and wood-based products, excluding sawn timber and veneer (this was also proposed in the 1990 Budget).

Malaysia recently introduced incentives to encourage multinationals to set up their operational headquarters in Malaysia. In order to encourage investment in high risk technological ventures, incentives for venture capital companies have also been introduced. Finally, certain concessions have been introduced to encourage the development of unit trusts.

VIII. DOUBLE TAXATION RELIEF

Under the Act, the Minister of Finance is empowered to make arrangements on behalf of the Malaysian Government for the avoidance of double taxation by way of entering into a double taxation agreement (DTA) with any other country. As long as the DTA remains in force, it has effect notwithstanding any provisions in any written law in Malaysia. Where a DTA exists, bilateral tax relief is given to a resident for foreign tax suffered on income received in Malaysia. If no DTA is in existence, unilateral tax relief is given to a resident for foreign tax suffered on income received in Malaysia, but it is limited to one half of the foreign tax payable on the foreign income.

The DTAs that Malaysia has entered into generally follow the OECD Model Double Taxation Convention with certain modifications. Currently, Malaysia has DTAs with 28 countries:

Australia	Netherlands
Bangladesh	New Zealand
Belgium	Norway
Canada	Poland
China	Pakistan
Denmark	Philippines
Finland	Romania
France	Singapore
Germany (Dem. Rep.)	Sri Lanka
Germany (Fed. Rep.)	Sweden
India	Switzerland
Italy	Thailand
Japan	United Kingdom
South Korea	U.S.S.R.

Most of the DTAs provide for lower rates of withholding tax as well as the availability of tax-sparing relief.

Malaysia recently entered into a DTA with the United States, but this agreement only provides for reciprocal tax exemption on income of shipping and air transport enterprises of the 2 countries.

IX. CONCLUSION

This article overviews direct taxation in Malaysia. It should be noted that as in other countries, there are anti-avoidance provisions in the tax legislation whereby the IRD can ignore a transaction which alters the incidence of tax. Businessmen and corporations who wish to invest in Malaysia should seek appropriate advice from tax consultants on the tax ramifications of various proposals.

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MALAYSIA:

An Outline of Tax Incentives

Dr. Arjunan Subramaniam

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He is currently consultant to the Malaysian Institute of Economic Research. He is also the Chairman of the Taxation Committee of the Malaysian Institute of Accountants. He lectures part-time in Revenue Law at the Faculty of Law, University of Malaya. He is also an adjunct professor at the Northern University, Malaysia. He is the author of a number of books on taxation and writes frequently for taxation journals.

I. INTRODUCTION

Malaysia offers attractive tax incentives. The objective of this article is to outline the main incentives under the Promotion of Investments Act, 1986, as amended most recently in February 1990 by the Promotion of Investments (Amendment) Act 1990.[1] Before the Promotion of Investments Act, 1986, incentives were granted under the Investment Incentives Act, 1968. The Promotion of Investments Act, 1986 to some extent rationalized these incentives and the Act came into force on 1 January 1986, effective from year of assessment 1987. The main feature of the new Act is that incentives are granted for "promoted activity" and for "promoted products", whereas under the Investment Incentives Act 1968, incentives were only granted in the case of "pioneer products".

The major incentives under this Act, as amended, are as follows:

(i) Pioneer status
(ii) Investment tax allowance
(iii) Abatement of adjusted income:
  (a) Location in a promoted industrial area
  (b) Small-scale companies
  (c) Abatement for purchases from small-scale companies
  (d) Compliance with Government policy on capital participation or employment in industry
(iv) Abatement of adjusted income for exports
(v) Export allowance for agricultural produce and manufactured products
(vi) Deductions for promotion of exports
(vii) Hotel business – plant and machinery
(viii) Industrial adjustment allowance

II. PIONEER STATUS

A. Production day – pioneer certificate (Sec. 7)

Under Sec. 7, a company granted pioneer status has to request a pioneer certificate within 6 months from the date of such grant or within such an extended period as the Minister may allow. The date on which the factory commenced production of the promoted product in marketable quantities and the rate of production must be given. The production day, which is the day on which the tax relief period begins, is specified in the pioneer certificate.

Where pioneer status is granted for an additional promoted activity or promoted product, the production day for the additional promoted activity or promoted product must be a different production day.

B. Tax relief period (Sec. 14)

The tax relief period is 5 years beginning on the day of production. The tax relief period may be extended by an additional 5 years in respect of a manufacturing activity, making a total of 10 years (Sec. 14(A)). The criteria for extension may be summarized as follows:

1. Note that some investment incentives are given under the Income Tax Act, 1967. One major incentive is the reinvestment allowance. This allowance is given under Para. 1, Schedule 7A, Income Tax Act, 1967 to a company resident in Malaysia in respect of capital expenditure on a factory, plant and machinery or other apparatus for the purpose of an approved project. The reinvestment allowance is 40% of that expenditure, on 50% of the expenditure for small-scale companies under Sec. 33(4), Promotion of Investments Act, 1986. A reinvestment allowance is not given to companies granted the industrial adjustment allowance effective from year of assessment 1990.
The other major incentive in the Income Tax Act 1967 is the incentive for operational headquarters. An approved operational headquarters (meaning a company that has its operational headquarters in Malaysia to provide qualifying services, i.e. management, technical and other supporting services, credit facilities and research and development work, to its offices and related companies outside Malaysia) will be taxed at a rate of 10% on its qualifying income for a period of 5 years. This period may be extended by the Minister for a further period not exceeding 5 years.

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- a company must have incurred capital expenditure of at least M$ 25 million by the end of the 5-year tax relief period; or
- the company must employ 500 full-time Malaysian workers by the end of the 5-year tax relief period; or
- other criteria, determined by the Ministry of Trade and Industry, must be met which would contribute towards promoting and enhancing the economic or technological development of Malaysia.

C. New business

The pioneer business and the post-pioneer business are considered separately. When the pioneer period ends, the pioneer business is considered permanently ceased at the end of the tax relief period. The company is then deemed to have set up a new business (Sec. 15(1)).

D. Accounts: pioneer period and pre-pioneer period

If the company carries on the pioneer business before and after the tax relief period it is required to make up the accounts of the pioneer business:

- for a period not exceeding one year commencing on the date when that pioneer business of the company commenced (Sec. 15(1)(c)(i));
- for successive periods of one year thereafter (Sec. 15(1)(c)(ii));
- for a period not exceeding one year ending on the date when its tax relief period ends (Sec. 15(1)(c)(iii)).

Example

A Ltd. commenced business on 1 June 1986. A pioneer certificate was granted on 1 February 1987. Production day was determined as 1 February 1987. The accounts for tax purposes should be:

ITA 1967 Applies	1.6.86 - 31.12.86	= YA 1987 = Pre-pioneer period
	1.1.87 - 31.01.87	= YA 1988 = Pre-pioneer period
Sec. 15(1)(c) Applies	1.2.87 - 31.01.88	= YA 1989 = Pioneer period
	1.2.88 - 31.01.89	= YA 1990 = Pioneer period

The pioneer period would be from 1 February 1987 to 31 January 1992.

E. Capital allowances (Sec. 18)

With effect from year of assessment 1992 the following principles apply in respect of capital allowances where applications for pioneer status are received on or after 1 January 1991:

1. Capital allowances will be granted to a company as a deduction from pioneer income, even if no claim has been made (Sec. 18(1)). Previously, capital allowances were in general not given to a company during its tax relief period in respect of pioneer income, but were carried forward to be used after the tax relief period.

2. For all assets used in the pre-pioneer business which continue to be used in the pioneer business the residual expenditure on the day of commencement of the pioneer business will be the same as the residual expenditure prior to the pioneer business (Sec. 18(3)(a)(i)). In other words, the residual expenditure is simply carried forward from the pre-pioneer to the pioneer business.

3. Where capital expenditure is incurred by a company in the basis period in which the pre-pioneer period ends it is deemed to be incurred on the day of commencement of the pioneer business (Sec. 18(3)(a)(ii)).

4. Where an asset is used in a pioneer business and continues to be used in the post-pioneer business, the residual expenditure at the end of the pioneer period is taken as the residual expenditure on the day of commencement of the post-pioneer business (Sec. 18(3)(b)(i)).

Capital expenditure incurred during the basis period in which the pioneer period ends is deemed to be incurred on the day of commencement of the post-pioneer period (Sec. 18(3)(b)(ii)).

5. Where a capital allowance is due in a pre-pioneer business and there is insufficient adjusted income to absorb the capital allowance, the capital allowance must be carried forward and set off against adjusted income of the pioneer business (Sec. 18(5)).

6. Unabsorbed capital allowances in a pioneer period cannot be carried forward to a post-pioneer period (Sec. 18(7)).

This restriction, together with the loss restriction makes pioneer status less attractive than the investment tax allowance (see below). Careful consideration must be given to the 2 competing incentives before a decision is made as to which investment incentive to apply for.

7. Assets used both in a pioneer business (promoted activity or promoted product) and a non-pioneer business will be granted a capital allowance in respect of the non-pioneer business to the extent to which they are used in the non-pioneer business (Sec. 18(6)(a)).

The residual expenditure in respect of the portion of capital allowances relating to the pioneer business will be reduced by the amount of any deductions made in respect of an asset under Sec. 18(6)(a) (Sec. 18(6)(b)).

F. Incentives for the tourist industry

Tourist projects and hotel businesses can be promoted activities and are entitled to the following:

(a) pioneer status; or
(b) the investment tax allowance; and
(c) the industrial building allowance
  - initial allowance: 10%
  - annual allowance: 2%

  in respect of capital expenditure incurred on a hotel building carried on by a pioneer company or a company granted the investment tax allowance (see below VII);
(d) tour operators who bring in at least 500 foreign tourists through group tours are exempted from income tax for the years of assessment 1986 to 1990, provided they are registered and approved by the Tourist Development Corporation of Malaysia.

G. Treatment of losses (Sec. 25)

The Promotion of Investments (Amendment) Act, 1990 has brought about fundamental changes in the treatment of losses of pioneer companies. Losses for an accounting year incurred in a pioneer period must now be deducted from statutory income of the pioneer business or businesses (Sec. 25(2)). Losses incurred in a pioneer period which cannot be absorbed in the pioneer period cannot be carried forward beyond the pioneer period.

These new regulations are effective for year of assessment 1992 and subsequent years of assessment where applications for pioneer status are received on or after 1 January 1991.

The set-off of pioneer losses is subject to the restriction under Sec. 21A, that is, any loss incurred by a pioneer

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company in respect of a non-promoted product or activity will be deducted from the statutory income of a pioneer company in respect of its pioneer businesses. In other words, pioneer income in respect of a promoted activity or a promoted product will be reduced by losses made by the company in respect of a non-pioneer activity or product.

H. Exempt account and dividends (Secs. 22 and 23)

Where a statement showing the amount of income exempted is issued, the amount exempted as stated becomes final and conclusive and that amount is exempt from tax (Sec. 21(3)). The exempt amount is credited to an exempt account (Sec. 23(1)). Where an exempt account has a credit, dividends paid by the pioneer company are debited to the extent of the credit (Sec. 23(2)). Dividends paid from the exempt account are exempt in the hands of a shareholder (Sec. 23(3)). Where the shareholder is a company any dividends paid by that company out of exempt dividends received are exempt in the hands of the shareholders of that company (Sec. 23(6)).

I. Provision prior to 1 January 1991 and year of assessment 1992

Prior to the above amendment, pioneer losses could be carried forward to the post-pioneer period subject to the restriction in Sec. 21A as indicated above. Evidently, with effect from year of assessment 1992, it may be beneficial to apply for the investment tax allowance under Sec. 26 instead of pioneer status.

III. INVESTMENT TAX ALLOWANCE

A. General

This incentive is available to companies participating or intending to participate in promoted activities or in the production of promoted products.

B. Scope of the incentive

The incentive is available to manufacturing concerns, the agricultural sector, hotel businesses and tourist projects.

C. Companies not entitled to the incentive

Neither pioneer companies nor companies granted pioneer status are entitled to the incentive in respect of their promoted product or activity.[2]

D. Rate of allowance

The rate of the allowance may not exceed 100% of the capital expenditure incurred for the purpose of the promoted activity or promoted product. The table below gives the investment tax allowance rates for the manufacturing sector if certain criteria are met:

Criteria		Basis	% ITA	Max. % ITA
(a)	Export	50% - 80% 80% - 100%	15% 30%	30%
(b)	(i) Value-Added	Minimum 25%	20%	20%
	(ii) Local-Content	Minimum 25%	20%	20%
(c)	Employment	Employ at least 100 full-time paid Malaysian workers	25%	25%
(d)	Location	Location in "promoted industrial areas" as gazetted under S. 32(4) of the Promotion of Investments Act, 1986	5%	5%
				100%

E. Qualifying expenditure (Sec. 29(7))

1. Manufacturing concerns (Sec. 29(7)(i))

Capital expenditure in relation to manufacturing means expenditure that is incurred on a factory or plant and machinery used in Malaysia in carrying out the promoted activity or in producing the promoted product.

2. Agricultural projects (Sec. 29(7)(ii))

Capital expenditure in relation to agriculture means expenditure incurred in respect of:
(a) clearing and preparation of land;
(b) planting of crops;
(c) provision of plant and machinery used for crop cultivation, animal farming, agriculture, inland or deep-sea fishing and other agricultural or pastoral pursuits;
(d) provision of irrigation or drainage systems;
(e) construction of access roads including bridges; and
(f) construction or purchase of buildings, including those provided for the welfare of employees, and structural improvements to land or other structures used for the purposes listed in (c) above.

Example

Pastoral Industries Ltd. (year ending 31 December each year) is engaged in a promoted agricultural activity. For the year ended 31 December 1989, the company incurred the following capital expenditure:

Type of expenditure	*Sum expended M$*
Cost of land	400,000
Clearing land	20,000
Planting crops	30,000
Plant and machinery (crop cultivation)	110,000
Construction of building (agricultural pursuit)	200,000
Purchase of building (animal farming)	260,000
Construction of bungalow (director's use)	290,000

The qualifying capital expenditure for computing investment tax allowance is (M$ 20,000 + 30,000 + 110,000 + 200,000 + 260,000), i.e. M$ 620,000.

Comment

(a) Capital expenditure does not include the cost of land.
(b) Capital expenditure incurred on buildings used as living accommodation, plant and machinery, where such buildings, plant or machinery are provided for adminis-

2. Companies granted pioneer status in respect of a promoted activity or product are eligible only upon surrender of the pioneer status provided the Minister is satisfied with the reasons for the surrender. Note, however, under Sec. 26(2), a pioneer company can apply for the investment tax allowance for a promoted activity or promoted product other than the promoted activity or product for which the pioneer certificate has been issued or pioneer status or for which investment tax allowance has been granted.

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trative or clerical staff are specifically excluded for purposes of the investment tax allowance (Sec. 29(8)).

F. Hotel business (Sec. 29(7)(iii))

The qualifying capital expenditures for the hotel business are those incurred on the construction of a hotel building of an approved standard, the cost of alteration, extension and renovation of the hotel, plant and machinery, and other facilities used in connection with the hotel business.

G. Tourist project (Sec. 29(7)(iv))

A tourist project refers to a project, other than a hotel business, exclusively carried out for purposes connected with the promotion of tourism and registered with the Tourist Development Corporation of Malaysia.

Qualifying capital expenditure includes:
1. Clearing of land for purposes of a tourist project;
2. Planting of trees and plants;
3. Construction of roads and infrastructural facilities on land used for a tourist project;
4. Provision of birds, animals and other exhibits;
5. Plant and machinery; and
6. Buildings on land (including those for the welfare of or as living accommodation for persons), structural improvements on land and other structures on land used for a tourist project.

In all of the above cases, the qualifying capital expenditure excludes that incurred on buildings, plant and machinery which are wholly or partly provided for the use of a director, management, or administrative or clerical staff.

H. Conditions for allowance

The investment tax allowance is given in respect of capital expenditure incurred within 5 years from the date on which approval is to take effect (Sec. 29(2)(b)).

I. How the incentive is given

The amount of the approved allowance is set off as a deduction against the adjusted income of the company. If the adjusted income is insufficient to absorb the full allowance for any year of assessment, the balance of the unabsorbed allowance may be carried forward and set off against the first available adjusted income until the whole of the allowance is fully deducted.

J. Exempt income

The amount of the investment tax allowance given is credited to an exempt account. The company can then declare tax-exempt dividends to its shareholders from this exempt account and the provisions entitling it to withhold tax from the dividends do not apply.

IV. ABATEMENT OF ADJUSTED INCOME (Secs. 32-36)

A. Promoted industrial area

1. Factory in a promoted industrial area (Sec. 32(1))

Where income of a company is derived from the manufacture of products and the factory is in a promoted industrial area, the company qualifies for a 5% abatement of the adjusted income.

2. Non-eligibility

The following companies are not eligible for the abatement:
(a) pioneer status companies which intend to apply for the grant of a pioneer certificate; or
(b) companies which have been granted a pioneer certificate and whose tax relief period has not ended; and
(c) where the investment tax allowance has been granted under Sec. 27.

3. Tax relief period (Sec. 32(3))

The tax relief is available for each year of assessment in the basis period for which the factory is located in a promoted industrial area. The relief period is not less than 5 consecutive years of assessment, even where the declaration of a promoted industrial area is revoked by the Minister.

B. Small-scale companies

1. 5% abatement

A small-scale company resident in Malaysia which manufactures products and commences business on or after 1 January 1986 is granted a 5% abatement of the adjusted income. A small-scale company is defined as a company with a shareholders' fund not exceeding M$ 500,000.[3]

2. Non-eligibility

The abatement does not apply to a company which has been granted pioneer status and which intends to apply for a pioneer certificate or a company which has a pioneer certificate and whose tax relief period has not ended or a company enjoying the investment tax allowance under Sec. 27.

3. Tax exemption

So much of the adjusted income as is equal to the abatement in A.3. and B.1. above will be exempt from tax. Dividends paid out of this exempt income will also be exempt in the hands of the shareholders.

C. Abatement of adjusted income for purchases from small-scale companies (Sec. 33A)

1. 5% abatement or total value of components, whichever is lower

A resident company engaged in a manufacturing activity in Malaysia and which purchases components for use in its production from a small-scale company under a registered Government programme qualifies for an abatement of 5% of its adjusted income or the total value of components purchased, whichever is lower.

2. Companies not qualifying

The following companies do not qualify for the abatement:
(a) pioneer status companies;
(b) pioneer certificate companies;
(c) companies granted the investment tax allowance under Sec. 27; and
(d) companies enjoying an abatement under Sec. 36(2)(b) of 5% of the value of indigenous Malaysian materials incorporated in the product (see V.A.1. below).

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3. Sec. P.U. (Legislative Notification) (A) 83-84.

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D. Abatement of adjusted income for compliance with Government policy on capital participation or employment in industry (Sec. 34)

1. Abatement of adjusted income

A resident company engaged in a manufacturing activity in Malaysia which has complied with Government policy on capital participation or employment in industry is given an abatement for a period of 5 consecutive years of assessment commencing from the year of assessment in which the company is first given the abatement. The rate of abatement is as prescribed by the Minister by statutory order. When a company fails to comply with Government policy on capital participation or employment in industry, the abatement will cease for the year of assessment related to the basis year in which the failure arose. The abatement will not be granted for companies complying with these conditions prior to 1 January 1986 (Sec. 34(4)). This incentive is not available to pioneer status companies, pioneer certificate companies or companies granted the investment tax allowance.

E. Exempt dividends

An amount of income equal to the amount of the abatement is credited to an exempt account and dividends declared from the exempt account are exempt in the hands of the recipients. The treatment accorded for pioneer status under II.H. above will apply.

V. INCENTIVES FOR EXPORTS

A. Abatement of adjusted income for exports

1. Abatement for exports

A company exporting, directly or through agents, products manufactured by the company in Malaysia qualifies for an abatement of adjusted income. The amount of the abatement is calculated as follows:

$$\frac{\text{Export sales}}{\text{Total sales}} \times 50\%,^{4} \times \text{Adjusted income}$$

and another 5% of the value of indigenous Malaysian materials incorporated in the manufacture of the products exported (Sec. 36(2)(b)).

No abatement is given for goods exported but subsequently re-landed in Malaysia. If there is insufficient adjusted income to absorb a Sec. 36(2)(b) abatement, i.e. 5% of indigenous Malaysian materials, the abatement can be carried forward to a subsequent year of assessment until it is fully utilized. This incentive is not available to a company whose primary activity is trading in and exporting agricultural produce or manufactured products purchased from farm producers or manufacturers in Malaysia.

2. Exempt dividends (Sec. 37(3))

Any amount which has been abated must be credited to an exempt account. Dividends paid out of this exempt account will not be liable to tax in the hands of the shareholders and the provisions entitling the company to withhold tax from the dividends will not apply. Where the shareholder is a company, the dividend received by this company will be credited to an exempt dividend received account. Any dividend declared out of this account will also be exempt in the hands of the shareholders (i.e. a 2-tier exemption).

3. Companies not entitled to abatement

(a) pioneer companies;
(b) companies enjoying pioneer status;
(c) companies enjoying investment tax allowance; and
(d) non-resident companies.

B. Export allowance (Sec. 39)

1. Eligibility

The export allowance incentive is given to resident companies which:

(a) export agricultural produce as declared in a statutory order and which have not been granted the abatement of adjusted income for exports (see V.A. above); or
(b) which are trading companies and export any product manufactured in Malaysia.

Trading companies are defined as companies whose primary activity is trading in and exporting agricultural produce or manufactured products purchased from farm producers or manufacturers in Malaysia.

2. The amount of incentive

The incentive is 5% of gross income from the export of agricultural produce or the export of products manufactured in Malaysia by a trading company. The 5% is deducted from gross income to arrive at adjusted income. This export allowance applies to the following categories of taxpayers:

- sole proprietors, partnerships and associations solely engaged in agriculture;
- companies;
- agro-based cooperative societies;
- farmers' associations (area, State, federal);
- fishermen's associations (area, State, federal).

VI. DEDUCTION FOR PROMOTION OF EXPORTS

Under Sec. 41, a company can claim double deductions in respect of approved outgoings and expenses incurred for the promotion of exports in Malaysia, including agricultural produce. This deduction can be claimed in addition to the deductions allowed under Sec. 33(1) of the Income Tax Act, 1967. In other words, a company can get double deductions for the same expenditure. Expenditure which qualifies for double deduction is laid down in the Income Tax (Promotion of Exports) Rules, 1986.

VII. HOTEL BUSINESS: DEEMED INDUSTRIAL BUILDING

Secs. 19 and 30 provide for a hotel building to be deemed an industrial building if a hotel business is carried on in that building by a pioneer company or a company granted the investment tax allowance. The building must be of an approved standard, a term defined in Sec. 2 as a standard determined by the Minister of Trade and Industry with the concurrence in writing of the Minister of Finance. A hotel has been defined as any accommodation, which includes a hotel, motel, chalet or hostel, of the approved standard registered with the Tourist Development Corporation of Malaysia.

Any extensions to the hotel building will also qualify so long as they are of an approved standard. Where the hotel or any extension thereof is not maintained at the approved standard in a basis period for a year of assessment, the hotel or

4. Sec. 36(2)(a).

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extended part, as the case may be, ceases to be an industrial building for that year of assessment.

The qualification of a hotel as an industrial building means that industrial building allowances become available (see II.F. above).

VIII. INDUSTRIAL ADJUSTMENT ALLOWANCE

The industrial adjustment allowance is a new incentive, effective from year of assessment 1990. Industrial adjustment means "any activity proposed to be undertaken by a particular sector in the manufacturing industry to restructure by way of reorganisation, reconstruction or amalgamation within that particular sector with a view to strengthening the basis for industrial self-sufficiency, improving industrial technology, increasing productivity, enhancing the efficient use of natural resources and the efficient management of manpower".

A. Method of giving the allowance

The industrial adjustment allowance is given as a deduction from the adjusted income of a company. The deduction may not exceed 100% of the capital expenditure (Sec. 31E(1)). The allowance is given only after allowances for abatement of adjusted income under Secs. 32, 33, 33A, 34 or 36. The allowance is given for a year of assessment in the basis period for which the capital expenditure was incurred. It is available for expenditure incurred within 5 years from the date when the approval is to take effect.

Unabsorbed industrial adjustment allowance can be carried forward for future years of assessment (Sec. 31E(4)).

B. Persons eligible (Sec. 31B)

A company must apply in writing to participate in the industrial adjustment allowance scheme. Pioneer companies or companies approved under Sec. 27 can apply provided the following conditions are fulfilled:

(a) the manufacturing activity or product is not a promoted activity or product for which pioneer status has been granted;
(b) the capital expenditure is not capital expenditure on which the investment tax allowance has been granted.

C. Exempt dividends (Sec. 31E(3))

Where the industrial adjustment allowance has been given, an amount of income equal to the allowance is credited to an exempt account and any dividends paid from this exempt account are not liable to tax in the hands of the shareholders.

If the exempt dividends are paid to a company, any dividends which that company pays out of them are also exempt in the hands of the shareholders.

Conference Diary

AUGUST 1990

44th Congress of the International Fiscal Association: I. Taxation of Cross-border Leasing; II. International mutual assistance and exchange of information. Seminars: 1. The Nordic multilateral tax treaty; 2. Double tax treaties between industrialized and developing countries, the OECD and U.S. models – a comparison; 3. The extension of tax sovereignty – especially in connection with emigration; 4. Tax reform in Scandinavia. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125, 3001 DE Rotterdam, The Netherlands.

SEPTEMBER 1990

Monte-Carlo Workshop: Entertainers and Athletes (inbound transactions); Taxation of international shipping. Monte-Carlo, 17-18 September (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

The Tax Effective Management of an International Treasury. London, 20-21 September (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

7th European Congress of Tax Consultants. Cannes (France), Lectures 27 September, working group 28 September (multilingual):
C.F.E. General Secretariat, Dechenstrasse 14, Postfach 1340, D-5300 Bonn 1 (G.F.R.).

OCTOBER 1990

International Conference on Computer and Law, organized by the Buenos Aires Bar Association and the French Association pour le Développement de l'Informatique juridique. Buenos Aires, 16-19 October (English, French, Spanish):
Secretaria del Congreso Internacional de Informatica y Derecho, Uruguay 485, piso 3°, 1015 Buenos Aires, Argentina.

International Taxation – Management Techniques: Transfer Pricing; Mergers and Acquisitions. Paris, 18-19 October (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

NOVEMBER 1990

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

ITPA Maui Seminar: e.g. Private Banking in the Pacific Rim; Investment in Taiwan; New Offshore Centres, Belize, Labuan, Western Samoa, Maui, Hawaii, 15-16 November (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

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HONG KONG:

Taxation of Profits from International Business: Recent Cases

Jefferson P. VanderWolk—Baker & McKenzie, Hong Kong.

For the past several years, Hong Kong businesses engaged in international activities have suffered from uncertainty as to whether their profits from such activities are subject to Hong Kong profits tax. The uncertainty revolves around the question of the source of profits: if profits do not "arise in or derive from" Hong Kong, they are not taxable in Hong Kong.[1] The 2 most recent cases on the issue have further confused the already uncertain law in this area, and highlight the need for careful structuring of international operations involving Hong Kong.

BACKGROUND

The uncertainty regarding the source of profits for Hong Kong tax purposes began in 1985, when the High Court decided, in *Sinolink Overseas Co. Ltd. v. C.I.R.*,[2] that profits from contracts entered into in China had their source in Hong Kong due to the substantial operations of the taxpayer in Hong Kong. Prior to *Sinolink,* the generally accepted view had been that trading profits were not taxable in Hong Kong if they were derived from contracts negotiated and concluded outside Hong Kong.

Both the traditional view and the *Sinolink* decision were rationalized under the so-called "operations test" of source, i.e. profits have their source where the operations occur which in substance give rise to the profits. The traditional view held that profits arising from contracts of purchase and sale arise where the contracts are in substance made. The *Sinolink* court expanded the scope of the relevant operations to include not only the making of contracts but also pre-contract preparation and post-contract performance. Since the taxpayer in *Sinolink* was doing just about everything in Hong Kong except signing the relevant contracts, the court departed from the place-of-contracting approach.

Thus, *Sinolink* created uncertainty about the proper scope of the operations test in cases involving trading profits. Further uncertainty was created by an apparent change in the Hong Kong Inland Revenue Department's view of the taxability of reinvoicing companies.

Following *Sinolink,* the Inland Revenue Department became more aggressive in trying to tax the profits of Hong Kong reinvoicing companies. These companies, which in their simplest form have no substance apart from an agent in Hong Kong who receives and accepts orders from offshore, had long benefited from a kind of benign neglect on the part of the Inland Revenue (with one or 2 exceptions which led to taxpayer victories in the courts, as we will see below). In the latter half of the 1980s, however, the Revenue argued in several cases before the Inland Revenue Board of Review, with mixed success, that reinvoicing companies' profits must have their source in Hong Kong because, although such companies do not have much in the way of operations, whatever operations they do have are in Hong Kong. The alternative and more traditional view was that the reinvoicing companies' profits do not arise from the minimal operations occurring in Hong Kong but rather from offshore operations of independent agents and affiliated companies.

Within the past year or so, the Hong Kong courts have decided 4 cases on the basis of the operations test, without producing greater certainty as to the proper scope of the test in general, or the taxability of reinvoicing operations in particular. Indeed, the most recent decision contained dicta that challenge fundamental principles not previously contested by the Revenue or by taxpayers. These 4 decisions will be discussed in chronological order.

Bank of India v. CIR[3]

In *Bank of India v. CIR,* Hong Kong's High Court considered whether the Bank of India earned Hong Kong-source profits from certain discounting activities. The bank had provided trade financing to customers by purchasing bills of exchange at a discount in Hong Kong. The bank forwarded the bills to Kuwait for payment and sent the proceeds to New York. The High Court concluded that the profits derived from these operations had their source in Hong Kong and were therefore subject to profits tax. To arrive at this decision, the High Court applied the operations test.

In applying the operations test, the High Court felt that it was important that the taxpayer conducted its operations mainly in Hong Kong; it was not conclusive that the acts most immediately responsible for deriving the profits (the presentation of the bills in Kuwait) took place outside Hong Kong. This result is not surprising, since the offshore acts were formal in nature. The business operations giving rise to the bank's profits were undeniably occurring in Hong Kong.

Hang Seng Bank v. CIR[4]

Next, the Court of Appeal (which is Hong Kong's highest court, subject to reversal only by the Privy Council in London) handed down its decision in the *Hang Seng Bank* case. The court's opinion discussed at some length the proper application of the operations test to Hong Kong-based businesses deriving profits from contracts entered into offshore or from other offshore operations.

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1. Inland Revenue Ordinance (Laws of Hong Kong [hereinafter "LHK"] Cap 112, 1986 edn.) Sec. 14.
2. (1985) Hong Kong Law Reports [hereinafter "HKLR"] 431.
3. (1988) High Court [hereinafter "HCt"], *Inland Revenue Appeals* [hereinafter "IRA"] No. 4 of 1988 (unreported).
4. (1989) Court of Appeal [hereinafter "CA"], IRA No. 7 of 1988 (unreported).

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According to the Court of Appeal, in cases where profits are derived from both onshore and offshore activities of the taxpayer, the source of the profits is where the activities occur which are the "dominant factors" in the production of the profits. Thus, the Hang Seng Bank's profits from purchases and sales of securities through brokers in New York and Singapore were held to have their source outside Hong Kong, even though the operations of the bank in Hong Kong, which constituted nearly all of the bank's operations, contributed to the making of such profits.

Exxon Chemical v. CIR[5]

The High Court decided the Exxon Chemical case shortly after the *Hang Seng Bank* decision was rendered. *Exxon Chemical* was the first reinvoicing-related case to go beyond the Inland Revenue Board of Review in many years.

Exxon Chemical, the Hong Kong branch of a company organized in Panama, bought petroleum products from offshore affiliates and sold them to other offshore affiliates. Upon receiving a purchase order from an overseas affiliate, Exxon Chemical's Hong Kong office would transmit the order to a U.S. affiliate, which would identify a source of supply, purchase the goods on Exxon Chemical's behalf and arrange for direct shipment to the buyer. The U.S. affiliate received a fee from Exxon Chemical for these services.

Exxon Chemical conceded that it was carrying on business in Hong Kong by accepting orders and placing orders from its Hong Kong office. It argued that it was not taxable because its profits had their source outside Hong Kong. Virtually all operations relating to the performance of the contracts of sale took place outside Hong Kong; thus, it was argued, the profits must be treated as arising from offshore operations.

The court decided that Exxon Chemical's profits had their source in Hong Kong and, therefore, were subject to Hong Kong profits tax. In the court's view, Exxon Chemical's profits arose from a sales mark-up that was effected by Exxon Chemical's acceptance of purchase orders and placing of corresponding orders with suppliers at a lower price. Both of these activities technically took place in Hong Kong. The activities of Exxon Chemical's U.S. affiliate and other contractors were not viewed as giving rise to Exxon Chemical's profits. Rather, the offshore activities were seen as giving rise only to the profits earned by the contractors from their fees.

The court apparently was influenced by an often overlooked statutory provision that states that profits "from the business transacted in Hong Kong" have their source in Hong Kong for tax purposes.[6] Given that the sales contracts producing all of Exxon Chemical's income were entered into by Exxon Chemical in Hong Kong, the court had no difficulty in concluding that all of Exxon Chemical's business was transacted in Hong Kong and that its business profits, therefore, had their source in Hong Kong.

The *Exxon Chemical* decision produced great consternation among Hong Kong tax experts despite (or perhaps because of) the court's open-and-shut analysis of the source issue. The decision is at odds with other Hong Kong cases on the source issue, for it defies the common sense approach that looks at where "the real action took place, where the money was put to work", in the words of the *Hang Seng Bank* opinion. Clearly, Exxon Chemical's profits did not arise from any "real action" taking place in Hong Kong. The technical approach of the High Court did not sit well with the tax community, and it is widely hoped that the Court of Appeal will overturn the decision.

HK-TVB International v. CIR[7]

The final case in the quartet, which was decided in April 1990, has fueled the flames of discontent with the High Court's approach to the source issue. Moreover, certain gratuitous observations by Justice Godfrey in his opinion in the case have thrown accepted tax planning principles into doubt. It is worth noting that Justice Godfrey also wrote the *Exxon Chemical* opinion.

The *TVB* case was somewhat different from other Hong Kong-source cases in that it dealt with the source of royalties rather than trading profits. TVB International, a Hong Kong company with its offices in Hong Kong, earned fees from sub-licensing broadcasting rights with respect to film and television in jurisdictions other than Hong Kong. Its employees travelled to other countries to negotiate contracts with sub-licensees; the contracts were signed by the sub-licensees outside Hong Kong. TVB International had obtained the licensed rights (which did not include Hong Kong broadcasting rights) under a master licence agreement concluded in Hong Kong.

The Board of Review had accepted counsel's argument that the source of the royalties received by TVB International must be outside Hong Kong because the licensed intellectual property was used outside Hong Kong, and indeed did not even exist in Hong Kong – the taxpayer never had the right to broadcast films or television programmes in Hong Kong. This "place-of-use" approach, which is prevalent around the world in determining the source of royalties for tax purposes, is consistent with Commonwealth precedents.

The High Court, in contrast, decided that TVB International's profits had their source in Hong Kong and were therefore subject to Hong Kong profits tax. In the opinion of the High Court, TVB International's profits were generated by the grant of sub-licences to overseas persons, and "the grant of these sub-licences... was business transacted in and from Hong Kong". The court also stated that profits derived from contracts negotiated and concluded outside Hong Kong by Hong Kong-based salesmen generally have their source in Hong Kong, unless the taxpayer "sets up a separate operation" outside Hong Kong. The court concluded, "the time has come to make it clear that it is only where a taxpayer has established the existence of a profit-generating business carried on by him outside Hong Kong that he can hope to escape the charge to profits tax".

As in his decision in the *Exxon Chemical* case last year, Justice Godfrey referred to the statutory provision which states that profits "from business transacted in Hong Kong" have their source in Hong Kong. His interpretation seems to be that, if the taxpayer carries on a business in Hong Kong, all of the profits of the business have their source in Hong Kong unless the taxpayer also has a base of operations outside Hong Kong. This interpretation is inconsistent with numerous previous cases.

Two examples are the *Whampoa Dock* case[8] and the *International Wood Products* case.[9] *Whampoa Dock* is often

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5. (1989) HCt, IRA No. 2 of 1989 (unreported).
6. Inland Revenue Ordinance (LHK Cap 112, 1986, edn.) Sec. 2.
7. (1990) HCt, IRA No. 9 of 1989 (unreported).
8. *Hong Kong and Whampoa Dock Co. (No. 2) v. CIR* (1960) HKLR 166, 1 Hong Kong Tax Cases [hereinafter "HKTC"] 85.
9. *CIR v. International Wood Products* (1971) 1 HKTC 551.

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cited as the first case in which the operations test was applied in Hong Kong. It involved service fees received by a Hong Kong-based taxpayer for services rendered on the high seas, namely, salvaging a ship and towing it back to Hong Kong. The court held that the services were substantially performed outside Hong Kong (literally, "offshore") and so the service fees had their source outside Hong Kong. No "separate operation" from the Hong Kong-based business can be found in the facts of the *Whampoa Dock* case.

International Wood Products involved facts analogous to those in *TVB*. The Hong Kong-based taxpayer had entered into an agency agreement and then sub-contracted all of its duties to offshore sub-agents. The taxpayer's profits consisted of the spread between commissions received and commissions paid to the sub-agents. Similarly, TVB International's profits equalled the spread between royalties received and royalties paid. In both cases the taxpayers were not actively involved in earning the money on a day-to-day basis.

The court in *International Wood Products* took the common sense view that the "real action" producing the profits was occurring outside Hong Kong. The fact that the taxpayer had no operations of its own outside Hong Kong was not thought to be relevant, although the Inland Revenue Department had argued otherwise.

The High Court in the *TVB* case added a peculiar gloss to the statute by stressing that TVB International's profits were generated by business transacted "in and from" Hong Kong. The statute and prior cases look to whether relevant operations take place either in Hong Kong or outside Hong Kong. The notion that business transacted "from" Hong Kong produces Hong Kong-source profits was rejected in both the *Hang Seng Bank* case and, earlier, in the *Whampoa Dock* case.

THE FUTURE

Most Hong Kong businesses with offshore activities will wish to avoid the risk of capricious decisions such as that in the *TVB* case by carefully structuring their international operations so that profits from operations outside Hong Kong are not taxable in Hong Kong. It is relatively simple to minimize Hong Kong tax by using an appropriate offshore structure, in conjunction with a Hong Kong service company where necessary.

Careful planning is particularly important at this time because the law regarding source will undergo further changes in the near future. The *Hang Seng Bank* and *Exxon Chemical* cases are being appealed, and the *TVB* case may also be appealed. In this uncertain atmosphere, the risk of an unexpected Hong Kong tax liability can be avoided only through the use of an offshore structure.

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HONG KONG:

Budget 1990/1991: "Some Worrying Trends"

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The sub-title for the article on Hong Kong's 1989/1990 Budget which appeared in the June 1989 issue of the *Bulletin* was "predictable and boring". This cannot be said of the Budget presented by the Financial Secretary of Hong Kong, Sir Piers Jacobs, to the Legislative Council in Hong Kong on 7 March 1990. The events of June in the People's Republic of China (PRC) and the subsequent political turmoil coupled with a severe austerity programme in that country had its impact on Hong Kong during 1989. The PRC is Hong Kong's largest trading partner and therefore a substantial amount of business in Hong Kong relies on the relationship between Hong Kong and the PRC. The impact of this relationship was particularly noticeable in the aftermath of the June events by the appreciable reduction in the number of tourists visiting Hong Kong because many tourists include destinations in China as part of their visit to Hong Kong. As the PRC was no longer considered to be attractive, other destinations in Southeast Asia, particularly Thailand and Singapore, benefited as a result.

However, it was not only tourism that provided an impact on the Hong Kong economy after 4 June but what was termed as "the crisis of confidence" flowed through into the investment field with a sharp downturn in the stock market both as regards prices and turnover and also the property market which reflected an across the board 10% decline both in values and rentals. Increased emigration, particularly in the managerial class, was also evident.

It was not surprising therefore that given this scenario, the usual buoyancy of yields from direct taxes experienced in previous years did not eventuate. A breakdown of revenue was not made available at Budget time although the Financial Secretary did indicate that although revenues were expected to be up by 2% over forecast, this arose from salaries tax, betting duty and stamp duty. On the expenditure side, this is also expected to exceed Budget by 6% and therefore the forecast surplus of HK$ 11.5 billion for the year is now estimated to be only HK$ 9.3 billion.

EXPENDITURE ESTIMATES

Despite the downturn in economic activity in Hong Kong and the intense shortage of labour, the Government announced a considerable increase in expenditure in the year to 31 March 1991 of some 28%. The Financial Secretary stressed, however, that the majority of the expenditure would be going into capital projects particularly in relation to the work commencing on the new airport at Chek Lap Kok, including the associated infrastructure of road, rail and harbour works. He said that he was particularly concerned at the growth of the civil service now numbering some 190,000 staff and although he accepted that in certain areas it was desirable to increase services to the public particularly in the field of health and social welfare, he was most concerned to ensure that growth elsewhere in the civil service did not continue unabated.

PROSPECTS FOR 1990/91

Sir Piers Jacobs said that the double digit growth that had been experienced in previous years and which had not eventuated in 1989/90 was similarly not expected for 1990/91. Growth in GDP was expected to be in the region of 2.5% while growth in private consumption expenditure was expected to be only 3.5%. Imports and exports both due to the tightening situation in Hong Kong, competition from other Southeast Asian nations and restrictions on trade in Hong Kong's other major trading partners would also have an impact on growth. However, the Financial Secretary did expect a growth in tourism to be experienced and he saw no reason why the buoyant financial sector should not also continue to expand in the Budget period.

MONETARY ISSUES

On the monetary front Sir Piers Jacobs had little to say in this year's Budget although once again he stressed the value of the peg between the Hong Kong dollar and the U.S. dollar, particularly after the events in the PRC in the summer.

REVENUE STRATEGY

On some 8 separate occasions during his speech, the Financial Secretary referred to the undesirability of the heavy reliance that is placed on direct taxes. He said that in 1989/90 the percentage of direct taxes to indirect taxes rose from 60% in 1985/86 to 63% in 1989/90 and an anticipated 65% in 1990/91. He said that the cyclical nature of the economy meant that a downturn would readily translate into lower yields from direct taxation and in a period when there was pressure both on costs and a need for heavy capital expenditure, this was an unhealthy position to face. He referred to the Consultative Paper that he had issued on the proposal for a *wholesale sales tax* and said that although there had

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been a certain amount of criticism he was satisfied that from a technical aspect the proposal was feasible.

Following on from his comments on the relationship between direct and indirect taxation, the Financial Secretary said that his main proposals for 1990/91 would relate to increasing indirect taxes coupled with a modest reduction in direct taxes. His main proposals for indirect taxes, therefore, related firstly to restore fees and charges to compensate for the inflation factor and in respect of duties to raise additional revenue. He stressed that in his proposals for duties they were totally geared to raising revenue and not for any other social or political considerations. The chief increases proposed were as follows:

Hydrocarbon oils

Petrol from $ 2.75 per litre to $ 3.58 per litre.
Diesel from $ 1.37 per litre to $ 1.78 per litre.

Intoxicating liquor and alcohol

The specific duty rates on all liquors and alcohol are increased by 10%.

The ad valorem rate on champagne and sparkling wines, brandy, whisky and other spirituous liquors is increased to 35%.

The 2 categories of still wines are merged into one and the new duty payable is $ 24 per litre plus an ad valorem rate of 20%.

Tobacco

Duty on cigarettes is increased from $ 190 per 1,000 sticks to $ 240 per 1,000 sticks.

Duty on cigars is increased from $ 250 per kilo to $ 310 per kilo.

Duty on smoking tobacco is increased from $ 230 per kilo to $ 290 per kilo.

Duty on Chinese prepared tobacco is increased from $ 50 per kilo to $ 60 per kilo.

Motor vehicles first registration tax

The scale which defines basic, semi-luxury and luxury cars is to be redefined so that the rate of tax on basic cars is increased from 70% to 80%, the rate of tax on semi-luxury cars is increased from 80% to 90% and the rate of tax on luxury cars from 90% to 100%.

- The tax rates on both standard and exotic bets are increased from 9.5% to 10.5% and from 6% to 17%, respectively.
- Rates on property are increased from 6% to 7.5% of rateable value.
- The business registration fee is increased from $ 630 to $ 900.

The levy of $ 100 is unchanged.

The exemption levels are increased. A business whose average sales do not exceed $ 5,000 per month and a business which renders services whose average receipts do not exceed $ 1,500 per month are exempt from the fee upon application.

The company registration fee is increased from $ 600 to $ 1,000.

Vehicle and driving licence fees are increased by 10% by the level set last year.

Licence fees for banks other than restricted licence banks are increased by 22%.

Licence fees for restricted licence banks are increased by 30%.

Registration fees for deposit-taking companies are increased by 30%.

The $ 17 passenger embarkation fee applied at the Macau and China Ferry Terminal is increased to $ 19.

The berthing fees are increased by 15%.

A number of charges are scheduled for review in 1990.

Wholesale tax

The public consultation on the issue of wholesale tax was completed in October 1989. The consultation did not uncover any major technical hurdle to the introduction of a wholesale tax in Hong Kong. Although there are concerns relating to the timing of the introduction of the tax and its adverse consequences on the economy, there was a general recognition of the need for a more stable tax base which is less vulnerable to the vicissitudes of economic performance.

The issue of a wholesale tax will be given a second thought but the Financial Secretary is not working to any specific timetable.

Stamp duty

The proposals relate to concession on stamp duty on share transfers; changing the system of levy is also under consideration.

As can be seen, the major increase in indirect taxation comes from rates on property which the Finance Secretary proposed to increase from 6% to 7.5% on the rateable value of property. At the present time, a percentage of the rates for Hong Kong, Kowloon, New Kowloon and the New Territories are passed over to the Urban and Regional Councils respectively but the total increase of 1% would go to the Central Government. Sir Piers said that it was proposed to revise the building valuations in the next financial year but he undertook to review the level of rates should building values rise to sufficiently high levels.

Direct taxes

The majority of the Financial Secretary's proposals related to minor adjustments at the bottom end of the salaries tax paying scale both in respect of allowances and rate bands as follows:

Profits tax

Standard rate remains unchanged:

– for corporations	16.5%
– for persons (other than corporations)	15.0%
– capital gains	nil
– dividends	No withholding

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Salaries tax

New rate bands

	1989/90			Proposed 1990/91		
	Rate	Tax HK$	Cum total HK$	Rate	Tax HK$	Cum total HK$
First 10,000	3%	300	300	2%	200	200
Next 10,000	6%	600	900	4%	400	600
Next 10,000	9%	900	1,800	9%	900	1,500
Next 10,000	12%	1,200	3,000	12%	1,200	2,700
Next 10,000	15%	1,500	4,500	15%	1,500	4,200
Next 10,000	18%	1,800	6,300	18%	1,800	6,000
Next 10,000	21%	2,100	8,400	21%	2,100	8,100
Balance over 70,000	25%			25%		

	1989/90 HK$	Proposed 1990/91 HK$
For a single person	32,000	32,000
– additional allowance	7,000[1]	7,000[2]
	39,000	39,000
For single person with dependent children		
– personal allowance	32,000	32,000
– additional allowance	7,000[1]	7,000[2]
– single parent allowance	20,000	20,000
	59,000	59,000
For married couple	66,000	66,000
– additional allowance	14,000[1]	14,000[2]
– working wife's allowance	Nil	Nil
	80,000	80,000

1. Where assessable income exceeds $ 39,000 for a single person and $ 80,000 for a married couple, the additional personal allowance is clawed back so as to reduce the allowance by 10% of the excess over the levels of $ 39,000 and $ 80,000, respectively and therefore the additional allowance is totally eliminated at income levels of $ 109,000 and $ 220,000, respectively.
2. The clawback rate is reduced to 0%. Therefore all eligible taxpayers will be entitled to the full additional allowance irrespective of their income levels.

Child allowances

	1989/90 HK$	Proposed 1990/91 HK$
First	13,000	14,000
Second	9,000	10,000
Third	3,000	3,000
Fourth to sixth (each)	2,000	2,000
Seven to ninth (each)	1,000	1,000

Dependent parent allowances

– residing with taxpayer	14,000	15,000
– not residing with taxpayer	11,000	12,000

Of major significance to owners of commercial buildings was the long lobbied decision to increase the allowance on commercial buildings from 0.75% per annum to 2% per annum which is half the rate granted on industrial buildings. Despite the amount of commercial property in Hong Kong this concession was only estimated to cost HK$ 50 million in a full year. Changes were also made to the estate duty rates as follows:

Where the principal value of the estate	*Rate of estate duty 1989/90*
Does not exceed	HK$ 2.0M Nil
Exceeds $ 2.0M but does not exceed	2.5M 8%
Exceeds $ 2.5M but does not exceed	3.0M 6%
Exceeds $ 3.0M but does not exceed	3.5M 10%
Exceeds $ 3.5M but does not exceed	4.0M 12%
Exceeds $ 4.0M but does not exceed	4.5M 14%
Exceeds $ 4.5M but does not exceed	5.0M 16%
Exceeds $ 5.0M and above	18%

Where the principal value of the estate	*Rate of estate duty proposed 1990/91*
Does not exceed	HK$ 4.0M Nil
Exceeds $ 4.0M but does not exceed	4.5M 6%
Exceeds $ 4.5M but does not exceed	5.0M 12%
Exceeds $ 5.0M and above	18%

The duty-free limit on gifts 10,000

A matrimonial house is normally exempted.

Legislative changes

The Financial Secretary said that in his previous Budget he had indicated that he would consider exempting the profits of venture capitalists. He said, however, these have been given close examination but that it had been found impractical to produce simple legislation to exempt profits and as it had been calculated that the tax involved amounted to no more than HK$ 25 million he had decided to defer this matter.

He said, however, representations had been made by unit trusts and mutual funds to redefine the term "securities" so that profits made by such taxpayers would be exempt from tax. He said that he was looking at the question and hoped to introduce legislation later in the year.

Many commentators were disappointed that he had not indicated the position regarding proposed legislation in respect of fringe benefits. A case had been heard by the Privy Council in the United Kingdom [*Glynn v. Commissioner of Inland Revenue*] earlier in the year which had determined that most benefits provided by Hong Kong employers which had not previously been subject to tax were now considered to be taxable. The Revenue had indicated after the Court of Appeal decision that they would not be following the decision other than for:

(a) payments made by an employer in respect of the education of an employee's child, irrespective of how or to whom the payments are made;
(b) payments made by an employer to discharge any personal liability of an employee;
(c) assets transferred or given to an employee by an employer free of charge or at an undervalue.

At that time the Commissioner hoped that the legislation would be introduced to restore the position to what was required. Therefore it is not surprising in this author's view that no further mention was made in the Budget Speech. However, it is understood that legislation is in fact being drafted but it is not likely to be published until later in the year. In the meantime the position remains as indicated in the Commissioner's Practice Note.

CONCLUSION

The Budget was thus neither predictable nor boring. The substantial increase in public expenditure and the less than buoyant revenue are clearly going to be a trend for at least the next few years. Most commentators expected substantial increases in commodity duties but certainly did not anticipate the substantial increase in respect of rates. However, although the gap between revenue and expenditure is likely to continue to decrease and even likely to go into deficit with requirements of additional revenues each year measuring billions of dollars there is clearly a limit to which existing taxes both direct and indirect can be expected to shoulder

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this burden. This is true even though the tax take in Hong Kong as a percentage of GDP is well below the OECD average. The commitment of Government to a long and costly programme of capital works and the acceptance that in some years this will result in a deficit is clearly a major change of policy. That Hong Kong's substantial reserves will be used to cushion any shortfalls has been accepted but time will only tell to what extent these reserves will have to be utilized. It is also clear that the Government's long avoided policy of not borrowing will need to be reviewed as there appears to be a limit on Government's ability to fund the anticipated substantial new capital expenditure out of direct taxes.

Whatever the end result it is unlikely to be good news for the Hong Kong taxpayer.

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INDIA:

1990-91 Budget and the New Corporate Tax Proposals

An Evaluation

J.V.M. Sarma

The 1990-91 Budget has many features that intimate an overhaul of the corporate tax system in India. The Finance Minister's attempts, for a change, are not so much directed at increasing short-term revenue gains; rather, his proposals aim to simplify the tax structure by removing some of the complexities with a view to improving tax compliance in the long term. At the core of the new corporate tax proposals lies a twin strategy, namely, to remove the plethora of tax incentives which are in the form of deductions from the taxable profit base and have led to wide disparities in the effective tax rates between companies, and instead, grant a general reduction in the statutory tax rate. This article examines the effect of the package of proposed changes on the long-term growth of the corporate sector, as well as on the revenue yield.

Dr. J.V.M. Sarma is a fellow at the National Institute of Public Finance and Policy (NIPFP), New Delhi. His area of interest is corporate taxation on which he has written widely. Dr. Sarma's works include *Taxation and Corporate Dividend Behaviour in India* (New Delhi: Harman Publishing House); *Investment Allowance: A Study* (New Delhi: NIPFP); *Financing Public Sector Development Expenditure in Selected Countries – India* (Manila: Asian Development Bank); and *Taxation and Corporate Saving Behaviour in India* (New Delhi: Indian Council for Research on International Economic Relations).

I. BACKGROUND

India's tax structure is characterized by the predominance of indirect taxes. The share of direct taxes has declined steadily over the years and there is no indication of a reversal of this trend in the near future. Heavy reliance on indirect taxes is not unusual for an economy in the early stages of development; however, as the economy evolves, direct taxes are looked upon to play a more important role in view of their flexibility to accommodate the egalitarian objectives of fiscal policy. Therefore, an important objective of the tax reform in India has been to reverse the decline in the share of direct taxes.

The falling trend in the corporate tax buoyancy during the last few years has been a source of anxiety, particularly in the wake of the continued poor performance of its other major complement of direct taxes, the individual income tax. While the meager revenue productivity derived from personal income tax results from a narrow tax base and widespread evasion, the declining buoyancy of the corporate tax revenue can be attributed largely to the erosion of the tax base owing to numerous exemptions and deductions. But the experience of the Government in undertaking measures to reverse the trend so far shows that it is easier said than done. Starting with the 1985-86 Budget, all efforts of corporate tax reform have rightly concentrated on tax incentives. The Long Term Fiscal Policy Document, issued about 5 years ago, posed 2 alternatives: reduction of the corporate tax rate by 5 percentage points and abolishing the investment allowance, or retention of the investment allowance with no cut in the tax rate. However, experiments that later followed (e.g. replacing the investment allowance by the investment deposit scheme) have proved ineffective. The tax base erosion has continued unabated and many large companies, by taking advantage of the tax shelter, have been able to reduce their taxable profits to zero. To counter this gap, a minimum profits tax law had to be incorporated to ensure that companies pay tax on at least 30% of their book profits.

That bolder measures are required to prevent further erosion of the corporate tax base has never been in doubt. The basic philosophy underlying the present corporate tax proposals which is directed towards broadening the base, simplifying the tax structure, making the tax system neutral as between large and small companies, and thus improving the scope for better tax compliance in the long term, is therefore, welcome.

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II. THE NEW CORPORATE TAX PROPOSALS

A. Abolition or modification of tax incentives

With a view to streamlining the existing corporate structure, the following concessions are proposed to be withdrawn or modified.

1. Withdrawal of the investment allowance (Income Tax Act (ITA) Sec. 32A)

Under the existing provisions, a sum equivalent to 20% of the cost of plant and machinery installed or put to use may be deducted when computing the profits and gains from a business or profession. This deduction is also available in respect of a new ship or aircraft acquired or put to use. This provision will be abolished.

2. Withdrawal of investment deposit scheme (ITA Sec. 32AB)

As an alternative to the investment allowance, a deduction to the extent of 20% of the profits of a business or profession is allowed to the assessee if the amount is deposited with a Development Bank for a specified period and withdrawn or utilized only for the purchase of a new ship, new aircraft or new machinery and plant. No such deduction will be allowed under the proposed amendments.

3. Discontinuation of the tea development allowance (ITA Sec. 33A)

Under Sec. 33A, assessees carrying on the business of growing and manufacturing tea in India are granted a "development allowance" by means of a deduction in the computation of profits at the rate of 50% of the actual cost of planting tea bushes. This deduction is available for planting tea bushes on land which had been previously abandoned or which is newly brought under plantation. Under the new provisions this facility will be available only if the planting of tea bushes has been completed before 1 April 1990.

4. Withdrawal of backward area allowance (ITA Sec. 80HH) and rural area allowance (ITA Sec. 80HHA)

Under Sec. 80HH, assessees are entitled to a deduction of 20% of the profits derived from new industrial undertakings (other than those engaged in mining) and approved hotels set up after 31 December 1970, in specified backward areas. Similarly, Sec. 80HHA entitles new small-scale undertakings (other than those engaged in mining) to a tax deduction of 20% if they are set up in a rural area. These deductions are allowed in respect of each of the 10 assessment years beginning with the assessment year relevant to the year in which the industrial undertaking starts operating. Under the new provisions, these deductions will not be available for industrial undertakings starting to operate after 31 March 1990.

5. Withdrawal of minimum profits tax law (ITA Sec. 115J)

Under existing provisions, companies whose taxable income is less than 30% of the book profit computed under this section are charged the normal rate of tax applied to 30% of the book profit. This provision was enacted to restrict erosion of the taxable income base on account of a large number of tax concessions. In view of the package of measures proposed for rationalizing the tax structure, including discontinuance of certain investment incentives in respect of future investment (which will now have the effect of increasing the taxable income base), this section is proposed to be withdrawn.

6. Modifications of exemptions of income from exports (ITA Secs. 80HHC and 80HHD)

Under existing provisions of Sec. 80HHC, exporters are allowed a 100% deduction in respect of the profits derived from the export of goods or merchandise. Under Sec. 80HHD, persons engaged in the hotel business or tour operators or travel agents are allowed a deduction of 50% of the profits derived from services provided to foreign tourists and so much of the balance profits as is credited to a reserve account to be utilized for specified purposes. To qualify for the deduction the receipts must be in convertible foreign exchange. It is not necessary to bring the foreign exchange into India. In the absence of the requirement that the foreign exchange must be imported, one of the purposes of allowing such concessions, namely, to augment the foreign exchange earnings of the country, is defeated. It is therefore proposed that to obtain the deduction, the taxpayer will be required to import the sale proceeds of goods or merchandise or receipts in relation to services rendered to foreign tourists in convertible foreign exchange within a period of 6 months from the end of the year. The Chief Commissioner or Commissioner of Income Tax may extend the 6-month period if he is satisfied that the taxpayer was prevented from complying with this requirement for reasons beyond his control. Further, the deduction may not exceed a percentage computed by reference to the ratio of the foreign exchange brought into India to the total turnover/receipts of the business.

It is also proposed to extend the benefit of Secs. 80HHC and 80HHD to the supportive manufacturers who sell the goods to export houses or trading companies for export purposes. However, the requirement of receipt of sale proceeds in convertible foreign exchange will not apply in the case of supporting manufacturers. The deduction is computed as

$$\text{profits} \times \frac{\text{export turnover}}{\text{total turnover}}$$

B. New tax rates on companies

To compensate for the withdrawal of the above tax incentives it is proposed that the tax rates be reduced. The proposed tax rates are as follows: in the case of a domestic company in which the public are substantially interested, the existing rate of 50% will be reduced to 40%; in the case of a domestic company in which the public are not substantially interested, the existing rate will be reduced from 60% to 50% if it is a trading or investment company, and from 55% to 45% if it is not. For foreign companies the tax rate will remain at 65%. The additional surcharge levied last year at the rate of 8% to provide relief for the unemployed is proposed to be continued.

III. THE IMPACT OF THE NEW TAX PROPOSALS

The initial reactions of the corporate world represent something of a conundrum. While some have complimented the Finance Minister for his proposals to lower the statutory tax rate by as much as 10 percentage points and do away with the reprehensible minimum tax law (Sec. 115J), others have viewed the abolition of the major tax incentives (i.e. the investment allowance (Sec. 32A), the investment deposit scheme (Sec. 32AB), and backward area allowances (Secs. 80HH and 80HHA)) as a retrograde step that will inhibit the growth of the corporate sector. Neither group, however, appears to be certain of the outcome of the proposals as a whole.

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In attempting to clear some of the mist surrounding the effect of the package of proposed changes in the corporate tax structure on revenue yield as well as on long-term growth of the corporate sector, I will draw heavily on a recent study conducted by the National Institute of Public Finance & Policy (NIPFP).[1]

A. Impact on the growth of corporate investment

The findings of the study, if extrapolated to the current financial year, indicate that the tax proposals do not provide any more inducement for new investment than the existing tax structure. The 10% tax rate reduction has more or less the same inducement effect as the 20% investment allowance provision. Hence, the new proposals have only a marginal impact on investment decisions and on the long-term growth of the corporate sector. This result will be clear if we take a closer look at the investment decision-making process of companies.

In a rational world, which the corporate sector is presumed to be, the major factors that guide investment decisions are the likely future demand for the output generated and the likely rate of return on the new investment. Given the demand, investors expect a minimum rate of return from their investment; otherwise they will opt for alternative investment opportunities. The required minimum rate of return can be expressed as a notional cost associated with the investment, which will differ from company to company depending upon factors such as equipment price, rate of economic depreciation, debt-equity structure, tax rate and the associated unit value of tax deductions, and so on. Students of financial management are well aware of the role of such a notional or "user cost" per unit of capital in project evaluation studies. Corporate tax pushes up the cost of capital; tax incentives such as investment allowances have the opposite effect.

Sarma and Sondhi[2] constructed the average of the user cost of capital for the Indian corporate sector for the period 1960-61 to 1981-82, based on certain plausible assumptions. Following their formulae and method, the average user cost of capital for the year 1990-91 with the existing corporate tax structure can be reckoned at 27% of the equipment price. Abolition of the investment incentives is likely to push up the cost-price ratio to 31%. However, the 10% tax rate reduction will pull it down to 26.5%. Consequently, the new proposals will result in a net 0.5% decline in the cost of capital.

It remains to be seen to what extent corporate investment is sensitive to changes in the cost of capital. Sarma and Sondhi also examined in detail (for the period 1960-82) the impact of the cost of capital on the growth of corporate investment. To isolate the impact they constructed a model of the investment decision-making process in an integrated framework of corporate behaviour. Basically, growth of capital stock (plant and machinery) was modeled as determined by user cost of capital at the margin, given the output demand. Tax parameters were built into the capital cost variable. The response of capital growth to changes in the cost of capital (or the constituent tax parameters) was quantified by fitting a regression equation on the aggregate time series data.

Following the same technique, I have updated the regression estimates by taking into account the later period's observations as well. If the technical details of the econometric estimation process are skipped with a view to minimize the reader's burden, the empirical results based on the time series from 1970-71 to 1985-86 show that capital cost plays a significant role in altering the growth profile of the stock of equipment and hence the investment. The inducement effect was such that a 1% drop in the cost of capital would cause roughly a 0.34% rise in the corporate capital stock growth over and above what could have taken place otherwise. The results further show that this effect is not instantaneous, and in a single year, the capital stock growth would change only by 0.068%. Thus the inducement effect appears to spread over 5 to 6 years. Since the net increase in the cost of capital caused by the new tax proposals is 0.5%, the resultant change in the capital stock growth would be 0.034%. By way of illustration, the size of the induced investment of the private corporate sector for 1990-91 can be estimated using the official estimates of capital stock figures for 1981 to be 31.2 billion Rs.

B. Impact on corporate tax yield

Even the Finance Minister appears to be not very well informed about the extent of additional revenue that can be generated by his budgetary proposals pertaining to corporate taxation. The 8 billion Rs. estimate of additional revenue in a single year is, perhaps, an over-statement of the net effect of the twin strategy underlying the tax proposals. The additional gain shown in the Budget receipts statement is only about 5.3 billion Rs. which also appears to be on the high side. These figures reflect either an exaggerated picture of the impact of abolishing the investment allowance/deposit scheme, or are based on the mistaken assumption that a perfect inverse relation exists between the corporate tax rate and the tax yield. There is no evidence thus far of such an inverse relation between the corporate tax rate on its yield; in any case, not in the short term. In fact, the net revenue effect of the new tax proposals can be viewed as the sum total of 3 components: (1) revenue gain due to the abolition of the tax incentives; (2) loss due to the reduction of the statutory tax rate; and (3) revenue gain associated with a rise in corporate investment induced by the tax rate reduction. Unless each of these components is studied separately, the precise effect of the Budget proposals will not be clear.

An idea of the revenue gain due to the abolition of investment incentives can be obtained from the findings of Sarma & Sondhi. The study contains estimates of tax foregone due to the granting of investment allowances for the period 1960-61 to 1982-83, based on sample data published annually by the Reserve Bank of India (RBI) pertaining to medium and large private sector companies. Since information on tax revenue foregone due to the granting of development rebates/investment allowances was not directly available, the loss was computed indirectly using the yearly addition to the investment allowance which represents 75% of the investment allowance claimed. Extending the calculations to 1990-91 shows that abolition of the investment allowances without any reduction in the tax rate would have resulted in a gain of 7.3 billion Rs., making the corporate tax yield 54.9 billion Rs. However, the proposed rate reduction might affect the tax yield in 2 ways. An immediate effect is that the yield may come down proportionately. Estimates based on the RBI data yield the figure of 43.9 billion Rs., or the fall in the revenue to be 11 billion Rs.

[continued on page 352]

1. J.V.M. Sarma & H.K. Sondhi, *Investment Allowance – A Study* (New Delhi: National Institute of Public Finance and Policy, 1989).
2. Id.

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An Australian Court's Review of the Australia–Switzerland Double Taxation Agreement

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In 1989 the provisions of the Australia–Switzerland double taxation agreement were the subject of dispute between a Swiss resident and the Federal Commissioner of Taxation in *Thiel v. FCT*.[1] This is one of the few cases in which a double taxation agreement has been interpreted by an Australian court. The case has been decided by the Full Court of the Federal Court of Australia and is presently on appeal to the High Court of Australia.

The decision of the Federal Court is important in a number of respects. Firstly, the case turned on the interpretation of "enterprise" under the agreement. This term is fundamental to the operation of a number of articles in the agreement, and is also of interest to those entities resident in other countries with which Australia has a double taxation treaty who carry on (or anticipate carrying on) business in Australia. Secondly, the court considered how double taxation treaties should be interpreted generally, and to what extent the court should have regard to external materials in interpreting a treaty. Finally, the case assists in determining the way double taxation agreements will be interpreted by a court in view of the recent changes to the income tax laws in Australia. These changes have meant that the tax laws are substantially different from those which existed when the Australia–Switzerland double taxation agreement and most other agreements were made.

FACTS

The taxpayer was a resident of Switzerland who operated an earthmoving equipment distribution business. In January 1984, whilst visiting Australia, the taxpayer purchased 4 units in the Energy Research Group Unit Trust and a further 2 units were purchased several months later. In November 1984 these units were exchanged for 600,000 shares in Energy Research Group Australia Limited. The taxpayer sold 520,000 shares in February and March 1985. He had intended to sell all the shares and remit the proceeds to Switzerland; however, he stopped selling when the Commissioner of Taxation assessed the proceeds of the sale in the hands of his stockbrokers. He was also assessed on the gain made on the sale of the trust units for the shares. At no time were the taxpayer's activities carried out through a permanent establishment in Australia.

Court of first instance

The taxpayer appealed against the assessment to the Supreme Court of Western Australia. In that case the trial judge held that the taxpayer was assessable under Sec. 26AAA of the Income Tax Assessment Act 1936 in respect of both the sale of the units and the ultimate sale of the shares. Sub-sec. 26AAA(2) provides that:

> Where –
> (a) the taxpayer has purchased property ....; and
> (b) the taxpayer has,..., sold the property or an interest in the property before the expiration of the period of 12 months from the date on which he purchased the property,
> then, subject to this section, the assessable income of the taxpayer includes any profit arising from the sale of the property or interest.

The taxpayer firstly argued that the profits arising on the sale of the units and shares were profits of an *enterprise* carried on in Australia by a resident of Switzerland and were therefore not taxable in Australia under Art. 7(1) of the Australia–Switzerland double taxation agreement (the Swiss agreement).[2]

Art. 7(1) provides that:

> The profits of an enterprise of one of the Contracting States 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 profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to that permanent establishment.

It was not disputed that the taxpayer did not carry on business in Australia through a permanent establishment.

In the alternative, the taxpayer argued that he was exempt from Australian tax by virtue of Art. 13(3) on the basis that the profits were "income from the alienation of the capital assets of an enterprise". The relevant parts of Art. 13 provides that:

> (1) Income or gains from the alienation of real property or of a direct interest in or over land or of a right to exploit, or to explore for, a natural resource may be taxed in the Contracting State in which the real property, the land or the natural resource is situated.
>
> (2).....
>
> (3) Subject to the provisions of paragraphs (1) and (2), income from the alienation of capital assets of an enterprise of one of the Contracting States shall be taxable only in that Contracting State, but, where those assets form part of the business property of a permanent establishment situated in the other Contracting State, such income may be taxed in that other State.

Art. 13 differs from its counterpart in the OECD Model in a number of respects:

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1. 89 *Australian Tax Cases* 4015.
2. This Article basically accords with the standard Art. 7(1) set down in the 1977 OECD Model Double Taxation Convention.

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- the substitution of the term "real property" for "immovable property";
- the inclusion in the Australian agreement of provision for taxation by the country of source of income on gains from the alienation of a direct interest in or over land or of a right to exploit, or to explore for, a natural resource;
- Art. 13(4) of the OECD Model Convention has been excluded from the Australian agreement. This Article deals with the taxation of other gains from the alienation of property.

Australia had made a reservation to the OECD Model Convention, claiming the right to amend the Model so as to reflect the fact that Australia did not levy a capital gains tax. (It now does levy tax on capital gains.)

In order to qualify for the benefit of Arts. 7(1) and 13(3), the taxpayer argued that his transactions involving the units and shares were an extension or a diversification of his Swiss earthmoving equipment distribution business or that the transactions amounted to the commencement of a new business in Australia so that he could be said to be carrying on an "enterprise". However, the trial judge concluded that the taxpayer's activities constituted an isolated transaction of a speculative nature and did not represent any part of his existing business or the commencement of a new business. Nor could the units or shares be categorized as capital assets of an enterprise under Art. 13 as there was no enterprise being "carried on". Accordingly, the taxpayer was denied the benefit of Arts. 7(1) and 13(3) of the Swiss agreement.

Appeal to the Federal Court of Australia

The taxpayer appealed to the Full Court of the Federal Court of Australia claiming that the trial judge had erred in respect of several conclusions of fact and that he had incorrectly interpreted Arts. 7(1) and 13(3) of the Swiss agreement.

Northrop, Sheppard Lee JJ reviewed the available evidence and agreed with the trial judge that the purchase and sale of the units and shares was not a diversification of the taxpayer's Swiss business, nor was it a commencement of a new business in Australia. Rather, it was merely an isolated venture which gave rise to profits.

"Enterprise"

In finding that the taxpayer was not engaged in an "enterprise", Sheppard and Lee JJ first looked to the definition of "enterprise of one of the Contracting States" set down in Art. 3(1)(f) as an "enterprise *carried on* by a resident of Australia or Switzerland". However, "enterprise" or "enterprise carried on" is not further defined in the Swiss agreement. Art. 3(2) provides that where any term is not otherwise defined, the term shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State relating to the taxes to which the agreement applies. Accordingly, it was left to the Court to determine the meaning of "enterprise".

Lee J decided that the meaning could be ascertained from the context of the Swiss agreement. He said that the "context shows that the term 'enterprise' means the conduct of continuing activities rather than the carrying out or execution of an isolated transaction".[3]

Sheppard J found that although the term "enterprise" should be given a wide meaning, it should be read in conjunction with the words "carried on". In his opinion, Art. 3(2) required the Court to interpret the words according to the domestic law of Australia together with the "purposive construction" that the treaty is enacted to avoid double taxation of affairs which have a connection with both Switzerland and Australia. After referring to a number of judgments in which the words "carried on" were considered, he concluded that although the taxpayer could be said to have *carried out* an enterprise, he could not be said to have *carried on* an enterprise, as the latter expression denotes a continuing activity of indefinite or indeterminate duration.

However, Northrop J concluded that the taxpayer *was* engaged in an "enterprise" within the meaning of Arts. 7(1) and 13(3). He said that "enterprise" should be given a wider meaning than "business" and that it encompasses commercial activities other than those associated with some entity attached to a fixed place of business.

General comments on interpretation of double taxation treaties

All 3 judges made interesting general comments in relation to the interpretation of international conventions. The Swiss agreement has the force of law in Australia under Sec. 11E of the Income Tax (International Agreements) Act 1953 and under the Act, the Swiss agreement forms part of the domestic law of Australia.[4] Nevertheless, the Court referred to a number of English authorities which suggest that international conventions, even though they are incorporated under the domestic law, are to be interpreted in a more liberal manner. For example, Lee J concluded:[5]

> Although the interpretation should not be constrained by technical rules of construction, the object of construction should be to achieve the purpose of the treaty as elucidated by any available *travaux préparatoires* in the event of any ambiguity or obscurity in the words of the treaty. That is not to say that the treaty is to be given a liberal construction without regard to ordinary canons of construction but it should receive as liberal an interpretation as will provide a true construction according to its language, object and intent and will not hinder the working of international arrangements.

Northrop and Lee JJ considered that the OECD Model Convention and the official commentary could be referred to in construing the Swiss agreement, whereas Sheppard J felt it would be appropriate to consult these documents "if there be the need to resolve an ambiguity".[6] Of course, in relying on these documents, an Australian Court should bear in mind any reservation noted when Australia entered into the agreement.

The Court noted that the general purpose of the Swiss agreement was to avoid double taxation; however, as there was no such general rule in the Swiss agreement, relief from double taxation would only be available in relation to the categories of income which were specifically dealt with in the various Articles. Significantly, the Swiss agreement did not contain any provisions similar to Arts. 13(4) and 21 of the OECD Model which deal with the treatment of income not specifically covered by an Article, and capital gains. Lee J stated:[7]

> The failure to include provisions such as Arts. 13(4) and 21 of the Model Convention means that the Swiss Agreement has

3. Supra, footnote 1, at 4050.
4. Indeed, it generally overrides the domestic income tax law to the extent of any inconsistency.
5. Id. at 4047.
6. Id. at 4034.
7. Id. at 4048.

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nothing specific to say about capital profits treated as income under the provisions of the Assessment Act and the elimination of liability to double taxation is left to the general provisions of Art. 22 of the Agreement and the mutual agreement procedures for the resolution of difficulties arising as to the application of the Agreement provided for in Art. 23 of the Agreement.

He further noted that:

> Australia has concluded agreements for the avoidance of double taxation with several other countries which do include a form of Art. 21 of the Model Convention. Those agreements are incorporated as Schedules to the Agreements Act. However, the text of the relevant article included in such agreements consistently reflects the reservation expressed by Australia in 1977 in respect of Art. 21 of the Model Convention by expressly reserving the right for the country of source to tax income derived by a resident of the other Contracting State if such items of income are not expressly mentioned elsewhere in preceding articles of those agreements.

Northrop and Sheppard JJ expressed similar views.

The case was decided on the basis that Sec. 26AAA applied to the gains made by the taxpayer. Subsequently, the capital gains tax (CGT) regime has been adopted in Australia and Sec. 26AAA no longer applies to sales which occur after 25 May 1988. The CGT provisions came into effect after 19 September 1985 (i.e. after most of Australia's double taxation treaties were concluded).

The CGT provisions seek to tax capital gains derived by a resident on his world-wide assets and by a non-resident on "taxable Australian assets". Taxable Australian assets are defined in the Income Tax Assessment Act and include such things as land, interests in resident partnerships, certain trusts and companies and assets previously used by the non-resident in carrying on business through a permanent establishment in Australia. As the provisions do not limit the application of the tax to gains arising on the sale of land or indirect interests in land and no provision equivalent to Art. 13(4) of the OECD Model is included in the Swiss agreement (which provides that gains other than those made from alienation of real property are taxable by the country of residence), some double taxation may occur. It is clear from the judgment of the case that the Court will not seek to avoid double taxation by extending the meaning of "income" when used in double taxation treaties to include capital gains.

INDIA/J.V.M. SARMA

[continued from page 349]

It is hoped that the proposed tax rate reduction will in the long term more than compensate for the revenue loss resulting from the abolition of the investment incentives and will result in additional revenue. However, much depends on to what extent companies treat statutory tax rate reductions as equivalent to the granting of investment incentives and the amount of new investment that is likely to take place in response to the rate reduction.

As we have seen, the size of the induced investment of the private corporate sector for 1990-91 can be projected at 31.3 billion Rs. If the corporate earnings rate (including economic depreciation) is taken to be 25%, and the tax rate 40%, the revenue gain for the current year works out to be not more than 3 billion Rs.

The results of the above analysis show that the net effect of the new tax proposals on the corporate tax yield may also turn out to be negligible. In any case, it is rather optimistic to expect a positive additional yield during the current year.

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INTERNATIONAL FISCAL ASSOCIATION

IFA NEWS

U.S./DUTCH JOINT MEETING IN AMSTERDAM

When: Thurs.-Fri., 23-24 August 1990 before the International Fiscal Association Congress opens in Stockholm on Sunday 26 August.

Location: In the "Koepelkerk" (Dome Church, an old building recently renovated as a Sonesta conference center) near the Central Railroad Station.

Hotels: A block of rooms has been reserved across the street in the Sonesta Hotel at:

Dfl. 250 (single) = $ 135*
Dfl. 290 (double) = $ 155*

* Exchange rate estimated at Dfl. 1.88 to the dollar.

Rooms are also available at "De Roode Leeuw" Hotel, Damrak 93, about a 5 minute walk:

Dfl. 165 (single) = $ 90
Dfl. 220 (double) = $ 120 room includes breakfast

Air fares: KLM would be

$ 618 to Amsterdam
$ 421 to Stockholm from Amsterdam
$ 1,039 when purchasing 2 round-trip tickets

Martinair, flying only Mondays NY-AMS could cut the $ 618 to ± $ 400.

Alternatively, $ 1,114 circle route NY-AMS-Stockholm entirely by KLM, or $ 707 to AMS via Pan Am, plus $ 16 U.S. tax (21 day advance reservation, 7 day minimum reservation), plus $ 440 tourist class AMS-Stockholm via SAS.

Registration fee: $ 100 or Dfl. 200 (includes lunches and dinner Thursday).

For more information, U.S. members should contact:

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U.S./DUTCH JOINT MEETING PROGRAM
23-24 August 1990: Thursday through lunch Friday, dinner party Thursday evening

Thurs., 23 August 1990:

Opening
Subject I: U.S.–Dutch Treaty Revision (including rules limiting those entitled to benefit and the likely future for the Act of the Kingdom with the Netherlands Antilles, including Aruba).
U.S. Speaker: Mary C. Bennett, Baker & McKenzie, Washington, D.C.; ex-Deputy International Tax Counsel
Dutch Speaker: Maarten Ellis, Loyens en Volkmaars, Rotterdam

Subject II: Europe 1992, including Harmonizing EEC Taxes
Dutch Speaker: Karel Kooyman, Unilever, Rotterdam
U.S. Speaker: Nicholas van der Kloot, Coopers & Lybrand, New York City

Subject III: Direct Investment into the U.S.
U.S. Speaker: Carl L. Estes II, Vinson & Elkins, Houston, Texas
Dutch Speaker: Fred de Hosson, Caron & Stevens, Amsterdam

EVENING DINNER PARTY (including accompanying persons)

Friday, 24 August 1990:

Subject IV: Portfolio Investment into the U.S.
Dutch Speaker: Marcel Romeyn, Moret Gudde Brinkman, Rotterdam
U.S. Speaker: Robert I. Stricof, Arthur Andersen & Co., New York City

Subject V: Investment in the Netherlands
U.S. Speaker: Erik J. Stapper, Stapper & Van Doren, New York City
Dutch Speaker: Frank van Brunschot, Stibbe en Blaisse, Amsterdam

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Göran Grosskopf:
THE SWEDISH TAX REFORM: RULES AND EFFECTS . **366**
Although the 1990/91 tax reform follows the same broad outlines as other recent reforms, i.e. lower tax rates and a broader tax base, it is revolutionary from a Swedish perspective. The philosophy that high nominal tax rates are the best means to distribute wealth is abandoned. This article offers an in-depth look at the changes to the individual and corporate income tax. Background information on the purpose of the new regime is provided so as to put it in perspective.

Leif Edvardsson:
SWEDEN: RESTRUCTURING COMPANIES/GROUPS OF COMPANIES **386**
This article examines the regulations which have developed in legislation and in practice in connection with restructuring operations within a group or between companies within a group of minority-owned associated companies.

CONFERENCE DIARY **394**

Kent Simon:
SWEDEN: FOREIGN HOLDING COMPANIES AND THE LUXEMBOURG RULE **395**
Swedish-owned international groups have increasingly made use of holding companies established in foreign countries in order to optimize the tax costs of the group. This goal is principally achieved by using the holding company to reduce foreign withholding taxes on capital flows from operating subsidiaries abroad to the parent company in Sweden and to equalize the income of subsidiaries established in the same country. This article examines the Luxembourg rule which applies to foreign holding companies and is likely to become more widely applicable because of the liberalization of the Swedish currency regulations.

Peter Sundgren:
CONTROLLED FOREIGN COMPANY (CFC) LEGISLATION IN SWEDEN **400**
Sweden has adopted two rules to combat the use of low or non-tax jurisdictions in order to deter or eliminate Swedish tax, i.e. the 1933 Luxembourg rule and the 1990 "16:2 company" legislation. Whether, and to what extent, these rules accomplish their purpose is the subject of this article. The author concludes that both pieces of legislation are in need of reconsideration and better integration.

Bertil Wiman:
SWEDISH TRANSFER PRICING RULES ... **404**
The Swedish arm's length rule is embodied in the Municipal Income Tax Act. The statute is worded in general terms and offers no real guidance in transfer pricing cases. Using examples from case law, Mr. Wiman examines how the arm's length rule applies in practice and how branch transactions are dealt with. He concludes with some thoughts of what the future might hold for the transfer pricing issue.

David A. Ward et al.:
INTERNATIONAL: THE OTHER INCOME ARTICLE OF INCOME TAX TREATIES **409**
This article is a reprint of an article appearing in the Canadian Tax Journal. *It examines the historical development of the "other income" articles, the evolution of their wording and their interpretation. The authors analyse the OECD and U.N. model treaties to ascertain what items of income do not fall specifically within the article preceding the other income article. The authors then direct their attention to the application of treaties to partnerships and the European economic interest grouping. Various tax treaties are surveyed and the survey shows that certain countries adhere to one model treaty or the other; other countries adopt formulations that are different from those contained in either the OECD or the U.N. model. The authors conclude that treaty negotiators who fail to include an other income article may do so without being fully aware of the consequences of the omission.*

SWEDEN: THE TAXATION OF INDIVIDUALS AND CORPORATIONS **425**
The description of the taxes to which corporations and individuals are subject in Sweden forms part of one of the standard published works of the International Bureau of Fiscal Documentation. As an overview of the Swedish taxation system, the chapter from Supplementary Service to European Taxation *on Sweden is published in this issue.*

CONVENTION BETWEEN THE NORDIC COUNTRIES FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL (Unofficial translation) **438**
The full text of the third multilateral Nordic convention for the avoidance of double taxation, which entered into force on 31 December 1989, is reproduced here. Some differences between this version and earlier versions are the inclusion of the Faroe Islands as a treaty partner and the introduction of a zero rate withholding tax on dividends paid to parent companies.

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Congrès Stockholm 1990 ..... *364*

Göran Grosskopf:

La réforme fiscale suédoise: Réglementation et effets *366*
Bien que la réforme fiscale de 1990/91 suive dans ses grandes lignes le même plan que celui d'autres réformes fiscales, à savoir: l'abaissement des tarifs et une base fiscale élargie, elle est révolutionnaire d'un point de vue suédois. On a abandonné l'idée selon laquelle des taux élevés sont la meilleure solution à une redistribution de la richesse. Cet article analyse en profondeur les modifications apportées à l'impôt sur le revenu des personnes physiques et des sociétés. L'auteur livre également des informations sur les causes d'introduction du nouveau régime.

Leif Edvardsson:

Suède: Opérations de restructurations de sociétés et groupes de sociétés *386*
Cet article analyse les réglementations introduites dans la législation et pratiquement quant aux opérations de restructuration à l'intérieur d'un groupe, ou entre des sociétés à l'intérieur d'un groupe de sociétés associées minoritaires.

Carnet des Congrès *394*

Kent Simon:

Suède: Les sociétés-holding étrangères et le règlement luxembourgeois *395*
Les groupes internationaux possédés par des Suédois ont utilisé de façon croissante les sociétés-holding établies dans des pays étrangers afin d'optimiser les frais fiscaux du groupe. Ce but est généralement atteint lorsque les sociétés-holding sont utilisées pour réduire les retenues à la source étrangères sur les mouvements de capitaux entre filiales opérant à l'étranger et société-mère en Suède ainsi que pour équilibrer le revenu des filiales établies dans le même pays. Cet article analyse le règlement luxembourgeois qui s'applique aux sociétés-holding étrangères et qui semble élargir son application en raison de la libéralisation des réglementations monétaires suédoises.

Peter Sundgren:

La législation suédoise sur les sociétés étrangères contrôlées *400*
La Suède a adopté 2 règlements pour lutter contre l'utilisation de juridictions de faible imposition, voire de non-imposition, afin de détourner ou d'éliminer l'imposition suédoise, à savoir: le règlement luxembourgeois de 1933 et la législation de 1990 "16:2 société". Le sujet de l'article analyse si, et dans quelle mesure, ces règlements atteignent leur but. L'auteur conclut que ces 2 textes ont besoin d'être reconsidérés et mieux intégrés.

Bertil Wiman:

Réglementations suédoises sur les prix de transfert *404*
Le règlement suédois d'assimilation à une entreprise indépendante est incorporé dans la Loi Interne de l'Impôt sur le Revenu. Le texte de cette loi est libellé en termes généraux et n'offre aucune aide spécifique aux problèmes posés par les prix de transfert. M. Wiman analyse, à partir d'exemples tirés de la jurisprudence, comment s'applique en pratique le règlement d'assimilation à une entreprise indépendante et dans quelle mesure les transactions entre succursales sont concernées. Il soumet en conclusion quelques pensées sur ce que le futur peut réserver comme problèmes de prix de transfert.

David A. Ward et autres:

International: L'article sur "les autres revenus" dans les conventions de double imposition *409*
Cet article est une reproduction de celui paru dans le *Canadian Tax Journal*. Il analyse l'évolution des articles sur "les autres revenus", les modifications de leurs rédactions et leurs interprétations. Les auteurs analysent les conventions modèles de l'OCDE et des N.U. pour déterminer quelles catégories de revenus ne sont pas spécialement prévues dans l'article de la convention précédant celui sur "les autres revenus". Les auteurs portent ensuite leur attention sur l'application des conventions aux associations et aux groupements d'intérêts économiques européens. Un certain nombre de conventions sont résumées; résumés faisant ressortir l'adhésion de certains pays à l'une ou à l'autre des conventions modèles; alors que d'autres Etats adoptent des formulations différentes de celles retenues par les 2 conventions modèles. Les auteurs terminent en considérant que les négociateurs de conventions qui omettent d'inclure un article sur "les autres revenus" ne réalisent pas vraiment quelles seront les conséquences de leur omission.

Suède: Imposition des personnes physiques et des sociétés *425*
La description de l'imposition des personnes physiques et des sociétés en Suède fait partie des travaux publiés régulièrement par le Bureau International de Documentation Fiscale. Le chapitre donnant un aperçu du système d'imposition en Suède, et publié dans *Supplementary Service to European Taxation*, est reproduit dans ce numéro.

Convention entre les pays nordiques pour éviter la double imposition sur les revenus et la fortune (traduction officieuse) *438*
Le texte complet de la troisième convention nordique multilatérale pour éviter la double imposition, entrée en vigueur le 31 décembre 1989, est reproduit dans ce numéro. L'introduction des Iles Féroé parmi les Etats membres ainsi que la retenue à la source au taux de 0% sur les dividendes payés aux sociétés-mères font partie des différences entre cette dernière version et les précédentes.

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Karl Beusch:

Der IFA-Kongress 1990 in Stockholm *364*

Göran Grosskopf:

Die schwedische Steuerreform: Regelungen und Auswirkungen *366*
Obwohl die Steuerreform 1990/91 im groben dieselben Umrisse wie andere neuere Reformen aufweist, ist sie aus schwedischer Sicht revolutionär. Die Philosophie, dass hohe nominale Steuerraten am besten dazu geeignet sind, Wohlstand zu verbreiten, wurde aufgegeben. Der vorliegende Artikel befasst sich eingehend mit den Änderungen, die im Einkommen- und Körperschaftsteuerrecht stattfanden. Desweiteren wird Hintergrundinformation über die Zielsetzung des neuen Systems geliefert, um es im richtigen Zusammenhang zu sehen.

Leif Edvardsson:

Schweden: Restrukturierung von Gesellschaften und Konzernen *386*
Der vorliegende Artikel untersucht von der Gesetzgebung und von der Praxis entwickelte Bestimmungen, die im Zusammenhang mit Restrukturierungsmassnahmen innerhalb eines Konzerns oder zwischen Gesellschaften eines Konzerns von minderheitsbeherrschten verbundenen Unternehmen entwickelt wurden.

Verstaltungskalender .....

Kent Simon:

Schweden: Ausländische Holdinggesellschaften und die luxemburgische Regel *395*
Schwedische beherrschte, international operierende Konzerne bedienen sich in zunehmendem Masse im Ausland gegründeter Holdinggesellschaften, um die Steuerkosten des Konzerns so gering wie möglich zu halten. Prinzipiell wird dieses Ziel dadurch erreicht, dass die Holdinggesellschaft dazu benutzt wird ausländische Quellensteuer auf Kapital zu reduzieren, das von ausländischen Tochtergesellschaften zur Muttergesellschaft nach Schweden fliesst, und um die Einkommen der Tochtergesellschaften, die sich in demselben Land befinden, anzugleichen. Der Artikel untersucht die luxemburgische Regel für ausländische Holdinggesellschaften, die aufgrund der Liberalisierung der schwedischen Währungsbestimmungen wahrscheinlich in weitem Umfang Anwendung finden wird.

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Peter Sundgren:

Schwedische Gesetzgebung betreffend auslandsbeherrschte Gesellschaften *400*
Schweden hat zwei Bestimmungen eingeführt, um die Ausnutzung von Rechtsprechung zu bekämpfen, die zu einer niedrigen oder gar keinen Besteuerung in Schweden führt, wie z.B. die luxemburgische Regel von 1933 und die 16:2 Gesellschaftsgesetzgebung aus dem Jahr 1990. Der Autor kommt zu der Schlussfolgerung, dass beide Bestimmungen nochmals überdacht und besser integriert werden sollten.

Bertil Wiman:

Schwedische Bestimmungen über Verrechnungspreise *404*
Das Gemeindeeinkommensteuergesetz ("Municipal Income Tax Act") enthält die schwedische Bestimmung über den Drittpreisvergleich. Die Bestimmung bedient sich allgemeiner Begriffe und bietet daher keine wirkliche Anleitung für Verrechnungspreisefälle. Anhand von Beispielen aus der Rechtsprechung überprüft Herr Wiman wie die Bestimmung über den Drittpreisvergleich in der Praxis angewandt wird und wie Geschäftsbeziehungen zwischen nahestehenden Personen behandelt werden.

David A. Ward und andere:

International: Der „andere Einkünfte" Artikel in Doppelbesteuerungsabkommen *409*
Der vorliegende Artikel ist ein Nachdruck eines Artikels, der im „Canadian Tax Journal" erschien. Er untersucht die historische Entwicklung der „andere Einkünfte" Artikel, die Entstehung ihres Wortlauts und ihre jeweilige Interpretation. Die Autoren analysieren die OECD- und UN-Musterabkommen, um festzustellen, welche Einkünfte unter den „andere Einkünfte" Artikel fallen und damit nicht unter die spezielleren anderen Artikel subsumiert werden. Weiter untersuchen sie inwieweit Doppelbesteuerungsabkommen auf Personengesellschaften und europäische wirtschaftliche Interessenvereinigungen anwendbar sind. Es folgt ein Überblick über die verschiedenen Doppelbesteuerungsabkommen, der zeigt, dass manche Länder sich mehr an das eine oder an das andere Modell halten, währendhingegen wieder andere Länder Formulierungen gebrauchen, die sowohl vom OECD-Musterabkommen als auch vom UN-Abkommen abweichen. Die Autoren kommen zu der Schlussfolgerung, dass Vertragsunterhändler, die keinen „andere Einkünfte" Artikel in das Doppelbesteuerungsabkommen aufnehmen, sich nicht immer der Konsequenzen dieser Unterlassung bewusst sind.

Schweden: Besteuerung natürlicher Personen und Körperschaften *425*
Die Beschreibung der Besteuerung von natürlichen Personen und Körperschaften in Schweden ist ein Teil der Standardpublikationen des Internationalen Steuerdokumentationsbüros. Einen Überblick über das schwedische Besteuerungssystem gibt das in dieser Ausgabe veröffentlichte Kapitel aus „Supplementary Service to European Taxation".

Abkommen zwischen den nordischen Ländern zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und Kapital (Nicht offizielle Übersetzung) *438*
Vorliegend wird der vollständige Text des dritten nordischen Abkommens zur Vermeidung der Doppelbesteuerung, das am 31. Dezember 1989 in Kraft getreten ist, wiedergegeben. Unterschiede zwischen dieser Version und den früheren Versionen sind die Aufnahme der Färöer Inseln als Vertragspartner und die Einführung einer 0% Quellensteuer auf Dividenden, die an Muttergesellschaften gezahlt werden.

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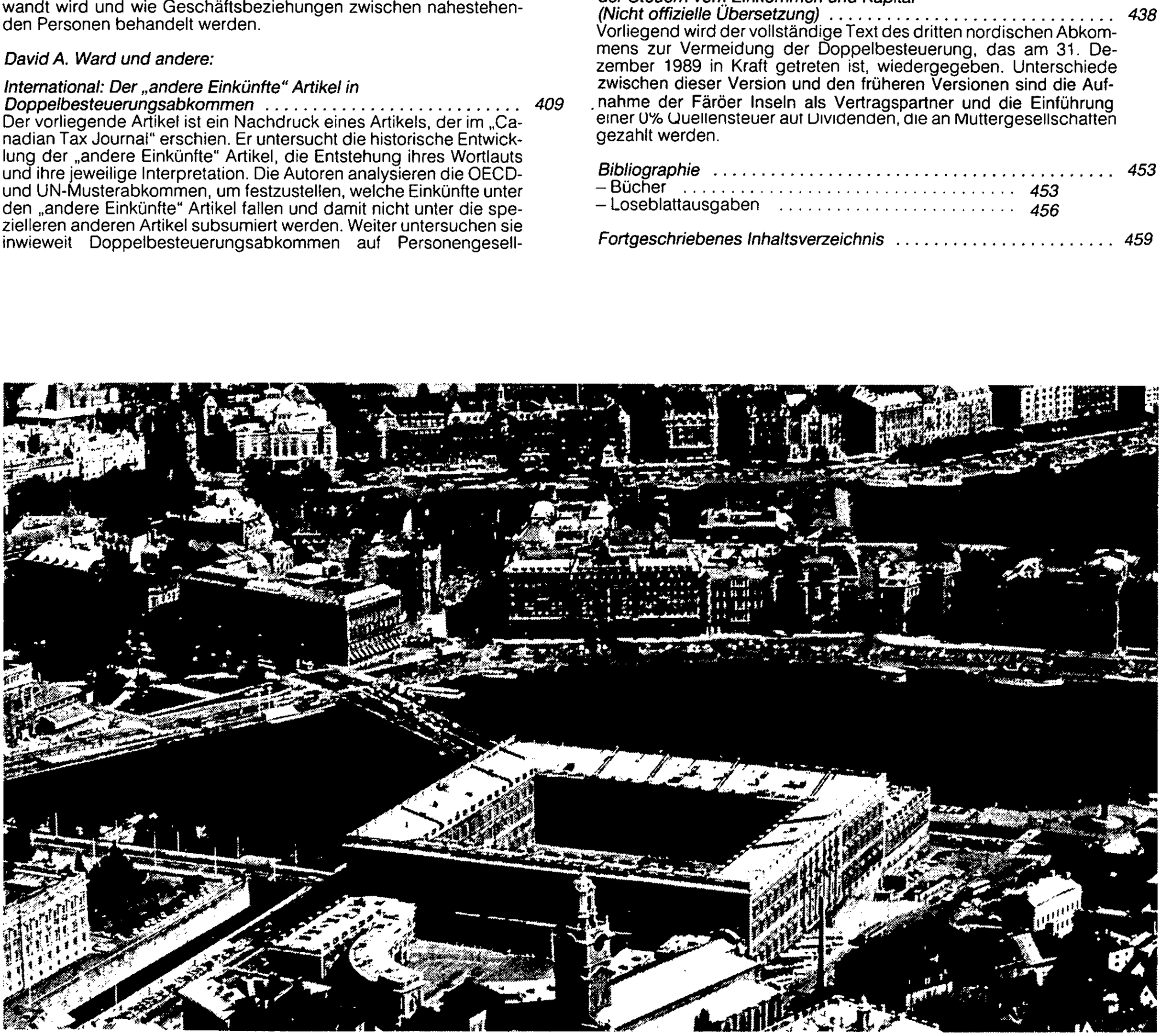

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1990 IFA Congress in Stockholm

Karl Beusch

For the second time Stockholm is hosting the IFA Congress, and for the second time it is doing so in August rather than September. In 1967 the Congress convened in August to ease the transition from left side driving to right side driving. While there is no such pressing need for the 1990 Congress to meet in August, the chance to enjoy northern summer light would seem to justify the departure.

The subjects and seminars of the 1990 Congress are of both inherent interest and practical importance. Subject I, "Taxation of Cross-Border Leasing", embraces a topic which has come to the forefront in tax planning. Leasing agreements are widely used – for automobiles as well as for aircraft and nuclear power plants. In some sectors leasing transactions have almost replaced the traditional purchase of assets. Despite this trend, most countries have developed their own legal framework for the taxation of cross-border leasing. The inconsistencies between the different approaches taken by domestic legislation often lead to inappropriate tax treatment.

Subject II, "International Mutual Assistance Through Exchange of Information", tackles the most significant aspect of international administrative assistance. Concurrent with the dynamic developments in domestic and international fiscal legislation are the establishment of informal channels of assistance and exchange of information between countries. The exchange of information is necessary to facilitate the correct taxation of international business activities and to prevent tax evasion and avoidance. But we should not lose sight of the fact that ultimately international mutual assistance should be exercised for the benefit of the taxpayer.

Continuing the trend of increasing the number of Congress seminars, Stockholm offers five: Seminar A: "The Nordic Multilateral Tax Treaty"; Seminar B: "Income Tax Consequences of the Transfer of Residence by Individuals"; Seminar C: "Double Taxation Treaties between Industrialized and Developing Countries, the OECD and U.N. Models – a comparison"; Seminar D: "Income Tax Reform in the Nordic Countries"; and Seminar E: "International Tax Aspects of East-West Joint Ventures". In light of the momentous events in Eastern Europe, Seminar E will be particularly fascinating. These developments are of incalculable consequence for prosperous future economic relations between most countries, both in Europe and elsewhere. The enormous strides made in Eastern Europe will also spur the efforts of the IFA. I hope that we shall hear how things currently stand. No doubt we shall also gain some insight as to how successful East-West joint ventures can be accomplished in the future.

Last but not least I would like to draw your attention to the social programme which offers participants the opportunity to renew and strengthen personal contacts and to obtain a lasting and vivid impression of the history, culture and life of our host city.

I welcome you to the 1990 IFA Congress in Stockholm!

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Subjects and Seminars of the 1990 IFA Congress

Subject I
Taxation of Cross-Border Leasing
Chairman:
Dag Helmers, Sweden
Discussion Leader:
Jean Pierre le Gall, France
General Reporters:
Gustaf Lindencrona, Sweden
Stephan Tolstoy, Sweden
Secretary:
Richard Arvidsson, Sweden
Chairman of Resolutions Committee:
Peter Cumyn, Canada

Subject II
International Mutual Assistance through Exchange of Information
Chairman:
Johan Salsbäck, Sweden
Discussion Leader:
Richard M. Hammer, U.S.A.
General Reporter:
Bruno Gangemi, Italy
Secretary:
Bertil Wiman, Sweden
Chairman of Resolutions Committee:
Ad Nooteboom, Netherlands

Seminar A
The Nordic Multilateral Tax Treaty
(English language only)
Chairman:
Nils Mattsson, Sweden

Seminar B
Income-Tax Consequences of the Transfer of Residence by Individuals
(Simultaneous interpretation)
Chairman:
Hans Georg Ruppe, Austria

Seminar C
Double-Taxation Treaties between Industrialised and Developing Countries, the OECD and UN Models – a comparison
(Simultaneous interpretation)
Chairman:
Leif Mutén, U.S.A.

Seminar D
Income-Tax Reform in the Nordic Countries
(English language only)
Chairman:
Edward Andersson, Finland

Seminar E
International Tax Aspects of East-West Joint Ventures
(Simultaneous interpretation)
Chairman:
Victor Uckmar, Italy

Tema I
Imposición de los arrendamientos internacionales
Presidente:
Dag Helmers, Suecia
Presidente de Debates:
Jean Pierre le Gall, Francia
Ponentes Generales:
Gustaf Lindencrona, Suecia
Stephan Tolstoy, Suecia
Secretario:
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Tema II
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Ponente General:
Bruno Gangemi, Italia
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Bertil Wiman, Suecia
Presidente del Comité de Resoluciones:
Ad Nooteboom, Países Bajos

Seminario A
El convenio fiscal multilateral de los países nórdicos
(Exclusivamente en inglés)
Presidente:
Nils Mattsson, Suecia

Seminario B
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THE SWEDISH TAX REFORM: RULES AND EFFECTS

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I. INTRODUCTION

The Swedish tax reform is finally a reality. From an international perspective, the reform follows the same broad outlines as the reforms in other western countries, that is, lower tax rates and a broader tax base. From a Swedish perspective, however, the reform is revolutionary because it abandons the policy that high nominal tax rates are the best means to distribute wealth.

The reform is actually comprised of 3 reforms: a reform of individual income tax, a reform of company tax and a reform of indirect taxes. Because the reform of indirect taxes is primarily a means to finance the income tax reform by increased revenues, it is of lesser interest from an international point of view. The financing aspects of the indirect tax reform will be described but this article focuses on the individual and company income tax reform.

One significant aspect of the reform must be emphasized at the outset. The reform does not lower the total taxes in Sweden, rather it reallocates them. The total tax burden remains the same except for a marginal amount of approximately 5 billion Skr. If the reform is put into effect as

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planned, it will lower inflation and stimulate economic growth.

As some background information on the rationale and structure of the Swedish tax reform will facilitate understanding the reform, this article commences with a brief discussion of these aspects. It is followed by a review of the reform as it affects individuals and companies. The anticipated effects of the company reform are also commented upon. The article concludes with a description of the methods used to finance the reform.

II. BACKGROUND

The old Swedish individual income tax system was based on the principle that high marginal tax rates would reallocate income and wealth. Swedish tax rates were extremely high – in the beginning of the 1980s, about 85% and in 1987, when the reform process was initiated, about 75%. The tax system was also characterized by unequal tax treatment of various types of income and generous deduction provisions; this combination gave rise to some serious problems.

First, the high marginal tax rates motivated taxpayers to exploit the deductions. Studies conducted in 1983 show that individuals in the 85% tax bracket paid scarcely more than 30% tax because of the liberal deductions. Second, the high tax rates prompted extensive tax planning schemes. In particular, the last 5 years have witnessed a proliferation in commercial tax planning.

On the company side, the nominal tax rate increased up to approximately 70% as a result of the profit sharing tax and the temporary profit tax. Even if many companies were able to escape with a lower tax burden, the high nominal tax rate forced an outflow of capital. Most Swedish companies chose to invest abroad, at least with respect to financing, so as to lower taxable income in Sweden.

Historically, companies had various options available to reduce their taxable income by making allocations to untaxed reserves, such as the investment reserve, the inventory reserve and the profit equalization reserve. These reserves protected Swedish companies against the high tax rates. The reserve system is only effective, however, when industry is flourishing, as was the case after World War II. Today, when the level of investments is much lower, the reserves have no real effect on the tax base, meaning that companies must pay the high nominal tax rate. This fact is borne out by a study of the tax rates during the 1980s. In the beginning of 1980, the effective company tax rate was about 10%, in 1985 about 20% and in 1989 about 30%. The effective tax rate increased because of the reduction in opportunities to allocate income to untaxed reserves.

A. Basic objectives of the reform

1. *Individuals*

The fundamental purpose of the Swedish individual tax reform is to make taxation more uniform. This goal will be achieved by requiring individual taxpayers with the same amount of income to pay the same amount of tax on the income. The tax rates will be lowered to facilitate uniform taxation. The reform is designed to ensure that the following objectives are attained:

- An effective response to international tax developments. Higher tax rates increase emigration and produce a higher inflation rate than in other western countries.
- A better distribution of income and wealth. The old system allowed individuals in high tax brackets to pay less tax than individuals in low tax brackets. The new system precludes this practice, thus leading to a better distribution of income and wealth.
- A fair tax system. The new system eliminates a number of inequalities and places an emphasis on equality in all particulars with a view to making tax planning less profitable and ensuring uniformity in taxation.
- Simplification of the tax system. Although the goal was to simplify the old system, it was recognized that it is impossible to combine tax rules that effectively prevent tax planning with simplicity. Consequently, the new system is also complex.
- Dynamic effects. Low tax rates are likely to encourage longer working hours, thus increasing the total tax yield.

2. *Companies*

The company tax system also suffers from a number of deficiencies. The tax rate has been high, the tax base narrow and tax allowances extensive. These factors, taken together, have led to a system that lacks neutrality. Therefore the following objectives are to be attained:

- Achievement of lower tax rates and a broader tax base in accordance with international trends.
- Neutral tax rules. The tax rules should be neutral so that various methods of arranging financing, production, etc. will not influence the level of taxation.
- Elimination of tax planning.
- Simplification of the tax rules. The same goal applies as for individuals.

B. Structure of the reform

As mentioned above, the basic structure of both the individual and company tax reform involves a significant lowering of the tax rate and a broadening of the tax base. There are, however, other structural elements that are critical to the success of the reform.

1. *Individuals*

a. Lower tax rates

The ultimate goal is that no individual should pay more than half of his income in tax. The majority of taxpayers will pay only municipal income tax, i.e. about 30%.

b. Broader tax base

The new system abolishes most allowances and limits deductions. Among the reasons for this change are the need to finance the reform and the desire to reduce the scope for tax planning and ensure uniformity in taxation.

c. Types of income

Under the old system there were 6 categories of income. These categories have been reduced to 3: income from employment, income from business and income from capital.

d. Uniform and fair taxation of income from labour

All income from employment is now taxable income; the form (e.g. fringe benefits) in which the employee receives the income is of no consequence.

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e. Uniform taxation of income from capital
All income from capital will be taxed in the same way. All returns on capital, whether in the form of distributions, capital gains or interest, etc., are taxed in a uniform manner at a flat rate of 30%.

2. *Companies*

a. Lower tax rate
The new tax rate is a nominal rate of 30% which is intended to yield approximately the same level of effective taxation as under the old system.

b. Broader tax base
Untaxed reserves will disappear under the new system. However, to obtain an effective tax rate of about 23%, a new untaxed reserve, the tax equalization reserve, will be introduced.

c. The link between accounting and taxation
The old tax system was founded on generally accepted accounting principles; the new corporate system maintains its close link to accounting principles.

d. Economic double taxation
Full economic double taxation of companies remains under the new system because dividend distributions will be taxed as income from capital at a flat rate of 30%.

e. Types of income
Company income under the old system was divided into several types. Certain types of income were calculated on an accounts basis (e.g. income from business activities) and other types of income were calculated on a cash basis (e.g. capital gains). Under the new system, all income is business income and it is calculated on an accounts basis.

III. THE TAXATION OF INDIVIDUALS

The new tax system for individuals generally comes into effect from 1 January 1991. Some parts of the system, however, have been effective since 1 January 1990. To accelerate the reform process, tax rates have been reduced up to 7% and some rules limiting allowable deductions have been introduced for 1990.

A. Types of income

Under the new system almost all income received by individuals will be taxable income. Previously, certain income was tax-free.[1] The 6 categories of income will be reduced to 3: income from capital, income from business and income from employment.

Income from capital and income from business are defined in detail, and any remaining income falls in the category of income from employment. Income from capital is defined as interest, dividends and all other income derived from a capital investment, and it includes capital gains derived from the sale of assets.[2] Income from business covers income from all types of business activities, i.e. traditional business activities such as production, sales of goods or services, farming, forestry and real estate.[3] To be considered a business, an activity must be carried out on an on-going basis, independently and with a view to earning a profit. All income that is not defined as income from capital or income from business will be treated as income from employment. The principal type of income from employment will be wages and salaries, but other types of income will also be caught by this category (e.g. certain distributions made by close companies).

One significant new principle is that the calculation of taxable income is made separately for each source of income and no joint taxable income will be computed. Losses from one source cannot be offset against profits from another source. Losses can, however, be deducted from future income of the same source under a carry-forward principle.[4]

1. *Income from employment*

Income from employment is a specific source of income that is taxed separately. Although income from employment is basically wages and salaries, this category also includes all income that can be considered the result of personal labour and not income from business or capital.[5] For example, profits from hobby activities are now taxable income from employment, as are profits from activities performed outside a business (e.g. occasional writing of articles).

a. Taxable income

The basic premise underlying the taxation of income from employment is that all income and all remuneration of whatever kind, paid or given for services rendered, will be taxable income and valued at arm's length.

The income must be reported on a cash basis, that is, salaries paid in 1991 must be reported in the tax return for 1992 assessment, etc. A special rule, however, applies to payments received near the year-end. If a payment is made on or before 15 January, the payment must be reported for the previous year if the services relating to the payment were rendered in the previous year. If a payment is made after 15 December for services performed in the following year, the payment must not be reported in the year of payment but rather in the following year. This rule is designed to remove the possibility of obtaining a tax advantage by planning payments around the year-end.

No changes have been made in respect of international taxation. Individuals resident in Sweden are taxed in Sweden on all income from employment wherever received. Exceptions to this rule are found in the so-called "6-month rule" and the "one year rule" (see text infra); additional

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1. However, scholarships and certain subsidies to low income earners will remain tax-free.
2. Income from a "private estate" is included in this source of income (see text, infra).
3. Private dwellings, however, are not included in this category.
4. A simple example illustrates the difference between the old and the new systems.
"A" has income from employment of 500,000 Skr. and income from real estate of –120,000 Skr. Under the old system, the loss of 120,000 Skr. was deductible from income from employment, resulting in a taxable income of 380,000 Skr. (according to a complicated national tax computation, the maximum value of the deduction will be 40%). Under the new system, the taxable income from employment will be 500,000 Skr. and full income tax must be paid on this amount because no deduction will be allowed for the loss from real estate.
Even though the marginal tax rate was 65% under the old system and is now only 50%, the total tax will be almost the same in both cases: 224,000 Skr. and 210,000 Skr. because of the removal of the deduction for losses.
5. Certain distributions of close companies will also be treated as employment income (see text, infra).

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exceptions can also be provided for in a double taxation agreement. Non-resident individuals are liable to Swedish tax on any income from employment that is paid from Sweden and is derived from personal services performed in Sweden.

The changes to the taxation of employment income primarily concern taxable items and the valuation of non-cash benefits. The basic premise underlying the reform is that it should be of no consequence whether a benefit is received in cash or in kind (e.g. accommodation, meals, etc.). The changes in this area are considerable.

(1) *Fringe benefits*

Fringe benefits were previously taxable subject to certain exceptions; for instance, fringe benefits having a total value of up to 600 Skr. per year were tax-exempt. Under the reform all benefits in kind are treated in the same manner as cash wages and salaries, that is, they are taxable income and taxable at market value.[6]

(a) *Meal subsidies*

Meal subsidies will become taxable income under the new system. Previously, subsidies up to a maximum of 40% of the value of the meal were tax-free. This rule no longer applies and any amount paid by the employer for meals is taxable income.[7]

(b) *Employer loans*

If an employee borrows money from his employer or someone directly linked to the employer and he receives a discount on the interest payable, the discount will be taxable income. The arm's length test is used to determine whether or not a discount has been given. An interest level corresponding to the official base interest rate plus 1% is regarded to be at arm's length.

(c) *Company cars*

The valuation of the benefit of a company car was a frequent topic of discussion during the committee debates and continues to be so. Nevertheless, the following rules will be in force from 1 January 1991.

The benefit of a company car that is less than 3 years old will be 0.8 times the so-called basic amount (geared to the consumer price index) plus 20% of the purchase price of a similar new car at the end of the preceding year. The benefit must not exceed 42% of the purchase price and it must not be less than 35% of the purchase price.[8]

If a car is more than 3 years old but less than 6 years old, the taxable amount will be 85% of the value described above. When the car is more than 6 years old, the taxable amount will be 85% of a notional value set by the National Tax Board.

(d) *Acquisition of shares*

The rules concerning employees acquiring shares in the company where they are employed have been changed from 1990. These changes, which are part of the new tax system, were implemented earlier than initially proposed to counter the obtaining of advantages from the issuance of shares and convertible debt instruments.

These rules also apply to foreign shares. When a foreign company offers employees of a Swedish company shares in the foreign parent, the parent will be valued according to the same principles as if it was a Swedish company. The fact that foreign employees can acquire shares in the parent company at lower prices without being taxed in their respective countries will be of no consequence. The taxation of Swedish residents will follow the Swedish market value principles.

Under the new rules, all shares and convertible debt instruments acquired by an employee from his employer must be valued at arm's length, that is, at market value. No discount is allowed and generally accepted principles for the valuation of these benefits must be used. The value must also include an anticipated increase in value on the same principles as the market adopts in establishing a market value (e.g. the Black & Scholes model).

Under the old system the valuation was generally based on the substance of the company, so long as the shares or convertibles were not traded on the market. This valuation method allowed employers to grant employees generous fringe benefits in the form of shares or convertibles. Since this advantage will no longer be possible it is likely that the practice of issuing shares or convertibles to employees will be of less interest to employers and will ultimately fade out.

(2) *Costs borne by the employer*

Under the new tax system all costs borne by the employer will be taxable income for the employee. It does not matter whether or not the costs are necessary to perform the job. If the costs are necessary, however, they will be deductible within certain limits according to special rules (see infra).

(3) *Social security charges*

All fringe benefits of whatever kind that are taxable income will also be liable to social security charges. These charges are paid only by the employer and will to some extent correspond to social welfare (e.g. pensions). The full charges will be about 38%.[9] If an individual is already retired, the charges will be reduced to 22.2%, and no social welfare will be paid.

b. Foreign researchers

Under current legislation foreign researchers working in

6. However, all benefits regarded as staff welfare benefits will be exempt from income tax. The term "staff welfare" will be narrowly defined. Benefits such as free coffee and staff discounts (so long as the discount is normal in the type of business; discounts granted by an employer which are unusual will give rise to a taxable benefit) will be considered staff welfare.
It is the author's opinion that the staff welfare rule is impractical. It will be impossible to monitor compliance with this rule and instead of creating a more uniform system, the black sector will increase.

7. This rule will also apply to situations where the employee frequently represents the company and the company pays for meals. Representation at occasional events, however, will not give rise to taxable income.

8. The taxable value of company cars will therefore increase considerably. For example, a car with a purchase price of 90,000 Skr. which currently has an income tax value of 27,000 Skr. will in 1991 have a value of 37,800 Skr. The increase will be less for more expensive cars. If the purchase price is 200,000 Skr., the value will increase from 60,000 Skr. to 70,000 Skr., and if the purchase price is 300,000 Skr., from 90,000 Skr. to 105,000 Skr.

9. The rules concerning social security charges are of prime importance to foreign companies. In the circumstances described in the text (see III.A.1.a(1)(d)), the Swedish company can incur heavy costs if the value is too low. If the employee purchases the shares for 100 Skr. and the arm's length value is 200 Skr., employee will have to report a taxable income of 100 Skr. for each share purchased, and the Swedish company will have to pay social security charges of roughly 38% for each issued share.

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Sweden can be granted special tax relief by the Swedish Board on Taxation of Researchers.[10] This legislation was enacted to compensate for the high tax rate in Sweden, as compared to the tax rate in other countries. Since the tax rates will be lowered to a level deemed comparable to other countries, there is no longer any need for specific tax relief for foreign researchers.

Therefore the law is abolished from 1 January 1991; from that date all foreign researchers will be taxed according to the rules for Swedish citizens.

c. Employment abroad

Specific rules apply to Swedish residents working abroad, i.e. the 6-month rule and the one year rule. Both rules have been changed under the reform; the 6-month rule will henceforth be the main rule.

The 6-month rule applies when the employment and the visit abroad are at least 6 continuous months. Visits to Sweden for vacation or holidays will not break the 6-month period unless the visits are of an unusual nature (for example, if the visits to Sweden exceed 6 days per month or 36 days in the 6-month period). According to the 6-month rule, income from employment exercised abroad is tax-exempt in Sweden if this income is taxed in the other country. The employee must prove that he has actually paid income tax abroad by presenting to the Swedish tax authorities his contract of employment and a tax bill or similar document.

The one year rule applies only in cases where the employee cannot prove any tax payments were made abroad; for example, if no income tax is imposed on foreigners in the country where the employment was exercised or if special privileges apply (e.g. U.N. employment).

Income of Swedish residents derived from employment exercised abroad will be tax-exempt in Sweden if the employment and the visit abroad are for at least one year in the same country. The Swedish employee must prove to the Swedish tax authorities, however, that the reason he paid no tax in the country of employment was because no tax rules existed for foreign employees, that the income was tax-exempt because of special tax legislation in that country or that the provisions of a tax treaty exempted the income. The burden of proof is on the employee to provide the relevant evidence.

The effect of the new rules is that most salaries from employment exercised abroad will be tax-exempt under the 6-month rule since most employment will be exercised in countries where the salary was fully taxable. In certain cases, such as Saudi Arabia where no income tax is imposed on salaries to foreign employees, the income will be tax-exempt only after one year of employment. This rule will probably create difficulties for Swedish multinationals who need to second employees to such countries because they will now need at least a one year contract of employment.

d. Tax rates

Sweden has a municipal income tax and a national income tax. The rate of the municipal tax varies according to locality, the lowest rate being 26.90% and the highest 33.45%, with an average of 30.8%. No changes have been made to the municipal tax rates. The national tax rate, however, has been lowered. From 1991, no national tax will be levied on income up to 180,000 Skr.; above that amount a flat rate of 20% will be imposed.[11]

Assuming a municipal tax rate of 30% is levied, the following rates will apply:

Taxable income (Skr.)	Rate
0 – 180,000	30%
180,000 –	50%

The 180,000 Skr. threshold will be adjusted for inflation with a percentage which corresponds to the change in the consumer price index plus 2%. The first adjustment will take place in 1992.

e. Allowances

Only one allowance, i.e. the basic allowance, has survived the tax reform. When computing taxable income from employment (and taxable income from a business), a minimum allowance of 10,000 Skr. will be granted.[12] The allowance will increase for income exceeding 58,000 Skr., up to a maximum of 18,000 Skr. when the income amounts to 90,000 Skr. From 95,000 Skr., the allowance again decreases to 10,000 Skr. at a level of 175,000 Skr. The allowance will be adjusted according to the change in the consumer price index.

The net effect of the computation of the allowance will result in the following marginal tax rates (municipal tax is 30%):

Taxable income (Skr.)	Marginal tax rate
– 58,000	30 %
58,000 – 90,000	22.5%
90,000 – 95,000	30 %
95,000 – 175,000	33 %
175,000 – 180,000	30 %
180,000 –	50 %

f. Tax credits

Most tax credits have been abolished. A maximum credit of 500 Skr. remains for fees paid to trade unions, and a new credit for capital losses is introduced (see 2(4)(h), infra).

g. Deductions

The main rule, that all costs incurred in earning or preserving income are deductible, remains in force unless otherwise prescribed.

Taxpayers with employment income are entitled to a fixed deduction of 4,000 Skr. However, the deduction may never exceed 10% of the income. If real costs are higher, they may be deducted unless any of the limits discussed below apply.

(1) *Allowance for expenses*

Generous allowances for expenses were available under the old system. From year of income 1990 one day travelling allowances will no longer be granted. If the employee travels for more than one day, the allowance will be 150 Skr. per

10. The relief granted is the exclusion from taxable income of 30% of the wages derived from research work. The relief is granted for a period of 2 years, or in special cases 4 years. For a discussion of the special tax relief for foreign researchers, see *Supplementary Service to European Taxation,* Chapter Sweden, Section B, International Bureau of Fiscal Documentation (1990).
11. These rates apply only to income from employment and income from business. Income from capital will be exempt from municipal income tax but subject to national income tax at a flat rate of 30% (see text, infra).
12. No allowances are available for income from capital (see text, infra).

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day plus real costs for hotels.[13] The new rule severely curtails travel allowances with the result that it will be more difficult to motivate employees to travel for only one day. Moreover, employees may well request higher salaries to compensate for the reduced allowances.

(2) *Expenses for a private car*

From 1990 new rules apply to employees using their own car on company business. A deduction of 12 Skr. per 10 kilometres is now allowed, considerably reducing the previous deduction. If the employer pays the cost of using the car, the amount paid will be taxable income to the employee.

(3) *Other expenses*

All other expenses necessary to exercise the employment will be deductible; for example, costs incurred in travelling to and from work.

One important new rule is that losses will be deductible against future income from employment. This change compensates for the more extensive definition of income from employment.

h. International aspects

Swedish income taxation of individuals has been extremely high in comparison with other countries, representing a formidable obstacle for multinational companies trying to transfer employees to Sweden. Many companies have devised loan-bonus plans or deferred payment schemes or have even paid the Swedish income tax of their employees. The latter devise has proved disastrous since it gives rise to a taxable benefit, thus enormously increasing the Swedish tax burden.[14]

The new system adopts significantly lower rates of income tax. Even though the tax rates remain higher than in many comparable countries, the differences will be small and in most cases acceptable. The position of multinationals will thus be eased and the need to arrange compensation in the form of complicated loan-bonus plans or deferred payments will be alleviated. As a result more highly qualified personnel will probably be seconded to Sweden to work both for multinationals and for Swedish companies.

A further consideration for multinationals sending employees to Sweden is that under the new system, all benefits will be fully taxable on fair market value. This includes benefits regularly provided by companies, such as payment for employees accommodation, payment of school fees for employees' children, etc.[15]

Despite the considerable reduction in tax rates in Sweden, the tax burden may still be heavier than in some countries. For instance, for U.S. citizens coming to work in Sweden from the United States where the top tax rate for individuals is 28%, the tax burden will increase by 22%. It must be reiterated that a salary is taxable in Sweden only if the salary emanates from employment exercised in Sweden and the salary is paid in Sweden. This rule applies to any person not regarded as resident in Sweden. In such cases, the employee can be paid for part of the employment when he returns to the United States and the payment will not be taxable in Sweden. However, if the payment is recharged to a Swedish company, there is a risk that the payment will be regarded as having been made in Sweden.

As a general rule, a foreign citizen will be regarded as resident in Sweden after a 6-month continuous stay in the country. Once resident in Sweden, he will be fully liable to Swedish income tax on a world-wide basis. The new tax system makes no changes in this respect. All salaries wherever received will be taxable income in Sweden even if part or all of the income is paid outside Sweden. A foreign citizen, however, ceases to be resident in Sweden once he permanently leaves the country. In practice, once he has left Sweden the taxpayer will only be liable to Swedish income tax on salaries paid from Sweden and deriving from Swedish employment. Even under the new system it will be possible to structure the salary in such a way that part of it is paid when the employee returns to his home country so thus escaping taxation in Sweden. Many multinationals have employed this option in the past and will probably continue to do so.[16]

With respect to tax relief granted under double taxation agreements, it is worth mentioning that Sweden is in the process of renegotiating a number of its tax treaties. Most of the treaties which are being renegotiated use the exemption method to avoid double taxation and the purpose behind the current renegotiations is to change to a credit method (e.g. treaties with France, the United States and West Germany).

2. *Income from capital*

The category of income from capital consolidates several sources of income under the old system (i.e. income from immovable property not used in agriculture, income from occasional activities, certain capital gains, income from movable property, investment income).[17] Income from capital includes dividends, interest and other like income which is received on a recurring basis. Also falling in this category are income from private dwellings and capital gains.[18]

The methods of taxing income from capital have been changed. All income in this category will be taxed in a uniform manner at a flat rate of 30%. Several considerations account for the changes. First, there is a consensus that all income that can be regarded as income from capital should be taxed uniformly, regardless of whether the income is received on a recurring basis (e.g. interest, dividends) or arises because of an increase in value (capital gains). Second, the disparity in treatment between interest and capital gains has been habitually exploited for tax planning purposes. Third, where the taxation of income from capital encompasses the taxation of capital gains, account must be taken of inflation. The best method of taking inflation into

13. This rule applies for the first 3 months of travelling; thereafter the allowance is reduced to 100 Skr. per day.
14. For a discussion of this problem, see Juhani Kesti, "Liability for Net of Tax Salaries", 28 *European Taxation* 2 (1988) at 63.
15. If the company issues shares, convertible debt instruments or options while the employee is in Sweden, they too will be fully taxable (see text, supra), so such benefits should be made available when the employee returns to his home country.
16. It is important to point out that a loan from the employer to an employee who is resident in Sweden will be regarded as taxable income if it is evident from the contract or from the circumstances that the loan will not be repaid. The cash basis would apply and the loan would be regarded as equivalent to a cash payment since it is not to be repaid.
17. The new income from capital category is defined in National Income Tax Act [hereinafter referred to as SIL] Sec. 3(1).
18. Under the old system only capital gains derived from the sale of shares and real estate were taxable income.

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account depends on a relatively low tax rate, which in turn is feasible only if interest, capital gains, etc. are uniformly taxed.

a. Interest income

The concept of interest assumes greater significance in the new system because of the rules limiting the deduction of interest expenses (see infra). In this context it is important to note that interest does not include interest on convertible debt instruments or participating debentures but it does encompass all changes in value on listed bonds. If an individual purchases an interest-bearing bond and pays consideration for accrued interest attached to that bond, the payment for accrued interest will be regarded as part of the acquisition cost of the bond, not interest.

b. Private dwellings

As stated above income from private dwellings will now be included in the category of income from capital. A private dwelling is a house or accommodation that is kept for the use of the owner or his close relatives. It is the place where the owner lives permanently. Though the definition indicates that a private dwelling is a "permanent house", a private dwelling may also be a summer or winter house which is used by the owner. It is not necessary for the owner to use the entire house himself; he must, however, use more than half of it for the house to be categorized as a private dwelling.

The rules regarding taxation of private dwellings are changed under the new system. No imputed income need be reported from an owner-occupied dwelling. If a private dwelling is rented out, the rental payments will be taxable income. An allowance of 4,000 Skr. will be granted unless the rental payments derive from the employer of the owner or his close relatives. If the rental payment is in respect of a small house, the allowance will be 20% of the gross income, or 4,000 Skr., whichever is less.

Interest payments in respect of private dwellings will be treated as any other interest payments and deductible within the limits discussed below. Rental payments for land will be regarded as interest.

The new rules on private dwellings will in many cases lead to increased living costs because of the decreased value of interest deductions and the imposition of the real estate tax.[19] To ease the transition, the real estate tax will be reduced for the years 1992-1996.

c. Capital gains

From 1 January 1991, all capital gains will constitute taxable income from capital, regardless of the type of asset sold or disposed of.[20] All basic principles concerning this source of income will apply, i.e. nominal taxation, deductions for all costs necessary to obtain the income, etc.[21] However, there are no holding periods, no indexing of purchase prices will be allowed and all capital gains will be taxable.[22]

(1) *Real estate*

Real estate will be split into 2 categories, private dwellings (discussed supra) and business property. All property that does not come within the rubric of private dwellings is business property.[23] As gains on the disposal of business real estate are taxed as income from capital, these are dealt with under business income below.

(a) *Sale of private dwellings*

There are 2 types of private dwellings, the owner-occupied dwelling and all other private dwellings. The difference between the 2 types of dwellings becomes important when the property is sold.

When an owner-occupied dwelling is sold, the maximum taxable profit is 30% of the sale price. If the sale price minus sale costs minus purchase price results in a profit of less than 30% of sale price, this lesser amount will be taxable income. Since the tax rate is 30%, the maximum tax on the sale price will be 9%.

The above rule for owner-occupied dwellings only applies if the following conditions are fulfilled:
- the owner must have been permanently living in the house for at least 3 out of the previous 5 years; and
- the house must have been acquired at market price, the owner must have lived in the house for at least one year prior to the sale and must not have owned the house for more than one year without living in it.[24]

For other private dwellings the maximum taxable profit is 60% of the sale price. If the real profit is lower, the real profit will be the taxable amount. In practice, this means that the tax cannot exceed 18% of the sale price.

(b) *Capital losses on real estate*

If a real loss is incurred on the sale of a private dwelling (or

19. A special tax on real estate of 2% of the "taxable value" must be paid annually. This tax is national and not treated as an income tax.
20. In addition, all income that can be regarded as deriving from property will be deemed to be income from capital. For example, if an individual sells his house and receives a down payment, but the sale does not go through because the buyer is unable to fulfil his obligations, the down payment (if retained) will be regarded as income from property and thus income from capital.
21. The new rules on capital gains are found in SIL Secs. 24-30.
22. The table below shows a comparison of the tax burden on capital gains under the old and new systems. It must be stressed that the table does not take all factors into account (for example, the indexing of the purchase price of real estate held for 4 years available under the old system and the deferral of capital gains on the sale of private dwellings also available under the old system). For this reason the comparison is slightly misleading but it does indicate, for example, the steep decrease in the tax burden on the disposal of shares held for a short time. Conversely, there will now be a 30% tax on the sale of other assets where previously there was no tax.

Type of asset	*1990 (%)*	*1991 (%)*
Shares held less than 2 years	65	30
Shares held more than 2 years	32.5	30
Close companies		
less than 2 years	65	40
more than 2 years	32.5	40
Permanent dwelling	65	9
Other private dwelling	65	18
Other real estate	65	27
Cooperative flat		
0-2 years	65	9 or 18
2-3 years	49	9 or 18
3-4 years	32.5	9 or 18
4- years	16	9 or 18
Other assets		
0-2 years	65	30
2-3 years	49	30
3-4 years	32.5	30
4-5 years	16	30
5- years	0	30

23. This category includes cooperative flats. The sale of real estate and cooperative flats will be taxed in the same manner.
24. This rule will prevent an individual from moving into a house which he owned for several years prior to the sale in order to receive favourable tax treatment.

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business property), the loss will be deductible to the extent of 70% from other income from capital. If no other income from capital is available, the deficit will be converted into a tax credit of 30% of the deductible part of the loss, i.e. 21% of the loss (see infra).

(2) *Shares*

From 1991, capital gains on the sale of shares[25] will be fully taxed at a flat rate of 30% irrespective of how long the shares are held.[26] The acquisition cost is always the average purchase price for shares of the same kind. Thus if 100 shares are purchased for 150 Skr. per share and 100 shares are purchased for 200 Skr. per share, the deductible purchase price when 50 shares are sold will be 175 Skr. per share. It is of no consequence which shares are actually sold. For tax purposes the purchase price will be the same whether the first shares are sold or whether the second shares are sold.[27]

The conversion of bonds or options does not constitute a taxable event. The original purchase price for the bond or option will be added to the price paid upon conversion or upon exercise of the option.

A new rule concerns the exchange of shares. If shares are sold and payment is made exclusively with shares of another company, there is no taxable event.[28] This rule, however, does not apply to an individual who has been resident in Sweden and has moved abroad but who still maintains a close connection with Sweden, nor does it apply to the sale of shares of a close company unless specific permission has been granted by the tax authorities. Permission will only be granted if the entire purchase price will be taxable income from capital.

In most other respects the rules regarding shares remain unchanged; for example, shares received by gift will be deemed to have been acquired when the donor purchased the shares and at the price the donor paid for them.

Capital losses on shares will be deductible to the extent of 70% except for losses on listed shares. These losses can be 100% deducted from profits on other listed shares during the same year. If there are insufficient profits, the excess loss will be reduced to 70%. Any remaining deficit will be converted into a tax credit (as is the case with capital losses from real estate).

(3) *Notes*

Capital gains on notes will in principle follow the same rules as for shares, that is, the purchase price will be the average purchase price of notes of the same kind. The profit will be taxed at 30% and losses will be deductible to a maximum of 70%.

A special rule applies to listed bonds. Any change in the value of a listed bond will be regarded as interest so an increase in value will be interest income that can be fully offset by interest expenses. A decrease in value will be an interest expense that will be deductible only within the limits described for shares.

(4) *Other assets*

Capital gains on other assets will be taxable income from capital taxed at a rate of 30%.

For personal assets, only gains exceeding 50,000 Skr. per year will be taxable income. The purchase price of such assets is taken to be either the real purchase price or 25% of the sale price. Thus it will always be possible to sell personal assets for at least 65,000 Skr. per year without incurring any tax liability. Losses on personal assets will not be deductible; they are considered living costs and consequently of a non-deductible nature.

No specific rules apply to other assets. The profit is the sale price minus the sale costs and the purchase price. Losses will be deductible to a maximum of 70%.

d. Tax rates

The tax rate on all income from capital will be a flat rate of 30%.[29] For income up to 180,000 Skr. the tax burden on income from capital and employment income will be much the same – this is because employment income up to 180,000 Skr. is subject only to municipal tax at a rate of roughly 30%. National tax at a rate of 20% on employment income cuts in at 180,000 Skr. so that above that level the tax burden on income from capital will be lower than that on employment income.

The difference in the tax rate between income from capital and other income exceeding 180,000 Skr. lends itself to tax planning opportunities. The Government has recognized this loophole and a number of tax rules have been proposed to prevent tax planning by converting employment income or business income into income from capital. Nevertheless, it is predictable that extensive tax planning will take place in the future, taking advantage of the lower tax rate for income from capital.

e. Allowances

Under the old system special allowances were granted both on traditional income from capital and on capital gains. These allowances have been abolished. Furthermore the general allowance of 10,000 Skr. (described above) will not be granted against income from capital, with the result that all income from this source above a level of 100 Skr. will be taxable (income is always decreased to the nearest 100 Skr.).[30]

f. Interest expenses

Deductions for interest expenses have frequently been exploited for tax planning purposes. Until 1982 there were no limits imposed on such deductions. The system was complicated because an additional national tax had to be paid on negative net income under the old income from capital concept. In practice this meant that the value of a deduction for interest expense was reduced from 85% to 50%. If an individual had dividend, interest or similar income, how-

25. Shares include stock, convertible debt instruments, participating debentures, etc.
26. Currently, 50% of the gain on the sale of shares held for more than 2 years is taxed as ordinary income.
27. If the shares are in a listed company, the purchase price can be set at an amount corresponding to 20% of the sale price minus sale costs.
28. This rule will primarily affect large listed companies planning to purchase other companies.
29. The tax is a national tax only (see supra, note 11).
30. Under the old system, parents frequently used their children for tax planning. Savings would be deposited in a bank account in the name of the children, thus taking advantage of tax-free allowances for interest, the maximum allowance being 11,600 Skr. This device has now been eliminated.

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ever, the full deduction was still available. Even though the tax rates were reduced in 1982 and the value of interest expense was also reduced, it has still been beneficial to take advantage of interest deductions. Taxpayers have availed themselves of the ample opportunities to amass a fortune on borrowed funds.

The new system reduces the availability of interest deductions. First the value of any deduction for interest expense may never exceed 30%. Second, specific limitations are prescribed as far as interest expenses are concerned. Interest paid will always be fully deductible from interest received. If the interest paid exceeds interest received by a maximum of 100,000 Skr. the excess will be fully deductible from other income from capital (e.g. dividends or capital gains). If the interest paid exceeds the interest received by more than 100,000 Skr., the first 100,000 Skr. will be fully deductible from other income from capital and the remaining amount will be deductible only to a maximum of 70% against other income from capital.[31]

Example
"A" has interest expense of 200,000 Skr. In Alt. 1 he receives interest of 200,000 Skr.; in Alt. 2 interest of 100,000 Skr. and a dividend of the same amount; in Alt. 3 he has interest of 50,000 Skr. and a dividend of 150,000 Skr.; and in Alt. 4 he has only dividend income of 200,000 Skr.

The taxable income from capital will be as follows in each of the 4 alternatives:
Alt. 1: 200,000 – 200,000 Skr. = 0
Alt. 2: 100,000 – 100,000 + 100,000 – 100,000 Skr. = 0
Alt. 3: 50,000 – 50,000 + 150,000 – (100,000 + 70% × 50,000) = 15,000 Skr.
Alt. 4: 200,000 – (100,000 + 70% × 100,000) = 30,000 Skr.

From this example it is obvious that a balance between interest income and interest expense is necessary; otherwise the tax burden may be formidable.

During the last few years companies have commonly issued convertible debt instruments to their personnel. As stated above, interest received on these instruments will be treated as a dividend so that once the total interest expense exceeds 100,000 Skr., the deduction will be reduced to 70%.[32]

If there is no income from capital to cover the interest expense, the deficit will not be deductible from employment income or business income.

g. Other expenses

The basic principle for deductions is that all costs that are necessary to acquire income will be deductible. Administrative costs will be deductible only to the extent that they exceed 1,000 Skr. Foreign exchange losses will not be deductible (this is the rule under the current system). A loan in foreign currency entails a substantial risk because no deductions will be available if the exchange rate becomes unfavourable.[33]

h. Tax credits

Under the new system, a tax credit for losses on income from capital will be granted. The tax credit will be 30% of the negative income from capital, and there are some restrictions on the deductions for interest and capital losses. Interest expenses exceeding 100,000 Skr. and capital losses (e.g. losses from the sale of real estate) are only deductible within the income from capital category to a maximum of 70%. The tax credit will therefore correspond to 21% of the interest expense or the real capital loss.

The tax credit for losses from income from capital can reduce both municipal and national tax on employment income and business income. It can also reduce the specific tax on real estate and the fee for forest maintenance.

i. Fiscal year

Under the old system income from capital and capital gains were reported for the year in which cash payment was received. In respect of capital gains, the receipt of any cash payment at all obliged the taxpayer to report the entire profit from the sale. These principles are now changed as far as capital gains are concerned. In the future, capital gains must be reported for the year in which the contract disposing of the asset is made. It is of no consequence whether or not cash has been received under the sale.[34] All other income must be reported on a cash basis.

j. International aspects

Most of the rules concerning income from capital will be of minor significance to non-residents of Sweden. Only capital gains derived by non-residents from the sale of real estate will be taxable income in Sweden. This rule accords with provisions in double taxation agreements so that foreigners owning real estate in Sweden will be liable to Swedish income tax on the sale of real estate under the principles described above.

For Swedish residents, the changes in the taxation of capital income will significantly impact on cases where a tax treaty uses the credit method to avoid double taxation. Previously, Swedish tax was higher than foreign tax paid, so full credit was granted for the foreign tax. Now that the Swedish tax rate may be lower than the foreign tax, full credit may not be available.[35] Since most Swedish treaties use the credit method, Swedish residents having foreign-source income from capital will pay only foreign tax on this income if the foreign tax is higher than the corresponding Swedish tax.

3. *Income from business*

Business income includes all income derived from the carry-

31. For children up to 18 years of age, the limit for full deduction is 10,000 Skr.
32. If, for example, an employee living in his own house pays 100,000 Skr. in interest payments on the house and has acquired convertible debt instruments for borrowed funds, the following tax effect will occur under the new tax system. Assume that the convertible debt instruments have a nominal value – acquisition cost of 500,000 Skr. and the interest received is 50,000 Skr. and that the employee has borrowed the full amount of 500,000 Skr., paying interest of 60,000 Skr. The full deduction on interest paid is already consumed by the interest paid on the house. Since the interest received on the convertible debt instruments will be treated as a dividend, the deduction for interest paid on the loan on the securities will be reduced to 70% or 42,000 Skr.
It is essential to understand these effects because it is highly likely that employees will try to sell the convertible debt instruments or to achieve advantages in other ways.
33. Foreign exchange gains will be tax-exempt. A proposal on the tax treatment of foreign exchange gains and losses is expected in the near future.
34. It may be possible in some situations where the sale is pending because approval of the authorities is required to obtain permission to pay the tax later.
35. Treaties rarely mandate that full credit be granted.

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ing on of business operations, farming, forestry and real estate (with the exception of private dwellings).[36] Business income encompasses a broad spectrum of activities and the rules apply to individuals as well as legal persons.

a. General principles

The new definition of business income is based on the old definition but is far broader in scope. However, the 3 fundamental concepts under the old definition remain intact: that is, an activity is a business activity if it is independent, on-going and with a view to earning a profit. These 3 conditions serve to distinguish business income from employment income; if income is dependent, temporary or not conducted with a view to earning a profit it is employment income and not business income.

Business income may be divided into 2 categories: active income and passive income. Active income is all income from a business where the owner has worked a substantial number of hours (generally more than 570 hours per year). All active income is aggregated (even if the activities are separate) so that losses of one activity can be set off against the profits of another activity. Income that is not active is passive. Passive income is not aggregated in this way, rather passive income from each separate, discrete source is treated separately. Passive income from each separate source is taxed separately so that losses from one passive source cannot be set off against profits from another passive source or against active profits.

Business income will be computed along the same general lines as under the old system; that is, business income must be reported for tax purposes according to generally accepted accounting principles unless a specific tax rule requires otherwise.[37] In principle, all income received will be taxable income. All costs incurred to obtain the income will be deductible.

b. Tax rates

The tax rates on business income are the same as for employment income (see supra III. A.1.d.).

c. Depreciation

The depreciation rules remain essentially unchanged under the new system.

Depreciation of machinery or equipment may be either on an accounts basis, i.e. the depreciation in the accounts must be the same as the depreciation for tax purposes, or on a fixed basis. The former basis allows for 30% depreciation using the declining balance method or 20% using the straight-line method. Under the latter, depreciation of 25% is given on a declining balance.

Only the straight-line method may be used for depreciation of buildings. Buildings are written off at a percentage specified by the National Tax Board; it varies between 2% and 5% depending on the use to which the building is put. The cost of work on the land can be fully depreciated according to the new rules, as against 75% of cost under the old system. The depreciation rate is 5%.

d. Losses

Losses from business income cannot be deducted from any other source of income. They can, however, be deducted against future income of the same activity. There is no time limit to the carry-forward of losses. If the activity ceases, unutilized losses will be converted to a capital loss which may be set off against income from capital. In effect this means that 70% of the unutilized losses will be deductible against other income from capital. If there is insufficient income from capital, the deficit will be converted into a tax credit according to the rules described above.[38]

e. Business real estate

The rules for other real estate are extremely complex because of the difference in the tax rate between business income and income from capital. Income from a business estate will be taxed as income from an ongoing business; thus depreciation and repairs may be deducted from business income and these deductions will have a maximum value of 50% which is the maximum rate for business income. When the property is sold, the capital gain will be income from capital. Depreciation recovered on the sale will be taxed at a lower rate than the rate at which it was allowed. For this reason special rules apply to the sale of business property to prevent tax relief as a result of the difference in tax rates.

When business real estate is sold, the real profit or loss is computed as follows:
Depreciation taken during the ownership period will be regarded as business income, provided the depreciation does not correspond to a real decrease in value or is less than 3,000 Skr. per year. Similarly all costs for repairs that can be regarded as increasing the value of the building will be deemed to be business income, but only if the costs have been deducted within 5 years prior to the sale. Depreciation and repair costs that are deemed business income will increase the purchase price to be deducted from the sale proceeds less sale costs. The remaining profit will be taxed as income from capital at a flat rate of 30%. The seller can instead opt to have the profit regarded as 90% of the sale price. This option will only be attractive in the case of assets purchased a long time previously at a low price.

f. Accounting year and fiscal year

Individuals engaged in a business and in partnerships must have an accounting year and a fiscal year corresponding to the calendar year. All taxpayers with business income who are currently using a different year must change to the calendar year. If the accounting year runs from 1 July 1990 it must be shortened so as to end on 31 December 1990. If the accounting year starts during the period 1 July 1990 to

36. Income from farming, forestry and real estate were previously separate sources of income but the new system includes them in the category of business income.
37. The taxation of business income is based on accounting and the annual report. Such a basis is unique today; Sweden appears to be the only country in the western world that preserves the close connection between the annual report and the tax return. The new system actually strengthens the integration between accounting and taxation. For example, the valuation of inventory will follow accounting principles set forth in the Accounting Act rather than special tax rules.
38. These rules only apply to individuals.

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31 December 1990, it may either be shortened to end on 31 December 1990 or extended to end on 31 December 1991.[39]

g. Taxation of private firms

Private firms will be taxed according to the same basic principles as under the old system. A complete change was envisaged but complicated reform was not completed due to lack of time. The committee work, however, will continue and it is expected that new tax rules will be proposed within a couple of years.

A private firm must pay social security fees of approximately 35% on active income, or payroll tax of 22.2% on passive income.[40] Both social security fees and payroll taxes are deductible but they will considerably increase the tax burden. The top marginal income tax rate will be 50% on business income. If social security fees are included, the marginal tax rate will be about 67.5%. If only payroll tax must be paid, the marginal tax will be 61%. These rates should be compared to the 30% tax rate for companies. Obviously the disparity in tax rates is far too great for the private firm to remain an attractive proposition in the long run. The Government also recognizes this disparity so opportunities to make allocations to untaxed reserves will be more generous for unincorporated businesses than for companies.

A number of different untaxed reserves were available under the old system. These reserves have been abolished and replaced with the tax equalization reserves (hereinafter referred to as SURV). For private firms, there are 3 different types of SURV: the K-SURV, the L-SURV and the I-SURV. An unincorporated business can make allocations to both the K-SURV and the L-SURV simultaneously. An allocation to the I-SURV can be made in the alternative but an allocation to the I-SURV can never be combined with an allocation to the K-SURV or the L-SURV.

The maximum which may be allocated to the K-SURV is an amount equal to 30% of the firm's equity at the beginning of the year (only the calendar year will be allowed as an accounting year). Special rules apply for computation of the equity, e.g. real estate can be regarded only to the extent of 70%. The allocation is deductible. The following year the K-SURV will be taxable income and a new allocation may be made according to the same rules. In practice this means that the firm will enjoy the full benefit of the allocation only in the first year. In subsequent years only the difference between the K-SURV and the allocation will be deductible or taxable.

The L-SURV is similar to the old profit equalization reserve. Twenty percent of wages paid during the year can be allocated to the L-SURV. The same rules as above apply to the L-SURV, i.e. the full benefit of the allocation to the L-SURV will be available only for the first year.

The maximum allocation to the I-SURV is 15% of the taxable business income for the current year. Thus, the effective tax rate can be reduced to about 57% if full social security fees must be paid, or in other cases about 52%. The same rules for other reserves apply regarding deduction of allocation.

In Sweden a private firm may have negative capital. In fact this is a common practice. Instead of being taken to capital as net profits, the profit is allocated to untaxed reserves. At the same time the owner has taken money out of the firm so that the capital has become negative. This practice will still be possible under the new system, but certain rules will prevent owners of private firms from obtaining tax advantages from negative capital. Basically, if the capital is negative, interest attributable to the negative capital must be reported as business income. The interest rate should be an arm's length rate.[41] The interest income will then be deductible (for the owner) as an interest expense against income from capital. The reasoning behind this complex rule is that there are certain limitations on the deductibility of interest expenses from income from capital and that the tax rate is lower for income from capital. More neutrality is achieved by treating the interest as income from business and allowing a corresponding deduction from income from capital.[42]

Upon termination of a private firm, any unutilized losses will be converted to a capital loss which may be set off against income from capital; 70% of the unutilized losses will be deductible against other income from capital or if there is insufficient income from capital the deficit will be transferred to a tax credit (see supra).

h. Taxation of partnerships

A partnership can either be a general partnership or a limited partnership.[43]

One partner in a limited partnership must be a general partner and have unlimited liability for partnership debts. This general partner may be a company, so in effect full limitation of liability is achieved.

The general partnership and the limited partnership are treated equally for tax purposes. Neither is recognized as a taxable entity; the individual partners are liable to income tax for income received by the partnership. As with the rules for private firms, the intention was that the system for partnerships would also be changed but lack of time prevented any amendments. It is expected that partnerships will be made taxable entities within a couple of years. Such a change will be particularly important for foreign companies participating in a Swedish partnership. If in the future the partnership is regarded as a separate entity at the time

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39. This rule does not apply to a partnership that has only legal persons as partners. However, if a partnership has one natural person as a partner, the partnership must have an accounting year corresponding to the calendar year. Groups of companies may also be affected by this rule. If one of the companies in the group is a partner in a partnership which also has a natural person as a partner, then the company must have an accounting year which corresponds to the calendar year. Because the companies in a group must all have the same accounting year, the entire group will have to change its accounting year to a calendar year unless the authorities grant permission to use a different accounting year.
Foreign companies are also bound by this rule. If a foreign company owns a Swedish partnership or a Swedish limited partnership and one partner is a natural person, the foreign company will need to change its accounting year, unless special permission is granted (such permission is generally granted).

40. There has been a payroll tax in Sweden for a long time although it was not officially recognized. From 1991, however, the payroll tax will be officially recognized. There will be a full social security tax of about 35% and a payroll tax of 22.2%. The social security tax will provide for social benefits such as pensions, salary during illness, etc.; the payroll tax will provide no such benefits. It is a true tax.

41. An interest rate is arm's length if it is equal to the official base interest rate.

42. The rules are more complicated than described but for purposes of this article, this discussion is sufficient.

43. Both types of partnerships are legal persons.

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of assessment, any income received by the partner will be deemed a distribution.[44]

All income received by a partnership is business income, except for gains derived from the sale of real estate, which is treated as income from capital and must be reported as such by the partners. Capital gains from shares, interest, etc., however, will be business income. The tax rate for individual partners is the normal rate for business income, i.e. 50%, plus social security fees.

Losses from partnership activities follow the ordinary business income rules. Losses can only be deducted from future income of the same activity. The loss rules are important, since, for example, capital gains on shares will be treated as passive income. Any losses on the sale of shares can therefore only be deducted from capital gains on other shares. Interest paid on loans to acquire assets that are not included in the active business of the partnership cannot be deducted from active business income but belong to a separate passive category. Thus the interest can only be deducted from future income derived from the specific investment. However, as the interest is deductible against business income, there is no deduction limitation as is the case with interest expenses deductible against income from capital.

A partnership is entitled to make the same allocations to the SURV as a private firm. The allocations are computed for the partnership as a whole even though the partnership is not a taxable entity. Consequently, if a partnership is more than 10% owned by legal persons that may not make allocations to the SURV (e.g. Swedish investment companies or Swedish holding companies), the partnership itself will lose the right to make allocations to untaxed reserves.

The rules on negative capital apply equally to partnerships. The partners must report interest attributable to their respective shares of the negative capital and they will be entitled to deduct the same amount from income from capital.

When a partner sells his interest in the partnership, the profit or loss will be taxed as a capital gain and thus as income from capital. The same rules apply as for shares of a company. However, a partner may be entitled to deduct partnership losses according to the rules described above. In such cases deducted losses will reduce the acquisition cost when the partnership interest is sold, i.e. the profit will increase in a corresponding amount.

i. International aspects

Until the reform a business abroad (for Swedish residents) was a special source of income within the category of income from capital. The new concept of business income includes business activities carried on in another country. With respect to individuals and partnerships, however, income from the foreign activity will always be deemed a specific item of passive income. Profits will then be taxed in the same way as any other Swedish activity, but only payroll tax must be paid. Losses, on the other hand, can be deducted only from future income from the same foreign source. Because this rule in effect already applies, this change is more cosmetic than substantive.[45]

Since the tax rate has been lowered, foreign tax may in some instances be higher than Swedish tax. If a tax treaty provides for the credit method to avoid double taxation, the ordinary credit method will probably apply. The tax credit may not exceed the Swedish income tax attributable to that foreign-source income, so the foreign tax in such cases will not be fully offset by the credit.[46]

A special rule applies to the taxation of foreign-source income where a treaty uses the exemption method to avoid double taxation. Under this rule no expenses that are connected to the foreign-source income are deductible in Sweden. This rule remains unchanged.

The new rules are equally applicable to non-residents of Sweden who have a business in Sweden or who participate in a partnership in Sweden.[47]

A non-resident (individual or legal entity) investing in a Swedish partnership should ascertain well in advance the identity of the other partners. If some partners are not entitled to make allocations to the SURV, the foreign partner will forfeit the right to make allocations to untaxed reserves, thus increasing his tax burden in Sweden.

B. Wealth tax

Traditionally, the wealth tax in Sweden has been high. From 1990, the wealth tax is as follows:

Taxable wealth (Skr.)	Rate (%)
0 – 800,000	0
800,000 – 1,600,000	1.5
1,600,000 – 3,600,000	2.5
3,600,000 –	3.0

The high rates of wealth tax have often resulted in a total income and wealth tax of more than 100%. For this reason a special law limits the total burden of income tax to 75% of the income. Municipal tax and wealth tax on one half of the fortune, however, must always be paid, so in some cases the total tax burden will still be more than 100%.

Thus far, nothing has been mentioned about wealth tax from 1991 or about the limitation rule. Rumours have circulated to the effect that the wealth tax will be lowered to a flat rate of 1% on capital above 1 million Skr.[48]

IV. THE TAXATION OF COMPANIES

The most far-reaching changes in the reform relate to the rules on company taxation. In keeping with the global trend, the tax rate has been substantially lowered and the tax base broadened. The old system was based on high nominal tax rates and generous allocations to untaxed reserves. The new system lowers the nominal tax rate and reduces the alloca-

44. Some tax treaties may need to be changed as a consequence. However, even if the treaties do alter the treatment of partnership income, the tax effects may still be different.
45. However, the changes regarding companies will significantly impact Swedish investments abroad (see text, infra).
46. Such an outcome raises the question whether the payroll tax can be regarded as a tax that can be reduced by the foreign tax. Thus far no one has raised the issue. In any event, it seems unlikely that the payroll tax will be so regarded since the payroll tax is not included in tax treaties as a tax eligible for the credit.
47. Since non-residents will now be liable for payroll tax, the point raised in footnote 11 again becomes an issue. If a treaty allows a deduction for special foreign taxes, the payroll tax may be deductible. Otherwise, effective double taxation will result.
48. If no changes are made to the wealth tax and the limitation rule, the wealthy will still pay 75% tax on income from capital.

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tions to untaxed reserves. In addition, the valuation of assets for tax purposes is revised.[49]

A. General principles

In the future companies will have only one source of income – business income (even capital gains and interest on pure capital investments will be regarded as business income). An important consequence of this consolidation of sources of income is that the arm's length principle now applies to all transactions made by companies. Previously, only transactions that fell within the old concept of business income were subject to the arm's length principle. In effect this meant that, for example, shares or real estate could be sold at a price far below market value without any income tax effect. Under the reform, all sales are taxed at fair market value. If assets are sold for less than fair market value, the fair market value must be reported for tax purposes.

All income must be reported on an accounts basis, that is, income must be reported for the year in which it should have been entered in the books according to generally accepted accounting standards.[50] Expenses will be deductible when they should have been entered in the books according to generally accepted accounting standards. In all cases where no specific tax rule dictates otherwise, generally accepted accounting standards apply.

Income will be computed according to the same principles as those for private firms. The basic rules for income computation and deductions remain unchanged. However, any losses incurred in a foreign activity will now be fully deductible against Swedish income. Swedish companies establishing abroad will benefit from this new rule because losses in foreign countries can be financed by untaxed profits. One restriction must be noted: expenses connected to income that will not be taxed in Sweden because the income is exempt under a tax treaty will not be deductible in Sweden. This means that losses relating to activities carried on in countries with which Sweden has treaties providing for such an exemption will not be deductible in Sweden.

In general, expenses will be deductible without any restrictions. Interest, capital losses on shares, real estate, etc. will be fully deductible. Losses on shares, however, will only be deductible from capital gains on other shares unless the shares are held as part of the business (e.g. the shares of a subsidiary that sells products produced by the parent company).

B. Tax rate

The company tax rate has been reduced from 52% to 30%.[51]

Most Swedish companies will be entitled to make an allocation to an untaxed reserve called the K-SURV (see below), thus reducing the effective tax rate to 23.7%. It must be noted, however, that distributions may never be made out of untaxed reserves. The overall result is that the effective tax rate on distributed profits will be equal to the nominal tax rate of 30%, while that on undistributed profits is 23.7%.[52]

C. Untaxed reserves

The old system contained generous rules for allocations to untaxed reserves. The following reserves will be phased out under the new system:

- inventory reserve,
- work in progress reserve,
- profit equalization reserve,
- general investment reserve,
- ship renewal reserve,
- real estate renewal reserve.

The inventory reserve, the payroll reserve and the profit equalization reserve have been consolidated and replaced in a less generous form, by the right to allocate funds to the new tax equalization reserve. The balance on the old reserves is subject to income tax at 30% under the new system. The tax liability may be spread over 4 years with 25% to be returned each year. Particularly for companies with large inventory reserves, dissolving those reserves might cause difficulties even with a corporate tax rate of only 30%.

The investment reserve will be "frozen" until 1996, when it will automatically dissolve. The new tax rate of 30% will apply. If the reserve is reported for taxation purposes before 1996, a 50-70% gross-up on the reserve will be made depending upon when the allocation was made. This will, in most cases, make it unprofitable to have the reserve taxed before 1996.

D. Tax equalization reserves (SURV)

Tax equalization reserves have been introduced in the new tax system to maintain the average effective tax burden. As stated above, these reserves will result in an effective tax rate not exceeding 23.7%.

The basic principles for the SURV were described above for private firms. There are, however, only 2 SURVs for companies: the K-SURV and the L-SURV. A K-SURV allocation can never be combined with an L-SURV. Either an allocation is made to the K-SURV, which excludes the L-SURV, or an allocation is made to the L-SURV, which excludes the K-SURV.

Investment companies and holding companies (as defined below) are not entitled to make an allocation to SURV because special rules apply to these companies which in combination with allocations to the SURV could create tax planning possibilities. Holding companies will thus have a nominal tax rate of 30%. Investment companies are taxed according to other rules, which prevents the tax burden on these companies from being compared to that of traditional income tax.

Taxpayers may allocate to the K-SURV an amount up to 30% of the company's equity at the beginning of the fiscal year.[53] As is the case for private firms, special rules apply for computation of equity. It is sufficient to point out that

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49. The new system is, in general, effective for companies from 1989.
50. The possibility of using the cash basis (which was often used for tax planning schemes) has been abolished.
51. Corporate income tax for financial years ending on or after 31 December 1989 is 40%; the 30% rate will be effective from 1991.
52. One reason for the complex K-SURV system is the international aspect. Many countries have special tax rules which apply to interests in foreign countries with a tax rate below 30%. By having a nominal rate of 30%, these rules will probably not apply to Swedish-source income. Nevertheless the new rules are favourable and among the most liberal in the western world.
53. The fiscal year is the same as the accounting year. Unlike private firms, companies may have an accounting year which is different from the calendar year.

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untaxed reserves are regarded as debts, that shares in another Swedish company will not be regarded as assets unless the voting power carried by the shares is less than 25% and the shares are not closely connected to the company business; and that shares in a foreign company will be regarded as assets only to the extent of 65%. In tax terms, this will make it expensive to purchase shares in the future. The tax burden on shares in a Swedish company will be 9% under the new rules; on foreign shares it will be 3.15%. Swedish companies will no doubt endeavour to acquire foreign (and possibly Swedish) companies via a foreign subsidiary with a low equity. To prevent companies from obtaining tax benefits via this practice, a specific rule requires that a notional debt be reported when computing the equity of the Swedish parent company. The debt will be equal to 65% of the value of the Swedish company's interest in a foreign entity computed according to a prescribed formula.

Real estate is reported at tax value. All other assets and liabilities are reported at book value.

Special rules apply to groups of companies. The group must always use the same SURV, either the K-SURV or the L-SURV. If one company in the group makes an allocation to the K-SURV, all companies within the group must use the K-SURV. If the equity as computed is negative (as is often the case if there are shares in the balance sheet), a notional income of 30% of 70% of the official base interest rate multiplied by the negative equity must be reported. Currently, this amount is slightly below 3%.

The maximum allocation to the L-SURV is 15% of salaries paid during the fiscal year which is the same percentage that could previously be allocated to the profit equalization reserve. Companies that were using the profit equalization reserve will continue to make the same contributions to untaxed reserves. These companies, primarily service companies (e.g. consultants), will reap substantial benefits from the reform. They previously paid about 60% on profits over the level of untaxed reserves and will now pay only 30%.

E. Valuation of inventory

It is widely known that the Swedish tax system traditionally allowed generous depreciation of inventory (formerly 60%, then 50%, and from 1989, 40%). The new system allows no depreciation of inventory value.

Inventory will be valued at the lower of acquisition cost or real value, and the FIFO principle must be observed. Real obsolescence is thus automatically taken into account when the real value of the goods is estimated. If the acquisition cost is used for the whole inventory, a deduction of 3% of acquisition cost will be allowed as notional obsolescence. In all other respects, generally accepted accounting standards are to be adhered to.

F. Depreciation

The basic rules for depreciation have not been changed, aside from some minor changes regarding real estate. The rules are described above under the heading of private firms.

G. Carry-forward of losses

Current rules allow companies to carry forward losses for 10 years. The carry-forward provision remains intact but there will be no time limit. However, losses must be deducted from profits as soon as a profit is made. Under the old system it was possible to reserve the loss for a future year even if a profit was made in an intervening year. A loss will no longer be treated as a separate deduction but rather it is treated as a normal business expense, and only if the profit is insufficient to cover the loss will the excess be carried forward to a future year.

Because there is only one source of income for companies, losses can be offset against any type of income. However, a specific rule concerning shares held as capital investments requires that losses on such shares only be deducted from profits deriving from the same type of asset. As with other types of losses, no time limit is imposed on the period of carry-forward.

The loss carry-forward system is the only official method of transferring losses from one year to another. However, the tax equalization reserve offers an indirect opportunity for loss carry-back. To some extent, depreciation rules for machinery and equipment also contain a carry-back possibility. If a company earns a profit in 1991 and allocates a portion of the profit to the K-SURV, part of the profit remains untaxed. The reserve representing this portion of the profit can be dissolved in the next year in which the company sustains a loss. In this way the loss is effectively offset against the profit of a previous year.

H. Groups of companies

The rules concerning groups of companies remain fundamentally unchanged. Group taxation is not recognized in Sweden;[54] each company within a group is treated as a separate entity for tax purposes. However, Swedish law does permit income shifting within an affiliated group through group contributions. In practice group contributions will have almost the same effect as group taxation.

1. *Reallocation of profits*

a. Group contributions[55]

For civil law purposes[56], a group contribution is a distribution. Restrictions are imposed on the company with regard to distributions. It follows that if a particular group contribution exceeds the distribution limits set forth in company law, all persons involved in the decision to make the contribution will be held personally liable to repay the contribution or to repay the amount that cannot be repaid by the recipient. This rule applies even if the contribution is "ordered" by the parent company.

Group contributions are only allowed where a Swedish parent company owns more than 90% of the shares of a Swedish subsidiary for the entire fiscal year.[57] A foreign parent company owning Swedish subsidiaries directly from

54. There are some indications, however, that the Government may investigate the possibility of group taxation.
55. Group contributions are subject to the rules set forth in SIL Sec. 2(3). For a thorough discussion of the treatment of groups of companies, see Leif Edvardsson, "Restructuring Companies/Groups of Companies" in this issue at p. 386.
56. The main source of company law is the Companies Act pf 15 December 1975.
57. Various other requirements must also be fulfilled to qualify for group contributions. See *The Taxation of Companies in Europe,* Volume II, Chapter Sweden, International Bureau of Fiscal Documentation.

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abroad is out of the question if it is intended to make use of group contributions. Instead it will be necessary to establish a Swedish holding company to obtain the benefits of group contributions. According to the new rules, it will now be possible to cover the interest expenses of the holding company by group contributions from the other companies, even if the holding company performs no activity other than holding the shares of the subsidiaries.

Many foreign companies are unwilling to use a Swedish holding company because of incompatibility with group structure. If profit and loss equalization is to be achieved in Sweden, however, the Swedish holding company offers the only solution; the group structure problems must be solved in other ways.

b. Transfer of assets

Under present rules, assets may be transferred from one company to another without any tax consequences provided that group contributions between the companies are possible. Since group contributions can only be made between Swedish companies, assets may not be transferred to a foreign company without incurring Swedish taxation.[58] In principle, this rule is similar to the inter-company pricing rule proposed by the OECD. It is, however, important to note that the inter-company pricing rule does not apply to the transfer of non-business assets. For this reason, it is possible to transfer shares without activating the arm's length rule in Sec. 43(1).[59] The reform alters this principle. A company may now only have business income, so all of its assets must be business assets. Therefore all assets that are transferred abroad will be caught by Sec. 43(1). This change is particularly important in the context of restructuring multinational companies. For example, under the present rules a Swedish company can sell its Swedish or foreign subsidiaries to a Dutch holding company at book value. Even if the market value is considerably higher, no Swedish income tax will be imposed on the sale because Sec. 43(1) is not applicable. The Dutch company can subsequently sell the shares tax-free under the Dutch participation exemption and the profit can be distributed to Sweden without any withholding tax and will be tax-exempt in the hands of the Swedish recipient. Under the new rules, the sale to the foreign company will be a taxable sale caught by Sec. 43(1). If the sale price is less than market value, the arm's length principle will apply for Swedish tax purposes.[60]

c. Sale of shares

A special rule governs the sale of shares among Swedish related companies. Under this rule, a sale will be tax-exempt if the shares are held only for business purposes and if the sale is made to a Swedish company within the same group.

d. Sale of goods

Under the old law, an internal profit from the sale of goods to a related foreign company could be offset against an "internal profit account". The offset was deductible provided the goods were not sold at the company's year-end. This rule has now been abolished, creating a dilemma for Swedish multinationals. Swedish companies will now either deliver goods to the foreign entities in smaller consignments (particularly near the year-end to avoid internal profits on unsold goods) or they will attempt to reduce the sale price to avoid internal Swedish profits. In the latter case, of course, the arm's length rule will be activated.[61]

2. *Distributions between related companies*

Since corporate profits are subject to full double taxation in Sweden (see infra), inter-company dividends pose some problems. Swedish law grants tax relief on dividends received by companies under certain conditions.[62] However, if shares are held as a capital investment, any dividend received is treated as ordinary income from capital, i.e. as taxable income.

Minor changes have been made to the inter-company dividend rules but the main structure remains intact. It is still necessary to distinguish not only the type of company but also the character of the shares held. Four categories of company are relevant in this context:
- construction and similar companies[63],
- holding companies,
- investment companies,
- other companies.

Shares may be retained as inventory, they may be held as a capital investment or the shares may be business-related shares.

a. Holding companies

A holding company is a company whose main purpose is to hold (directly or indirectly) shares or other securities in other companies. A holding company may not perform any activity other than the holding of shares or securities. If the company has a business[64] and this business has any real substance it will not be a holding company. In practice, no precise limits are set as to the extent of business activities that can be performed without losing the status of holding company. However, the company will forfeit its status as a holding company if the turnover of the business activity is more than 4-5% of total turnover.[65]

58. See KL, Sec. 43(1) which deals with inter-company pricing. For a discussion of Sec. 43, see Bertil Wiman, "Swedish Transfer Pricing Rules" in this issue at p. 404.
59. See Supreme Administrative Court 1983, 1:13.
60. Although this example is extreme, the same tax effects will occur on any transfer of shares or real estate under the new system. Any restructuring of Swedish activities that includes the transfer of shares or real estate needs to be effected before the new rules enter into force. Companies having a fiscal year corresponding to the calendar year need to accomplish the restructuring before the year-end; other companies need to complete the restructuring before the end of the present fiscal year.
61. In practice, very few cases have been found to fall under the arm's length rule so it may well be that in the long run Sweden will lose some taxable income as a result of the lower sales prices.
62. SIL, Sec. 7(8). For example, Swedish dividends are generally tax-exempt if the recipient is a company which owns or holds shares that represent at least 25% of the entire voting power of the company; if the 25% requirement is not fulfilled, the exemption may still be available if the recipient can prove that the shares were acquired for organizational purposes.
63. This article will deal only with holding companies and investment companies. For a discussion of construction and holding companies, see Edvardsson, supra, note 20.
64. Business is interpreted broadly, i.e. it encompasses any activity other than holding shares and other securities.
65. It is the opinion of the author that this criterion simplifies the issue. Turnover is only one feature that should be considered; if, for example, the securities produce a low revenue, it is misleading to use turnover as the sole yardstick. The value of the assets is also relevant.
A business may be small and yet the company may not attain the status of holding company. To avoid any complications, a company wishing to attain holding company status should not engage in any business activities at all.

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The new system expands the definition of holding company, i.e. the activities of subsidiaries will now also be taken into account. A parent company will not by definition be a holding company (even if it performs no activity other than the holding of shares of the subsidiaries) if the subsidiaries engage in business activities. Under the old system groups of companies engaged in various complex artificial devises to circumvent the holding company rules.

The new definition of holding company is particularly important for foreign companies with Swedish activities. If a foreign company engages in separate activities in Sweden via various Swedish companies, the profits and losses cannot be set off against each other if the Swedish companies are held directly from abroad. If a Swedish holding company is set up to hold the shares of the Swedish companies, it will be possible to eliminate the profits of one company by a group contribution to a company which has a loss. In the past this has been possible in principle but in reality difficult to achieve because it was not possible to use a pure holding company for these purposes. In the future it will be possible provided that the Swedish holding company has no activities other than the holding of shares of other Swedish companies and provided that these other companies have some business activities.

For purposes of foreign investment, it is of interest to note the difference in tax treatment between a holding company and other companies. A holding company can receive dividends tax-exempt if they are redistributed. This rule applies to all dividends, i.e. dividends received from listed shares are tax-exempt provided they are redistributed. However, all distributions retained by the company after deducting costs will be fully liable to tax.

Other companies can receive tax-exempt dividends only if they hold at least 25% of the entire voting power of the distributing company or if there is a close connection between the companies. Distributions on listed shares will generally be fully taxable; in the case of other dividends redistribution will not be necessary for tax exemption.

A foreign company wishing to invest in listed shares in Sweden might be well advised to consider the use of a Swedish holding company. Any dividend received by the holding company will be tax-exempt if redistributed, and it may be possible to qualify for reduced rates of withholding tax under relevant tax treaties. Thus the Swedish holding company may present a viable method of reducing withholding taxes on investments in Swedish listed companies.

b. Investment companies

An investment company is no longer defined as a holding company even though an investment company must also hold shares or securities. If the company engages in any business other than the holding of a diversified portfolio of shares and securities it will not be an investment company. An investment company must also have a large number of individuals as owners.

Investment companies are treated favourably under the new system. They are described in detail below.

I. Investment companies[66]

Two conditions must be fulfilled for a company to qualify as an investment company. First, the company must have a diversified portfolio of shares which offer the shareholder a reasonable risk.[67] This requirement will be fulfilled even if the investment company has some wholly-owned subsidiaries provided there are numerous listed shares. Second, the investment company must have a large number of individuals among its owners. This requirement does not preclude a legal person from being an owner. On the contrary, most investment companies have one or two dominating legal persons as owners. However, the remaining shares must be held by individuals. In nearly all the cases in which this issue has come before the Supreme Court, the Court has decided that the requirement is fulfilled only if the company is a listed company. Although listing is not specifically mandated by law, in practice only listed companies will attain the status of investment company.

An investment company is entitled to special treatment as follows:

- all capital gains will be tax-exempt (capital losses, however, will not be deductible);
- all dividends received will be fully taxable and all dividends distributed will be fully deductible. Consequently, only the difference between dividends received and dividends distributed will be taxable income;
- interest received will be fully taxable and interest paid and any other costs incurred which are necessary to hold the securities will be deductible; and
- a notional income of 2% of the market value of the shares at the beginning of the fiscal year must be reported.

The most interesting aspect of the new rules is the tax exemption for capital gains. Investment companies can now receive the benefits of a capital gains participation exemption privilege similar to the Dutch and Austrian participation exemptions. The main difference between the 3 systems is that the Swedish investment company must in practice be a listed company. In addition, the listing of the company can be one method of obtaining a high capital for investments. Since a legal person may own a substantial part of the company and control the voting power, capital investments via a Swedish investment company remain an interesting opportunity.[68]

J. Double taxation

Traditionally, Swedish companies have been subject to full double taxation, except for a limited deduction (10% on the capital paid in to the company) for distributions on newly-issued shares. Both the double taxation of companies and the limited deduction remain in the new system. However, the change in tax effect will be considerable. When the company rate was almost 70% only 30% of the profit could be distributed. The shareholder was in turn taxed at a level of, say, 75%, so only 7.5% of the company profit remained for the shareholder after tax. Under the new system, the tax will be 30% at the company level, so that 70% can be distributed. The shareholder's tax rate will be 30%, i.e. 49% of the company profit will remain after tax. The net value of a distribution for a shareholder will be about 6.5 times higher under the new system than in the old system. It seems likely

66. An investment company is defined in SIL, Sec. 2(10).
67. Most investment companies have been established by traditional businesses to increase their portfolio of listed shares.
68. The rules for investment companies are similar to the rules for mutual funds, except that the notional income in the case of a mutual fund is 1.5%.

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that there will be a considerable increase in distributions made by Swedish companies. Taking into account the respective levels of taxation a company may now distribute 230% of what it was able to distribute at the beginning of 1989 without increasing its costs. Given that shareholders will probably be more interested in receiving a distribution at the 30% rate, increased distributions seem a natural consequence.

Relief from double taxation is given on a deduction basis. This means that distributions on newly-issued shares will be deductible. The deduction may never exceed the distribution and is limited to a maximum of 10% of the value of the qualifying shares. If the shares are held by a company that owns at least 25% of the voting power of the distributing company the deduction is not allowed. This is because the distribution will be tax-exempt for the owner of the shares. Similarly, the deduction will not be allowed if for any other reason the distribution will be tax-free in the hands of the recipient.[69]

K. International aspects

The new regime for companies is in many respects revolutionary even though most of the basic structure of the old system remains intact. The new rules will influence the behaviour of Swedish companies so it is useful to consider what changes can be anticipated.

As stated above, companies will now be taxed at a 30% nominal rate and a 23.7% effective rate. Under the old system, the nominal tax rate was approximately 60%; for 1990, it is slightly less than 50%, including the profit sharing tax. From an international perspective, the old tax system had a nominal tax rate substantially higher than most other countries. To counter the high taxation in Sweden many multinationals endeavoured to declare as low profits as possible in Sweden; for example by structuring the capital of the company in such a way that interest was shifted to low tax countries. This philosophy will now change.

First it must be noted that the effective tax rate of 23.7% can only be achieved on undistributed profits. The only country in the western world (with the exception of tax haven countries) that has an ordinary corporate tax rate below this rate is Switzerland. Many other countries offer tax subsidies or tax holidays, etc. For instance, Ireland offers a 10% tax rate for manufacturing companies and financing companies. The Belgian coordination centre offers an even lower rate. In other countries, the average rate is approximately 35-40%, a rate lower than that under Sweden's old system but higher than the rate under the reform.

Swedish industry has been very profitable in recent years. Most companies have utilized their inventory and other untaxed reserves to the full and have been obliged to pay the high nominal tax rate on excess income. Swedish multinationals have tried to increase the capital in foreign subsidiaries and to increase loans in Sweden. Many Swedish multinationals have established finance companies abroad to transfer their interest income to a jurisdiction with a lower level of tax.

Many of these tax planning schemes will now be thwarted. Having a tax rate of, say 35%, in another country means that a subsidiary should only have a minimum of capital. It can be anticipated that Swedish companies will reduce the capital of foreign subsidiaries, thus reducing the borrowing in Sweden and bringing the net interest taxation back to Sweden. Of course, foreign finance companies may still be of interest to Swedish companies because of the lower tax rate in the country where the finance company is established (e.g. Ireland's level of taxation on finance companies is less than half of the corresponding taxation of a Swedish finance company).

Foreign companies investing in Sweden will want to increase the level of profit in Sweden. It is foreseeable that foreign parent companies will increase the capital of Swedish subsidiaries, thus increasing interest income in Sweden.

In other respects Sweden will be an interesting country for tax purposes. Even if Sweden cannot compete with Ireland, Belgium or Switzerland with respect to financing activities, it may still offer attractions for other activities. No special requirement must be fulfilled to qualify for the 23.7% rate of tax except that the income cannot be distributed. If distributed, the tax rate will be 30% which is still favourable. If a Dutch holding company is used for the investment in the Swedish subsidiary, no withholding tax will be levied on the distribution from Sweden. These may therefore be attractive possibilities for research and development activities, with the royalties channelled back to Sweden. The effective tax rate will be 23.7%, still making it possible to distribute a considerable portion of the profit. In addition, it will be possible to sell shell companies, i.e. the Swedish company can be emptied and sold on the market. Taxed reserves will probably be worth around 100% and untaxed reserves around 80-85%. The capital gain on disposal will not be taxable in Sweden for a foreign resident company. Whether or not this will be of interest depends on the tax rules in the home country. If capital gains are tax-exempt such a structure will be advantageous to foreign companies.

One consequence of the lower level of taxation may be that foreign tax authorities will become more aggressive in investigating inter-company pricing methods where Swedish companies are involved. Until the reform neither Swedish nor foreign companies had any reason to transfer profits to Sweden but the low tax rate may well reverse this orientation. Even though prices may not be adjusted directly, ultimately such adjustments will probably be made (e.g. by avoiding an increase in the sales price from Germany to Sweden).

One other important consideration with international implications concerns the restructuring of multinational groups. Comments made earlier on the sale of shares to a foreign company apply equally in this context so that any restructuring of a multinational group involving Swedish subsidiaries needs to be effected while the old system is in place. For example, a multinational group which has acquired a company through a Swedish subsidiary in order to increase interest payable in Sweden and so reduce its Swedish tax burden may wish to sell the subsidiary because of the change in the tax system. In such circumstances the sale needs to take place before the new regime is in force so that the arm's length principle will not apply to the sale.

69. An example illustrates the deduction. A Swedish company increases its capital with 100,000 Skr. by issuing 1,000 new shares with a nominal value of 100 Skr. per share and at a course of 120%. The maximum deduction for distribution will be 10% × 120,000 Skr. = 12,000 Skr. If a distribution of at least 12,000 Skr. per year is made, a deduction of 12,000 Skr. per year for 10 years will be allowed. If 10,000 Skr. is distributed, the deduction will be 10,000 Skr. but will be allowed for 12 years. In other words, the total deduction cannot exceed the amount paid in.

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V. CLOSE COMPANIES

Under the old tax regime the taxation of close companies was a complex area. Most of the rules remain intact under the new system with the addition of certain new rules to counter tax avoidance and evasion. Closely held companies are often the ideal vehicle for obtaining tax advantages that are otherwise not available. Under the new system this problem could be exacerbated because companies and income from capital are taxed at a much lower rate than income from employment. Owners of closely held companies may be motivated to use close companies as a vehicle for converting employment income with its high rate of taxation to income from capital with its lower rate of taxation. To prevent such practices, anti-avoidance rules have been laid down for close companies.

A. Definition

A close company is defined as a company in which the majority of the voting power carried by the shares is held directly or indirectly by a limited number of individuals.[70] In practice, for a company to be a close company the majority of voting power in the company cannot be held by more than 10 individuals. In this context an individual does not necessarily mean one single individual. An individual and his close relatives are regarded as one individual when calculating the number of individuals for the purposes of the close company test. For example, a company owned by a family comprising 2 parents and 3 children is deemed to be owned by one individual.[71]

The concept of close company has also been expanded by virtue of a new definition which treats all persons operating a business together as one person.[72] In such circumstances – and this will apply to most consulting firms – a close company is deemed to exist. It should be noted, however, that the new definition is only relevant in the context of capital gains, distribution levels and interest deduction limitations.

B. Special rules for employment income

Transactions between a close company and its owners are not always made at arm's length. To counter some of these non-arm's length transactions between closely held companies and their owners, special rules were introduced in 1976.[73] The taxation of these transactions is based on the principle that any transaction not made at arm's length will constitute a hidden distribution. On the one hand, a distribution is not a deductible expense for the company making the distribution. On the other hand, it is taxable income from capital in the hands of the recipient. Since the tax rate on income from capital is lower than the tax rate on employment income, all income deriving from transactions between a close company and its owners is taxed as employment income. The purpose of this rule is to subject these hidden distributions to the higher rate on employment income. However, although the hidden distribution is taxable as employment income in the hands of the recipient, it remains non-deductible for the company.

1. *Salaries*

All salaries paid by a close company to a husband or wife or to children (over the age of 16) of the owner must be paid on an arm's length basis. Any amount paid in excess of the fair market value for the services will be taxable employment income of the owner.[74]

2. *Purchases of assets*

If the company purchases assets that are not necessary for the business of the company, i.e. the assets are for the personal use of the owners, the total purchase price will be taxable employment income of the owner who uses the asset. For tax purposes, the asset will be deemed to have been acquired by the owner himself, which means that he can acquire the asset from the company at no cost without any further taxation consequences.

The arm's length rule applies to any purchases or sales between the owner (or his relatives) of a close company and the company. Any deviation from arm's length value will give rise to taxable employment income in the owner's hands.

3. *Rentals*

If the company rents an apartment situated in a private dwelling from the owner, the rental payments are employment income of the owner. Normally this type of income is income from capital taxed at the rate of 30% (see supra). In the close company context, however, it falls into the category of income from employment.

4. *Loans*

Special tax rules apply when a shareholder borrows money from the company. These rules apply even if the company is not a close company. A loan from a company to a shareholder or his close relatives is forbidden under company law. To make this rule more effective, such a loan will be regarded as taxable income.

C. Distribution rules

Distributions of a close company are more favourably taxed than salaries. A distribution on newly-issued capital is deductible up to a level of 10% per year. The corporate tax rate is only 30% while the social security charges are 38%. The tax rate on income from capital is 30% and on income from employment a top rate of 50%. This favourable treatment will, of course, encourage owners of close companies to convert salaries into dividend income. To prevent such practices, special rules will apply.[75]

According to the new rules, a distribution will be taxable income from employment if it has the characteristics of a salary. If the owner of the company is actively engaged in the company (which is usually the case if he works at least 570 hours per year for the company) the company profits to some extent derive from the personal services of the owner. In such circumstances, if the distribution exceeds the official base interest rate by more than 5%, the excess will be

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70. See KL, Sec. 35(1a)(7).
71. A close company that is listed on the Stockholm stock exchange or traded over the counter will no longer be a close company for tax purposes even if the voting power carried by the shares is concentrated in one family.
72. See SIL, Sec. 3(12).
73. See KL, Sec. 35(1a).
74. Sums paid to a child under 16 will always be taxable income of the owner.
75. SIL, Sec. 3(12).

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treated as income from employment. The base for the computation is the acquisition cost of the shares.[76]

It should be noted that full social security charges must be paid on salaries. However, no social security charges will be due on the excess amount of the distribution.

D. Capital gains on the sale of shares

The tax rules applicable to the sale of shares were described above. These rules also apply to the sale of shares of a close company. However, part of the capital gain on the disposal of shares in a close company is considered to come from the owners' services rendered for the company, so part of the capital gain is actually salary and for tax purposes should be treated as a salary.

The new rules stipulate that half of the capital gain should be treated as employment income when an active shareholder sells his shares in the company.[77] If he pays the higher tax rate on income from employment (which will probably be the case), the average tax burden can be computed as follows:

Capital gain: 100	
Income from capital:	50 × 30 = 15
Income from employment:	50 × 50 = 25
Total income tax:	40

In these cases the effective tax on capital gains for close companies will be 40%. It is possible, however, to decrease the tax burden if the taxpayer can prove that a larger part of the capital gain comes from other sources than his own labour, e.g. from a capital gain on real estate.

E. Interest payments

As described above, certain restrictions are prescribed for deductions on interest expenses. However, these restrictions will not apply to interest paid on loans to acquire shares of a close company. A maximum interest rate corresponding to the official base interest rate is stipulated.

F. Shell companies[78]

The sale of shell companies has recently become popular with owners of close companies because of the difference in tax rates between salaries and capital gains (today the difference is 65% compared to 32.5%). To prevent abuse of the disparity in tax rates, special rules for shell companies were introduced in 1972. Under these rules the total sale price is taxable income when the shares of a close company are sold under certain conditions.

Under the new system capital gains on the sale of shares in close companies will be taxed at a flat rate of 40%, a rate high enough to restrict the benefits from the sale of close companies. Consequently, the specific rules concerning the sale of shell companies are abolished.

G. Internal sales

A special rule applies when the shares of a close company are sold to another close company which the seller owns or within 2 years will own. In such cases, the total sale price will be taxable income.

The new 40% tax rate on capital gains on the sale of close companies is considered adequate to prevent tax benefits from accruing on internal sales; thus the specific rules on internal sales are also abolished.

H. International aspects

Only one aspect of the rules on close companies is relevant from an international perspective: a close company may be a Swedish company or a foreign company or a subsidiary of a foreign company. Thus, a Swedish company owned by foreign individuals will come within the definition of close companies. This will be the case when a Swedish company has a foreign parent company which is a close company according to the Swedish definition. The subsidiary will be a close company.

A foreign company owned by Swedish individuals will for Swedish tax purposes be treated as a close company if it would be a close company were it a Swedish company. Thus a subsidiary of a Swedish close company will be a close company for Swedish tax purposes.

VI. TAXATION OF PENSIONS AND INSURANCE

New rules have been introduced for the taxation of pensions and insurance. The new rules aim to achieve more neutrality within the tax system. Because exchange control legislation will be abolished from 1 July 1990, it will be possible for Swedish individuals to pay for insurance with a foreign insurance company. This is currently forbidden if the premium exceeds 3,000 Skr.

A. Taxation of pension savings

If an individual wishes to save money he may open a savings account with a bank, in which case interest earned on the account will be taxed at 30%; or he may invest money with an insurance company as a premium for a future pension. Until the reform the growth of the premium was tax-exempt for the insurance company but fully taxable for the individual as part of the pension. This is considered inequitable. To achieve more neutrality, the revenue from savings in pensions will be liable to a special revenue tax.

An insurance company, pension fund or any company having a pension liability on its books will be required to pay the tax. Taxable income will be the net income from the holding of capital or real estate. The rate of tax will be 10% where the capital is from company pension plans and 15% in the case of other capital. For pension liabilities, the tax will be 1.1% of the book value of the debt at the beginning of the year.

B. Foreign insurance

The taxation of Swedish insurance companies on income

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76. *Example:* A close company has an active owner who purchased his shares in the company for 100,000 Skr. The company decides to distribute 20,000 Skr. The official base interest rate is 13.5%. 18,500 Skr. will be income from capital and 1,500 Skr. will be income from employment.
77. SIL, Sec. 3(12).
78. A shell company is a company in which more than half of the assets of the company have been sold before the shares of the company are sold.

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from the capital derived from pension plans and premiums will, of course, stimulate interest in investing in foreign insurance. Under a recent bill, payments to foreign insurance companies will be allowed from 1 January 1991.[79] A new tax on premiums paid for foreign insurance will also be introduced. The tax rate will be 15% and to be paid by the person who purchased the insurance.

The premium tax can potentially lead to double taxation, for instance, if the revenue from the capital paid in is taxable in the country where the insurance company is established. If the tax rate is comparable to that in Sweden it will be possible to obtain permission from the Swedish National Tax Board not to pay the premium tax.

C. Taxation of life insurance companies

Life insurance companies were favourably taxed under the old tax system, having been permitted to make generous allocations to security and other untaxed reserves. These opportunities are now abolished. In practice, life insurance companies will be taxed at 30% on all revenue from life insurance capital, which is the same level of taxation as applies to individuals saving privately in banks. Payments on life insurance will be exempt for income tax purposes.

D. International aspects

The new tax rules on pensions and life insurance companies, combined with the fact that Swedish individuals will be permitted to take out foreign insurance, will probably result in increased activity by Swedish citizens in these areas. Swedish insurance companies have already anticipated this trend and have established abroad to meet the competition head-on.

VII. FINANCING OF THE REFORM[80]

As stated in the beginning of this article, the reform will not cut the total taxes in Sweden; rather it represents a reallocation of taxes and a shift from direct taxation to indirect taxation.[81]

The reform is financed from two main sources: a broader tax base which will yield about 47 billion Skr. in 1991, and increased tax revenue from indirect taxes that will yield slightly more than 14 billion Skr. in 1991.

The increase in indirect taxes will issue from a broader VAT tax base and some new energy taxes. The broader VAT tax base will be accomplished by levying VAT in principle on all goods and services. Previously, only services on goods were taxable; from 1991 most personal services will be taxable. The reduced tax rates on buildings and ground work are also abolished, so there will be just one tax rate of 19% on the sales price including VAT, or 23.46% on the sales price. The new taxes on energy aim in part to reduce consumption of certain types of petrol with a view to alleviating pollution.

Much discussion has ensued about the dynamic effects of the reform. Presumably it is likely to encourage longer working hours and a greater willingness to declare income. A decline in the black economy sector, however, appears to be a desperate hope more than a reality. The black economy sector is already sizeable and it seems highly unlikely that a person used to paying no taxes will be ready to pay 30-50%. Perhaps in the long term some improvement will be discernible but no immediate effect seems probable.

The forecasted increases in the working hours seem more realistic. Some taxpayers will have their marginal taxes cut from 40% to 22.5%, others from 54% to 30%, and yet others from 65% to 50%. Of course, these reductions will act as a stimulus. An individual who works an hour extra for which he is paid 100 Skr. will be more willing to do so if his net income will be increased by almost 80 Skr. rather than by only 60 Skr. as under the old system. This will undoubtedly increase national revenue. It is difficult, however, to estimate the amount of this increase. The bill estimates 5 billion Skr., i.e. the amount that is otherwise unfinanced.

The effects of the company tax reform are intended to be financially neutral, and this has apparently been achieved. Increased national revenue is estimated to be 1.2 billion Skr. from the phasing out of untaxed reserves. The principal effect for companies will be the enormous changes in tax burden between companies. The winners will be service companies, consultants and similar companies that have never been allowed to use untaxed reserves; the losers will be companies with large inventories, and financing companies.

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79. Government Bill 1989/90:135.

80. The reform will be financed as follows. The figures below are given for both 1990 and 1991.

	1990 (000,000 Skr.)	1991 (000,000 Skr.)
Lowered income tax	23.4	62.9
Increased transfers	0.4	6.9
	23.8	69.8
Broader tax base employment	3.5	8.7
Broader tax base capital	8.4	30.9
Broader tax base business	–	9.2
Increased VAT, etc.	11.9	14.4
From companies	–	1.2
Dynamic effects	–	5.0
	23.8	69.4

81. In total, the lowering of income taxes for individuals will result in reduced revenue for the State of about 70 billion Skr. for 1991, including increased subsidies. It should be noted that a smaller step on the reform was already taken in 1990, resulting in a decrease in national income of about 24 billion Skr.

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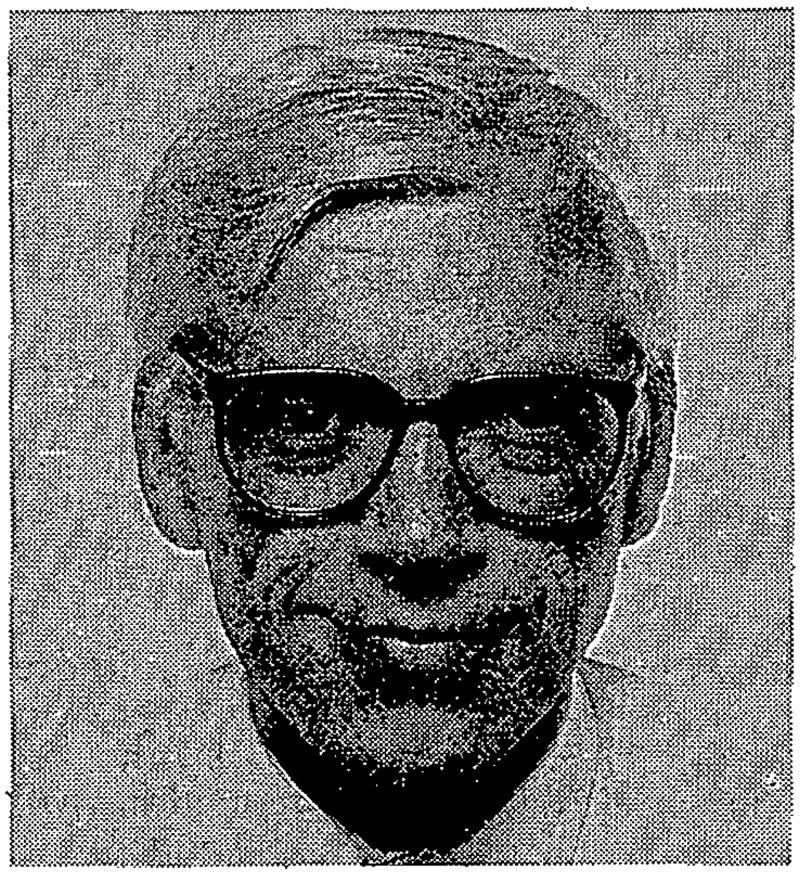

SWEDEN:

Restructuring Companies/ Groups of Companies

Leif Edvardsson

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This article examines the system of regulations which has developed in legislation and practice in connection with restructuring operations within a group or between companies within a group of minority-owned associated companies. The way in which these rules have been adjusted to fit the new tax system is also explained. Only transactions between Ltds are dealt with and there is no discussion of the fiscal regulations concerning the dissolution of Ltds by way of liquidation or merger, or changes in company form. Similarly, the rules connected with transactions between companies and employees or other parties have been omitted, as have the rules that are of interest only in the context of changes of generation of shareholders.

Central to the description which follows is the concept of double taxation in Sweden. First the rules on close companies are considered and the new regulations on capital gains are illustrated. The main topic of the article is the regulations on transfer of assets within groups and between companies in groups of minority-owned associated companies. The elucidation of these rules is preceded by a discussion of "cumulative" taxation and group contribution regulations.

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INTRODUCTION

An inevitable concomitant of economic progress is constant restructuring in the company sector. Such restructuring may take a number of forms. It may take place within an existing group, 2 or more separate companies may merge or consolidate, one business may split into 2 or more companies or an existing company may convert to another form.

Reorganization within an existing group may be achieved in several ways. One of the companies may transfer all or part of its activity to another company, at which point the latter company may be disposed of or it may commence a new activity. Such a transfer may also be made by a company in the context of a liquidation or a merger when all the assets and property of the merging company are transferred to the surviving company. In most cases the restructuring will not be so radical. It may, for example, be restricted to an exchange of products between the companies in connection with rationalization of the production, sale or purchase functions of the group. The transfer between the companies might concern only one line of activity or only certain assets.

A formal joint action by 2 separate companies is usually initiated when one of the companies purchases the other. Such a purchase is generally the first step towards a planned restructuring of both companies. The group thus established facilitates restructuring by way of intra-group transfers of assets, exchanges of products or merger. Because of the tax consequences it is extremely unusual for 2 totally separate companies to merge directly. Generally, a group is formed first with one of the companies as the parent company and the other as its wholly owned subsidiary and the merger taking place later.

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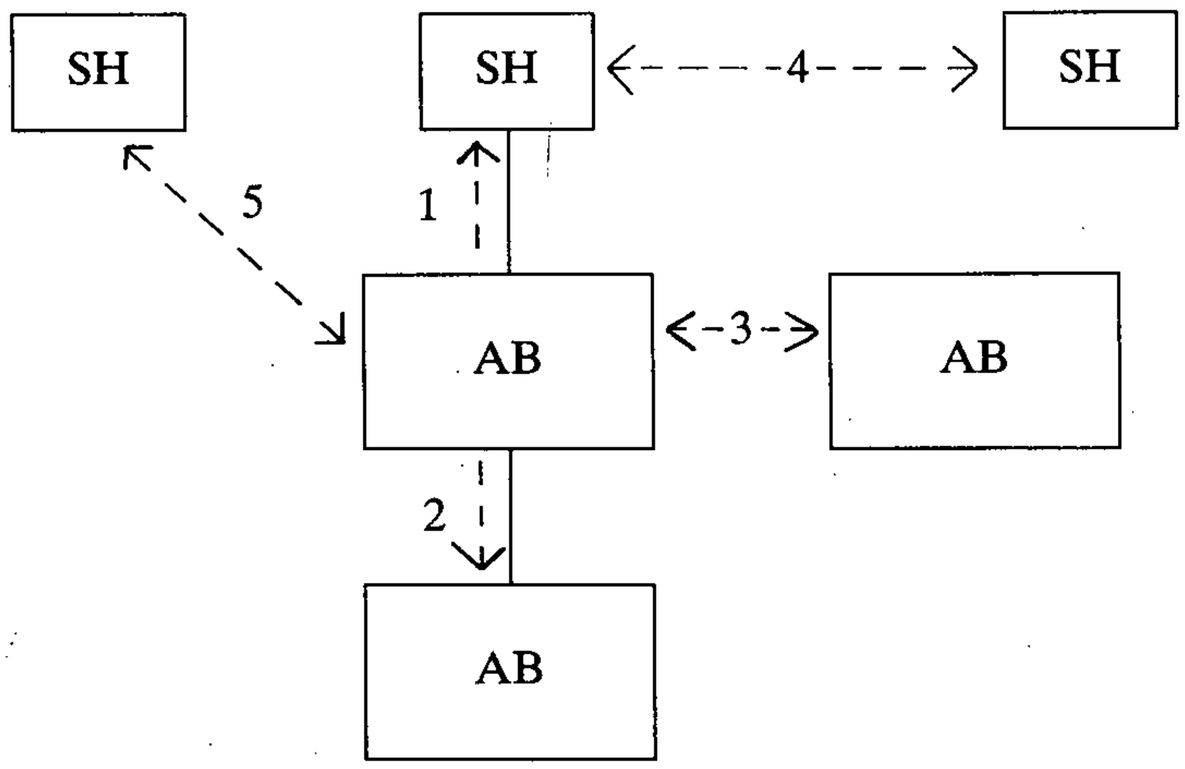
The essence of restructuring is that in one way or another assets are transferred between companies. As Swedish company taxation is built on the principle that each company is subject to tax separately, such transfers should generally give rise to taxation if the transfer was effected at a price that diverges from market price. However, taxation would often hinder or even preclude restructurings that are considered essential to the achievement of economic progress, so a system of rules has developed (to some extent in legislation, but mainly in practice) which in most cases eliminates these tax consequences. This system of rules encompasses intra-group transactions as well as transactions between formally independent companies. In principle, the same conditions must be fulfilled in both cases.

The main purpose of certain restructuring schemes is to obtain tax relief in a way very much akin to tax avoidance. It is generally agreed that this frequently happens where close companies are concerned. To prevent tax avoidance within the close company sector, specific legislation has been introduced, targeted at, among other areas, internal transfers of shares and trading between profitable and loss-making companies. The 1991 tax reform indicates that tax reliefs which could previously be obtained from internal transfers of shares or from transactions with companies with taxable income are to disappear. Consequently, the old anti-avoidance rules will be abolished. At the same time new anti-avoidance regulations will be introduced in the tax system to counter other avoidance possibilities. In addition, other anti-avoidance regulations have been amended to preserve their original purpose.

The various aspects of restructuring discussed above can be illustrated as follows (the continuous lines indicate ownership, the broken lines the direction of transactions):



SH = shareholder

"1" refers to transactions between the owner of a company (and persons associated with the owner) and the company, the context in which the close company legislation operates. This legislation includes stop regulations, i.e. rules to prevent certain transactions between the company and the owner. Stop regulations are directed at transactions which, looked at from the company's point of view, are not economically justified, having rather the character of disguised distributions to the owner of the company. In addition to these rules which existed under the former regime and which are now modified to conform to the remodelled tax system, entirely new rules applicable to the taxation of undisguised dividends are introduced. These new rules aim to ensure that dividends over a certain level are dealt with for tax purposes in the same way as salaries paid by a company.

Intra-group transactions are shown at "2". Under this heading are included the rules relating to double taxation and group contributions. These rules have been considerably simplified under the new tax system. The rules concerning company mergers are also assigned to this heading.

Transfers of assets between companies with common ownership are shown at "3". In this context what are usually at issue are transactions between companies in groups of minority-owned associated companies.

"4" refers to transfers of ownership of companies to the next generation of shareholders. The new rule on taxation of profits from the transfer of shares in close companies is related to the rule on transfers of ownership to the next generation.

Transactions between companies and other parties are referred to at "5". Two categories may be distinguished, namely employees and outsiders.[1]

DOUBLE TAXATION OF INCOME OF LTDs

A fundamental principle of the Swedish taxation system is that the income of Ltds is taxed twice. The income of a company is subject to double taxation because the income is taxed in the hands of the company ("first leg") and subsequently the shareholders are taxed when they receive the profits by way of dividends ("second leg").

Double taxation creates a number of problems. First, an extraordinarily complicated system of regulations is necessary to ensure that company profits will actually be taxed twice. Second, problems arise in connection with the taxation of close companies and their owners. Transfers of values that represent compensation to shareholders for work performed are deductible for the company and will consequently be taxed only once. Transfers of values which do not represent consideration will, on the contrary, be subject to double taxation. In the second instance it makes no difference whether the transfer is effected openly by way of a dividend or covertly, for example by way of the purchase of property from the company at undervalue. The third difficulty with regard to double taxation lies in the method of taxation. Because the second leg of double taxation takes place after a dividend has been distributed the tax burden will be lower if the profit is retained by the company. This tends to lock in the profits of individual companies. The tendency is exacerbated by the favourable tax treatment accorded to capital gains. To reduce the tendency to retain profits, certain reliefs have been introduced into the legislation governing double taxation. In some cases the company tax is in fact lower on profits distributed by way of dividend.

1. "4" and "5" are set out for illustrative purposes only. As stated in the text, the rules concerning these transactions are not discussed in this article.

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The tax reform represents a radical change of opinion as regards the importance of taxation for the development of the national economy. The rate of company tax will be reduced to 30%, as will the rate of tax on dividends. The result will be that the profit remaining after taxation of dividends will be increased to (70% × 70%) = 49%. To an individual with a high level of income the corresponding profit in 1989 was roughly 13% if no reliefs were given at the first stage of double taxation. Because of the reduction in tax rates it has been thought acceptable to abolish the reliefs formerly available and reintroduce traditional double taxation. The so-called Annell deduction, which for a limited period of time allows companies to receive a certain deduction for dividends paid on newly issued shares, is retained under the new system.[2]

When a sole proprietor takes current assets from the business for his own use the general rule, that tax will be imposed as if the assets had been sold at market price, applies. Other assets (e.g. equipment), the disposal of which is treated according to the rules governing income from business activity, are taxed as withdrawals when taken from the business in this way. The concept of disguised capital gains is not recognized in Swedish fiscal regulations in relation to natural persons. Thus, where a disposal of business assets would be taxed as a capital gain, there will be no withdrawals taxation except to the extent that depreciation deductions have been granted during the period of ownership and that repair deductions have been granted within the immediately preceding 5 years.

In the case of transactions between shareholders and companies the same rules apply as for the taxation of withdrawals from businesses, in order to preserve the first leg of double taxation. A sale of property by the company at undervalue or a sale to the company at overvalue will be the starting point for a corrective adjustment to the basis of taxation for the company. Apart from the property concerned, such a transaction also means that the shareholder receives a transfer of value from the company which does not represent consideration. If the transaction concerns property which could only be taxed according to the capital gains rules, no corrective adjustment will be made in relation to the company, but the shareholder will be taxed. The second leg of double taxation therefore always comes into operation. The general term for such taxation is taxation of dividends irrespective of what category of income is being taxed.

Under the new tax regime all kinds of income from an Ltd are classified as business activity income. Capital gains on real property and shares, that have formed part of the business activity of a natural person, will be taxed as income from capital; similar gains realized by a company will be taxed as income from business activity. From this it follows that the taxation of transfers of such assets by companies will be governed by the same rules as those for current assets and equipment. Disguised capital gains within the company sector will, therefore, be subject to withdrawals taxation, with one exception to be explained later.

THE RULES FOR CLOSE COMPANIES

Taxation of dividends

A shareholder employed in an Ltd may choose to be compensated by the company by way of salary or by way of dividend. If the salary option is taken, employer's contribution will have to be paid on the salary, but deductions for both the salary and employer's contribution are available. If the dividend option is selected, the company is not allowed a deduction for the dividend apart from the Annell deduction. On the other hand, there is no obligation to pay employer's contribution on the dividend.

Let us assume that the profit before taxation is 100 and that the maximum possible salary or dividend is paid. If the shareholder has a marginal tax rate of 50%, his income remaining after company tax and his own tax will be as follows:

(1). Income remaining if salary is paid		*Owner*
Surplus in the company	100	
Employer's contribution	28	
Salary	72	72
	0	
Income tax (50%)		36
		36

(2) Income remaining if dividend is paid		*Owner*
Surplus in the company	100	
Corporation tax	30	
Profit to divide	70	70
Tax on income from capital (30%)'		21
		49

The difference between these alternatives in terms of the total tax and charge burden is so great that the shareholder will generally opt for the latter. This is likely to be the case anyway if the shareholder has already availed himself of the maximum social benefits through his salary and in addition to his salary wishes to make further withdrawals from the company. A rule exists which provides for an adjustment to neutralize the differences between the alternatives.

This adjustment rule implies that a dividend of an amount higher than is consonant with a normal return on the capital invested in the company shall be treated in the receiver's hand as a specific item of income in the category of employment income. To ensure the effectiveness of this rule the withdrawal is regarded as income of the member of the family with the highest taxable income who has been active in the company. Unlike an ordinary salary, there is no obligation to pay social security charges, nor is there any entitlement to the standard deduction or basic deduction for the recipient.

One condition for applying the adjustment rule is that the distributing company must be or have been a close company during the last 10 years and that within the same period the person liable to tax, or a person associated with him, has been active in the company in such a way that he has clearly contributed to the creation of the company's profit. If the person liable to tax can prove that an outsider owns shares in the company to a substantial degree and has the right to dividends, the distribution will be taxed without the adjustment rule being applied. If an outsider owns at least 30% of the shares in a company, there is thought to be little risk that the salary income of the principal shareholder will be

2. The Annell deduction is a deduction for dividends paid on newly issued shares. The deduction is limited to 10% of the value of the qualifying shares over a period of 20 years. The total deduction over this period may not exceed the amount actually paid on the shares.

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converted into dividends, as the dividend also goes to the outside shareholder.

The difference between a "normal dividend" and an "extended dividend" is based on the official interest base rate plus 5% multiplied by capital invested in the company.[3] A distribution of an amount up to the official interest base rate plus 5% multiplied by invested capital is always treated as a dividend. Any distribution above that amount may be treated as employment income.

Where the company distributes less than the amount computed by applying the formula, the difference between the amount actually distributed and the formula amount may be carried forward and set off against either dividends in subsequent years or capital gains arising when the shares are sold. This unutilized amount may be adjusted upwards each year in accordance with the base interest rate on Government loans plus 5%.

Capital gains

The adjustment rule also covers capital gains when shares and other financial instruments representing investments in a close company are sold. According to the normal rule, any unutilized dividend amount is first deducted from the computed capital gain. Of the remaining amount, half will be taxed under the basic rule as income from employment and will thus be treated in the same way as "extended dividends". The remaining part of the gain (including the amount of the unutilized dividend) will be taxed as income from capital.[4]

The withdrawals tax will in fact be somewhat lower than the tax on a corresponding salary for a person with 50% marginal tax. The rationale behind this difference is that a sale involves costs and does not guarantee a 100% return.

If an individual liable to tax is able to prove that the capital gain can obviously not be referred to the results of his work or the work of a person associated with him, the part of the capital gain that may be treated as employment income will be reduced accordingly. The intention of the rule is not that a capital gain must be totally referable to either the results of a person's work or to income from capital in the usual sense. The adjustment may consequently have the effect of taxing 20% of the capital gain as income from employment and the rest as income from capital. In the Government Bill, the Finance Minister makes it clear that the adjustment rule is to be used sparingly.

Changes to the stop rules

In 1976 special rules were introduced to prevent directors and shareholders in close companies and persons associated with them from obtaining unwarranted tax advantages from various transactions between the company and themselves.[5] Examples of such transactions are where the owner of a company acquires property from the company at a lower price than market value or sells the property to the company at a higher price than market value, or where the company acquires movable property that is intended exclusively or almost exclusively for the personal use of the directors or persons associated with them.

These kinds of transactions have in common the fact that they are not motivated by the economic considerations of the company. They are in essence disguised dividends. The benefits to which they give rise have in the past been taxed under the schedule for income from casual activities to indicate that the company has no entitlement to deductions in respect of them.

The income from casual activities schedule does not exist under the new tax system. The stop rules have therefore been amended to correspond to those applicable to extended dividends from close companies. The result is that for taxation purposes there is a special item of income falling into the category income from employment with no obligation to pay social security charges and no entitlement to standard or basic deductions. Nor is the company allowed to deduct an amount corresponding to the item of income.

TAXATION OF GROUPS OF COMPANIES

According to the Swedish Companies Act[6], a group exists if a Ltd owns sufficient shares in another company to give it more than half of the voting rights in that other company. A group is also generally said to exist when 2 companies are owned by the same person. In this context what is referred to is a company directly owned by a natural person.

To tax a company means to tax the overall result of a particular economic activity. The tax burden for a group should therefore be identical to that which would ensue if the activities of the group were carried on within one company. Swedish tax law, however, does not recognize a group as a taxable entity. Rather, each legal entity is taxed separately. As the existence of a group usually has a considerable influence on the economic results of the individual companies, special rules for the taxation of groups have evolved to bring about tax neutrality. The most significant are the rules exempting from taxation dividends received by companies and open group contributions.

The elimination of "cumulative" taxation

An unmodified system of double taxation can produce the result that the same income will be taxed more than

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3. Invested capital means the amount invested when the company was incorporated, amounts later contributed on new share issues and outright contributions to capital.

4. (a) Example where computed capital gain exceeds unutilized dividend amount:

Computed capital gain		80,000
Unutilized dividend amount		12,000
		68,000
Taxed as employment income:		
$\frac{68,000}{2}$ =	34,000	
Taxed as income from capital:		
$\frac{68,000}{2}$ =	34,000	
Unutilized dividend amount	12,000	46,000
Total computed capital gain		80,000

(b) Example where unutilized dividend amount exceeds computed capital gain:

Computed capital gain		24,000
Unutilized dividend amount		30,000
Unutilized dividend amount balance to carry forward		(6,000)
Taxed as income from capital	24,000	

5. The Swedish Government Official Reports 1975:54, Government Bill 1975/76:79, Tax Subcommittee 1975/76:28.

6. Companies Act of 15 December 1975.

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once in the company sector ("cumulative" taxation) before it is distributed to a natural person and taxed yet again. This will occur where one Ltd is owned by another Ltd which in turn is owned by a natural person. To remove this unintended effect, a complex system has been developed to deal with the tax liability of Ltds on dividends from other Ltds. The basic principle underlying the system is that the profits of a Ltd should be taxed only once in the company sector. It is immaterial whether the profits on their way to their ultimate recipient, a natural person, pass through one or more companies or no company at all.

The elimination of the cumulative effects of double taxation in the company sector can be accomplished in two ways. One way is to allow the distributing company to make deductions for dividends paid. Alternatively, the shareholding company could be relieved from liability to tax on the dividend received. Sweden has chosen the latter course to eliminate the cumulative effects of double taxation. The general liability to taxation for Ltds and the fact that the second leg of double taxation is effected when the profit is divided or distributed to the individual shareholders makes it possible to accumulate capital in a way that is considered unacceptable from the distributional point of view. The legislator has therefore attempted to eliminate opportunities for such practices by way of a number of regulations which provide exceptions to the basic principle of freedom from cumulative taxation in the company sector. Indeed, cumulative taxation was actually extended when a tax relief for companies was reduced by limiting the entitlement to a deduction for dividends paid on shares. In this instance the reduction of tax relief was prompted by the desire to eliminate tax advantages which were not intended but which could have been obtained where tax was not paid in the company sector.

Both the original and the modified double taxation rules are based partly on a distinction between various types of companies and partly on distinctions between various kinds of shares so that tax exemption depends on both the type of company and the kind of shares.

The following types of companies are distinguished:
- construction and similar companies;
- holding companies;
- investment companies;
- other companies.

The category of companies carrying on construction or similar enterprises also includes companies trading in property. Almost all of the properties of such firms are stock-in-trade. Where such property is owned by a construction company subsidiary, the shares in that company will be regarded as stock-in-trade.

For tax purposes, a holding company is an Ltd or an incorporated association which is exclusively or almost exclusively engaged in the management of securities or similar movable property. In the past it was held that a parent company holding the shares of an operating subsidiary was not regarded as a holding company only if the parent company performed some functions for the subsidiary, for example accounting or marketing analysis. To simplify the distinction between holding companies and other companies, the rules which determine when a parent in a group is to be regarded as a holding company have been changed. When considering the status of the parent company one must now look at the circumstances of the group as a whole. This means that attention must be paid to the business of both the parent company and the subsidiary when considering whether the parent company is exclusively or almost exclusively engaged in the management of securities or similar movable property. The practical consequence of this rule is that a parent company of a group with operating subsidiaries will almost always be taxed according to the usual rules rather than the rules for holding companies.

A special class of holding company is investment companies. Investment companies are also engaged exclusively or almost exclusively in the management of securities or similar movable property, with the difference that investment companies have a broad portfolio of securities and are owned by a large number of natural persons.

Banks, savings banks and insurance companies belong to the category of other companies.

The law distinguishes the following kinds of shares:
- shares qualifying for participation exemption;
- capital shares;
- stock shares.

The dividend on a share qualifying for participation exemption is tax-free. The term "participation exemption share" corresponds to the previously used term "organization share". A share is normally a participation exemption share if ownership of it carries at least 25% of the voting power in the distributing company at the end of the fiscal year. There need be no inherent connection between the activities of the parent and subsidiary companies. If the votes carried by the share are less than 25%, the dividend may still be tax-free if the parent company can prove that the share is held because of the activity carried on by the associated company or companies.

Capital shares are shares that are not participation exemption shares or stock shares. Ownership of capital shares has the character of investment. The dividend is therefore taxable.

The third kind of share is a stock share. Such shares are regarded as stock-in-trade. Except in construction enterprises and property buying companies such shares may be regarded as stock-in-trade of security trading activities. The dividend on stock shares is always taxable.

The fundamental features of double taxation may be summarized as follows:

Type of company	*Tax-free*	*Taxable*
Building enterprises, etc.	Dividend on participation exemption shares	Dividend on stock shares, capital shares
Holding companies	Dividend to be redistributed in following year	Dividend that will not be redistributed in following year
Investment companies		The total dividend with entitlement to deduction of dividend paid
Other companies	Dividend on participation exemption shares	Dividend on capital shares

Open group contributions

Open group contributions refers to a transfer of income from one group company to another which is openly re-

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ported in the tax return of both companies. The contribution is deductible for the transferring company and taxable for the receiving company whether or not the contribution can be regarded as an expense of the activity of the transferring company and whether or not there is any connection between the activities of the 2 companies. The connection of ownership is alone sufficient to make group contributions possible. According to civil law, group contributions may be said to represent an informal channel for the profits of the transferring company even if for tax purposes the profit is transferred. The rules for group contributions are consequently closely connected to the rules exempting from taxation dividends received by companies. Thus, a group contribution is deductible for the transferring company only on the condition that the contribution does not result in the circumvention of the regulations governing liability to tax on dividends. From this it follows that the group contribution rules must be framed differently for contributions to subsidiaries and contributions to parent companies.

Group contributions can go a long way toward equalizing the liabilities of companies in the group. This is facilitated by the fact that the contribution does not have to be a cash payment. It is sufficient for a credit to be made in the accounts.

As a group contribution can be regarded as an alternative to taxing the group as a whole on a consolidated basis, certain requirements must be met before the group contribution can be made. The requirements to be met are partly ownership and qualifying activity requirements and partly formal reporting requirements.

The requirements can be summarized as follows:
(1) Both the transferring and the receiving company must be a Swedish company. The parent company may be an Ltd, an incorporated association, a savings bank or a mutual insurance company. The subsidiary may be an Ltd or an incorporated association.

(2) The parent company must own more than 90% of the shares in the subsidiary. It should be noted that what is important is the percentage of the shares owned; the voting rights carried by the shares are of no relevance. This ownership requirement means that open group contributions can only be made within authentic groups.

(3) Neither the transferor nor the recipient of group contributions may be life insurance companies, standard-taxed building societies, investment companies or holding companies. The distinction between holding and investment companies and other companies has already been discussed.

(4) To prevent group contributions from being used to postpone taxation in groups, the contribution must be fully reported by both transferor and recipient in their tax return for the same year.

(5) Subsidiaries, whether making or receiving group contributions, must be wholly owned for the entire fiscal year. Although the requirement is not strictly met if a change of ownership occurs within a fiscal year, in practice it has been considered met if the change of ownership was made within the group.

(6) As mentioned above, group contributions from a subsidiary to a parent company are only deductible if the parent is entitled to receive tax-free dividends from the subsidiary. This rule is intended to prevent circumvention of the cumulative taxation rules by means of open group contributions. To prevent avoidance of dividend taxation by transferring contributions to the parent via another subsidiary, special rules have been introduced for contributions between sister companies. Deductions for such contributions are allowed either if the receiving company cannot pay a dividend to the parent company or if both the transferring and the receiving company are entitled to pay dividends tax-free to the parent company.

(7) The regulations described above are concerned only with contributions between parent and subsidiary companies and between sister companies. There might be, however, a need to transfer contributions to or from lower tier companies in a group. In the case of contributions from higher tier companies to lower tier companies (for example from a parent company to a second tier subsidiary), these are acceptable group contributions for tax purposes if the relationship between transferor and receiver is such that merger between the companies involved would be possible, either directly or indirectly. Merger, for these purposes, would require 90% ownership.

A kind of contribution from a second tier subsidiary to a parent company which is not discussed above is where the contribution must be retraced step by step to ascertain whether it could have been made via another group company or other group companies and thence to the final recipient. If the retracing procedure indicates that the contribution could have been made at each step, there is entitlement to a deduction. If on the contrary there is a break in the cumulative, for example because a transferring company would not have been able to pay tax-free dividends, a deduction is not permitted.

To sum up, one may say that group contribution is a transfer of untaxed profit between 2 companies. Such a transfer may be made only on the condition that a substantial connection exists between the companies and that the transfer does not lead to circumvention of the cumulative taxation rules. Contributions can only be transmitted within genuine groups and not between companies which are connected because they are owned by the same individual.

INTRA-GROUP TRANSACTIONS

Disguised profit shifting between 2 companies occurs where the pricing of transactions or the terms of an agreement deviate from what would have been agreed between independent parties. Rules for the tax treatment of disguised profit shifting previously existed only in relation to profit shifting involving foreign countries. Rules on profit shifting between domestic companies liable to tax have been totally ineffective. This does not mean that disguised profit shifting has been permitted in all circumstances, nor that it has been totally forbidden.

A disguised shifting of profit in fact amounts to a disguised group contribution. Therefore, the pricing of agreed transactions has previously been accepted with no taxation adjustment provided that an open group contribution could have been transmitted between the 2 companies. There has been a condition, however, that the character of the assets in question must not change after the transfer from circulating to fixed assets. In certain cases, even where no entitlement to make a group contribution existed, no withdrawals taxation adjustment has been made in practice.

Under the new tax system the basic rule is that transfers of assets between companies in groups must be effected at a price corresponding to market value. This applies whether

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the entitlement to make group contributions between companies exists or not. A pricing that differs from market value will therefore in principle always lead to a taxation adjustment for both companies. A taxation adjustment will also be made if an asset is distributed.

The consequences of taxation will be different depending on the type of asset transferred. The basic rule will be complemented by a rule allowing for postponement of liability and a more general exemption rule. A tax deferral will always be granted if the transfer is of participation exemption shares. Under the exemption rule other assets as well as participation exemption shares may be transferred without any tax consequences provided that certain conditions are met.

Basic rule

A price that deviates from the market value indicates that a disguised shifting of profit has been effected between the companies concerned. This profit shifting has the character of a dividend if the profit was shifted from a subsidiary to its parent company. This will be the case where the subsidiary has disposed of an asset to the parent company at undervalue or has acquired an asset from the parent company at overvalue.

A shifting of profit from the parent company to the subsidiary occurs where the subsidiary sells an asset to the parent company at overvalue or acquires an asset from the parent company at undervalue. In this case the profit transaction has the character of an outright contribution to capital.

For the transferring company neither dividends nor contributions to capital are deductible for tax purposes. A profit shifting transaction with the character of a distribution of profit to the parent company may be taxable in that company's hands. This is the case if the shares held by the parent company in the subsidiary are stock shares. For the receiving subsidiary, an outright contribution to capital is not taxable but increases the acquisition cost of the shares.

As the profit for the selling company is based on market value a sale price lower than market value will result in withdrawals taxation for the selling company. Such transfer pricing whether at over or undervalue will generally lead to a similar adjustment to the acquisition value in the buying company which will be significant for future sales.

The basic rule may be summarized as follows:

Transfer from subsidiary to parent company

(1) *Sale at undervalue*
Subsidiaries must pay tax on the difference between the market value and the sale price as for withdrawals. If the parent company is not liable to tax on dividends from the subsidiary, the parent company does not have to pay tax on such transfers which are in the nature of dividends. The assets acquired by the parent company are deemed to have been acquired at a price corresponding to market value. A sale at this price followed by the receipt of a tax-free dividend in an amount equal to the difference between sale price and market value would have given the same result.

(2) *Sale at overvalue*
The difference between the sale price and the market value is deemed to be a contribution to the share capital of the subsidiary. The profit calculations are therefore based on market value, which is also taken to be the acquisition cost of the asset concerned. For the parent company, the contribution to capital increases the acquisition costs of shares in the subsidiary.

Transfer from parent company to subsidiary

(1) *Sale at undervalue*
The parent company is taxed as for withdrawals on the difference between market value and sale price. The difference is deemed to be a contribution to share capital by the parent company and consequently increases the acquisition cost of the shares in the subsidiary. Because this contribution increases the capital of the subsidiary tax-free, the subsidiary may account for the acquisition cost of the asset at market value.

(2) *Sale at overvalue*
The acquisition cost for the subsidiary of the assets acquired is market value. The surplus over market value is deemed to be a dividend to the parent company. It is therefore not deductible for the subsidiary but may be assessable in the hands of the parent company. Market value is the basis for profit calculations on the sale by the parent company.

The basic rule is modified somewhat in the case of transfers between companies in groups where the parent/subsidiary relationship does not exist. For example, in the case of profit shifting between sister companies, the deviation of pricing from market value is deemed to have been prompted by the parent company. A disguised dividend may therefore be deemed to have been received by the parent company and a contribution to share capital to have been made by the parent company. In other respects, the taxation of the sister companies will follow that described above (for both the selling and the purchasing company).

Previously, capital gains on certain fixed assets, among them real estate, condominium units and interests in a partnership were taxed under the category of income from casual activities. The basic rule produces the result that profits and losses on such assets are treated differently. Where there is a profit the selling company will be taxed according to the normal rule except where advantage may be taken of the postponement rule. The acquisition cost of the asset for the purchasing company is deemed to be market value.

A loss on the disposal of such assets, however, is not deductible unless it has a real effect on the group as a whole. Consequently, the purchasing company takes over the assets at original acquisition cost together with any unutilized depreciation from the selling company. When the loss is subsequently realized it is deductible only if it is a real loss and not simply a book loss. When calculating losses on the sale of shares in a subsidiary, all intra-group transactions treated as dividends and group contributions made by the selling company are to be taken into account. If the so-called exemption rule (see below) has precluded taxation on the transfer of assets from a company (either as a withdrawal or as a dividend) any profit shifting must be taken into account when calculating the losses.

The deferral rule

The deferral rule means that capital gains on transfers of shares between companies within the same group are not taxed. Rather, the purchasing company takes over the acquisition value and date from the selling company, so that tax will be charged when the shares are sold outside the

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group. The postponement still applies even should the shares in the purchasing company be sold outside the group.

To qualify for deferral the transfer must be made to a Swedish company in the same group. (If the transfer is made to a foreign company, tax relief may be afforded by way of exemption.) A further condition for qualification is that the transfer of shares must be connected with the activities of the group. Previous practice (and according to "travaux préparatoires" this will still be relevant under the new law) required the ownership of the shares to be determined by considerations relating to the activity of the group. In other words, what is contemplated is participation exemption shares.

In addition to shares the deferral rule also encompasses interests in partnerships, incorporated associations and foreign legal entities.

The exemption rule

It is not the intention behind the basic rule that disposals of stock and business assets other than participation exemption shares undervalue should always be taxed on the transferring company as withdrawals. The rule governing the taxation of withdrawals is therefore supplemented by an exemption rule, whereby withdrawals taxation will not apply in certain special circumstances. According to "travaux préparatoires" there would be no withdrawals taxation in such circumstances, as was the general practice previously. Without the explicit support of legislation, general practice has admitted exceptions from the basic rule in various types of company restructuring, for instance, when an activity carried on as a sole proprietorship has been transferred to a company owned by the sole proprietor. The rationale in such cases seems to be derived from discussions about the capacity of the taxpayer to pay tax and from common sense. It has been considered reasonable that a sole proprietor wishing to convert his firm into an Ltd should not be subject to withdrawals taxation provided that certain conditions are fulfilled.

In practice, assets may be transferred from one company to another in the context of restructuring at favourable values for tax purposes even where market value is considerably higher, on the following conditions:

– Assets may not be transferred outside the scope of double taxation. Transfers may thus be made between 2 Ltds and between one Ltd and an incorporated association. Transfers may even be made from a partnership to an Ltd but not from an Ltd to a partnership of natural persons.

– Transfers of current assets that become fixed assets in the hands of the recipient do not qualify for the exemption. It is, however, immaterial if fixed assets become current assets after transfer.

– There must be a high degree of common ownership. While this is not often relevant in the context of transfers between 2 companies in a group, the requirement is more important in the context of transfers between companies in a group of minority-owned associated companies.[7]

– The transfer must constitute a restructuring undertaken for organizational purposes. The transfer must therefore represent the whole of the transferor's business or a well-defined part of that business. This condition is still surrounded with a great deal of uncertainty. Previously, exemption from withdrawals taxation has been obtained even when the transfer related to single assets. Current practice indicates that the conditions are now considerably more restrictive.

TRANSACTIONS BETWEEN COMPANIES IN GROUPS OF MINORITY-OWNED ASSOCIATED COMPANIES

The rules on the deduction of losses on the disposal of assets, gains on the disposal of which are treated as capital gains, have already been outlined above. Such losses are deductible only if they are real losses and when they are incurred by the group as a whole. This limiting rule generally applies where the transfer is between companies with joint management. In keeping with this, the limiting rule is also applicable if the transfer is between companies in a group of minority-owned associated companies.

The exemption rule explained above is a direct outcome of practice developed in connection with, amongst other matters, transfers of assets between companies in a group of minority-owned associated companies. It is therefore evidently directly applicable to such transactions. If the exemption rule does not apply, a withdrawal is deemed to be made by the shareholders of the selling company immediately followed by an outright contribution to capital by the shareholders of the selling company to the purchasing company. A transfer at undervalue therefore brings about withdrawals taxation for the transferring company and dividend taxation for the shareholders. If a transferring company is a close company, the second leg of double taxation follows the rules for close companies. Tax is therefore charged under the schedule for employment income (see above). If the transferring company is not a close company, the tax will probably be charged under the schedule for income from capital.

CONCLUSION

The main rule on transfers of assets between 2 companies in common ownership is that the transaction should be effected at market prices. This is so irrespective of whether or not the companies are entitled to make group contributions to each other.

A price that deviates from the market price will always lead to a taxation adjustment affecting both companies. A sale at undervalue leads to withdrawals taxation on the transferring company – this is never so in the case of sales at overvalue. Depending on the direction of the transaction, a transfer which deviates from market value leads to dividends taxation and/or the provision of a tax-free contribution to capital.

The basic rule does not apply to most transfers made in connection with restructuring. This is the case in mergers between parent companies and subsidiaries, a topic which

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7. In a case concerning a group of minority-owned associated companies, a change of almost 24% in the ownership of both companies was accepted. See Supreme Administrative Court Reports (hereinafter referred to as "RÅ") ref. 19, alternative B. However, in another case, a 46% change of ownership was not accepted. See RÅ ref. 19, alternative A. The judgement in the latter case was influenced by the fact that the transfer in question obviously had the character of a transfer of ownership to the next generation, which was not the situation in the first case.

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has not been covered in this article. Furthermore, there is a deferral rule. This, however, only applies to intra-group transfers of participation exemption shares. A more specific exemption rule may in certain instances apply to transfers of assets other than participation exemption shares. The exemption rule is valid for both intra-group transfers and transfers between companies in groups of minority-owned associated companies.

Conference Diary

AUGUST 1990

44th Congress of the International Fiscal Association: I. Taxation of Cross-border Leasing; II. International mutual assistance and exchange of information. Seminars: 1. The Nordic multilateral tax treaty; 2. Double tax treaties between industrialized and developing countries, the OECD and U.S. models – a comparison; 3. The extension of tax sovereignty – especially in connection with emigration; 4. Tax reform in Scandinavia. Stockholm, 26-31 August (English, French, German, Spanish):
International Fiscal Association, World Trade Centre, P.O. Box 30125, 3001 DE Rotterdam, The Netherlands.

SEPTEMBER 1990

U.S. Tax Course: Fundamental elements of U.S. corporate taxation; U.S./International taxation: Tax Strategies for Cross Border Activities. Manly NSW, Australia, 3-7 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Internationale Steuerberaterseminare Deutschland – Belgien – Niederlande – Basisseminar Deutschland. Neuss (near Düsseldorf), 7-8 September (Deutsch):
Bundessteuerberaterkammer, Postfach 1340, D-5300 Bonn I, Federal Republic of Germany.

Autumn Residential Tax Update Conference. Nottingham, 7-9 September (English):
The Secretary, The Institute of Taxation, 12 Upper Belgrave Street, London SW1X 8BB, United Kingdom.

Das neue Steuer- und Gesellschaftsrecht der DDR. Berlin, 10 September (Deutsch):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

Monte-Carlo Workshop: Entertainers and Athletes (inbound transactions); Taxation of international shipping. Monte-Carlo, 17-18 September (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

The Tax Effective Management of an International Treasury. London, 20-21 September (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

7th European Congress of Tax Consultants. Cannes (France), Lectures 27 September, working group 28 September (multilingual):
C.F.E. General Secretariat, Dechenstrasse 14, Postfach 1340, D-5300 Bonn 1 (G.F.R.).

OCTOBER 1990

Taxation of Unit Trusts – the New Rules. London, 3 October (English):
Oracle Business Information, 8 Bartok House, 30 Lansdowne Walk, London W11 3LT, United Kingdom.

Holdingstructuren. Amsterdam, 5 October (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

U.S. Expatriate Taxation: Estate & Gift, Benefits/Retirement Plans & Financial Planning. London, 8-12 October (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Europees Economisch Samenwerkingsverband. Breda, 10 October (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Taxation, Trade and Investment in the European Communities. New York, 15-17 October (English):
ALI – ABA, 4025 Chestnut Street, Philadelphia, Pennyslvania 19104, U.S.A.

International Conference on Computer and Law, organized by the Buenos Aires Bar Association and the French Association pour le Développement de l'Informatique juridique. Buenos Aires, 16-19 October (English, French, Spanish):
Secretaria del Congreso Internacional de Informatica y Derecho, Uruguay 485, piso 3°, 1015 Buenos Aires, Argentina.

International Taxation – Management Techniques: Transfer Pricing; Mergers and Acquisitions. Paris, 18-19 October (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Joint International Tax Planning Conference, Brighton, 18-19 October (English):
P.O. Box 433, Chartered Accounts' Hall, Moorgate Place, London EC2P 2BJ, United Kingdom.

Internationale Steuerberaterseminare Deutschland – Belgien – Niederlande – Basisseminar Deutschland. Osnabrück, 19-20 October (Deutsch):
Bundessteuerberaterkammer, Postfach 1340, D-5300 Bonn I, Federal Republic of Germany.

NOVEMBER 1990

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

ITPA Maui Seminar: e.g. Private Banking in the Pacific Rim; Investment in Taiwan; New Offshore Centres, Belize, Labuan, Western Samoa, Maui, Hawaii, 15-16 November (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

International Conference on Corporate Tax Strategy and Intercompany Pricing. 19-20 November (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

DECEMBER 1990

Taxation of Branches and Subsidiaries, Brussels, 13-14 December, (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

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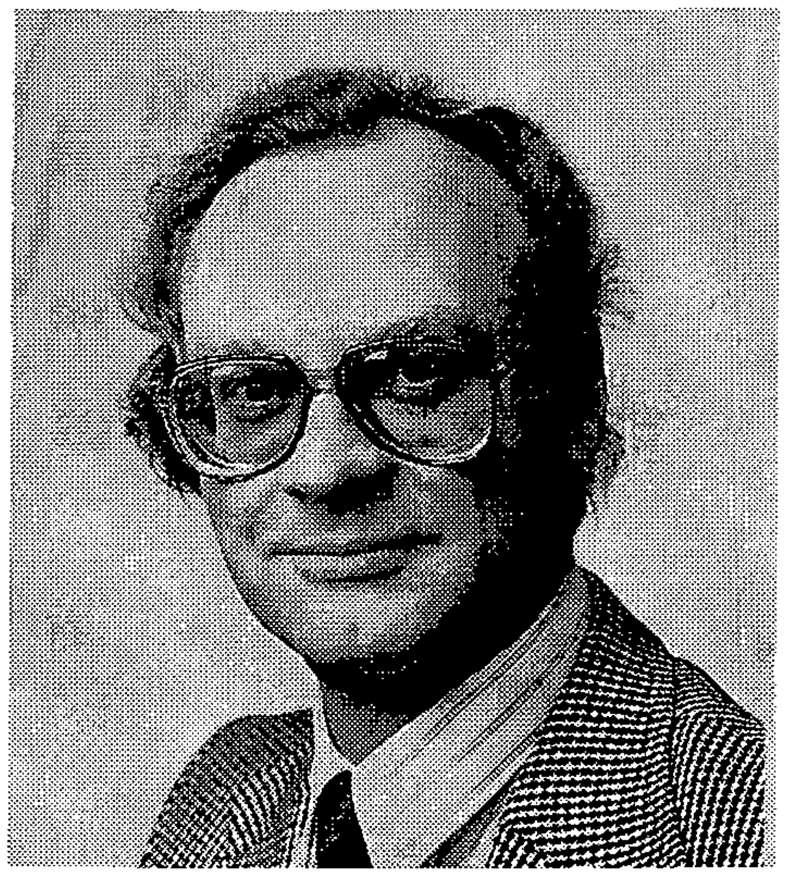
SWEDEN:

Foreign Holding Companies and the Luxembourg Rule

Kent Simon



Mr. Simon is an assistant professor and has lectured on Swedish tax law at the University of Växjö since 1980. As of 1989 he has worked as a tax adviser and partner of Vinge-Grosskopf Skattekonsulter KB.

I. INTRODUCTION

Swedish-owned international groups have increasingly made use of holding companies. Many such holding companies have been established in foreign countries. The purpose of establishing a foreign holding company is often to optimize the tax costs of the group. Principally this is achieved by using a holding company to reduce foreign withholding taxes on capital flows from operating subsidiaries abroad to the parent company in Sweden, and to equalize the income of subsidiaries established in the same country.

This article analyzes the Luxembourg Rule which applies to foreign holding companies and is likely to become more widely applicable because of the liberalization of the Swedish currency regulations. The new rules defining a foreign company are also discussed.

II. LIABILITY TO TAX

A. Normal rules

Swedish companies are liable to corporation tax on their world-wide income (unlimited tax liability). Foreign companies are liable to tax only on certain Swedish-source income (limited tax liability).[1] The same applies to foreign legal entities other than companies which are liable to pay a tax on income in the country in which they are resident which is of a kind similar to that paid by Swedish companies.

For the purposes of determining whether unlimited or limited tax liability exists in Sweden, Swedish tax law distinguishes Swedish companies, foreign companies and other foreign legal entities. Companies are formed, and generally registered, in a particular country in accordance with the laws of that country. Companies also have organizational structures consisting of managers, boards of directors (where necessary) and shareholders who exercise their rights through the medium of shareholders' meetings. These 2 factors allow the residence of a company to be determined either by reference to such formal criteria as the place where a company is incorporated and registered (where this is applicable) or on the basis of where the company's central management is exercised.

To determine whether a company is a Swedish company, Sweden uses the place of incorporation test. A company formed in accordance with the Swedish Companies Act and registered with the Swedish Patent and Registration Office is a Swedish company and therefore taxed on its world-wide income.

The definition of a foreign legal entity requires that, under the law of the country in which it is resident, the entity has legal capacity, has its own property which the individual partners may not dispose of without authorization and is able to sue before a court.[2] A company formed and registered abroad normally satisfies the conditions required for it to be regarded as a foreign legal entity. For a foreign legal entity to be considered a "foreign company" for Swedish tax purposes it must either be recognized in a tax treaty concluded by Sweden with the country where the company is established, or if no tax treaty exists, be subject to a tax that is similar to that paid by Swedish companies. If neither of these conditions are satisfied, the foreign entity will not be deemed to be a "foreign company", but an "other foreign legal entity". A shareholder resident in Sweden will be taxed on his share of the income of the foreign legal entity if the shareholder's interest and the interests of the other Swedish shareholders constitute a controlling interest in the foreign legal entity.

B. The Luxembourg rule

After a proposal from the Parliamentary Committee for Company Taxation of 1928 [hereinafter referred to as the "1928 Committee"], the Luxembourg Rule was adopted in 1933.[3] It concerns certain holding companies established abroad. The rule is a specific anti-avoidance rule and calls for specific examination of the company concerned. In many cases, the activities of a holding company consist of making investments, receiving dividends on shares, preparing annual accounts and distributing dividends. This does not require an extensive management organization – indeed in such circumstances it is possible for the management duties

1. National Income Tax Act [hereinafter "SIL"] Sec. 6(1).
2. SIL, Sec. 16(2).
3. The Swedish Government Official Reports [hereinafter referred to as "SOU"] 1931, 40.

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to be performed by a management service company. This means that a holding company can be established virtually anywhere. The experience of the 1928 Committee was that holding companies had been established in countries with favourable tax regimes. As these holding companies were neither incorporated nor registered in Sweden, their tax liability in Sweden was limited (to certain Swedish-source income).

The 1928 Committee took the view that for practical reasons registration should remain the test for deciding whether a company is a Swedish company or a foreign company. However, an exception should be made in the case of companies which, though registered abroad, are really Swedish companies. In such cases, the holding company would be treated and taxed as a Swedish economic association.[4]

According to the wording of the Luxembourg Rule, 4 conditions must be met if the rule is to apply:

(1) The company or other legal entity carrying on economic activities must be established outside Sweden.
(2) The activity of the entity must consist essentially of holding or trading in securities or other similar kinds of movable properties.
(3) The entity either, directly or through another legal entity, must be mainly owned or effectively owned by Swedish individuals.
(4) The actual management of the entity must be carried out in Sweden.

(1) Condition 1

The wording of the rule requires the entity to be a legal entity and to be established outside Sweden, for example, a company incorporated and registered according to the laws of the foreign country of incorporation. The crucial point is that the company's tax liability in Sweden should be limited, as this is the tax advantage the rule is aimed to remove. As formal criteria are used to determine residence, a company registered abroad will be deemed to be a "foreign company" and therefore to have only limited tax liability in Sweden.

The Luxembourg rule applies both to foreign entities that are deemed to be "foreign companies" and to "other foreign legal entities". Under Swedish tax law, "other foreign legal entities" are regarded as fully transparent for tax purposes if the Swedish shareholder concerned owns at least 10% of the equity or voting power and if all the Swedish shareholders taken together own at least 50% of the equity or voting power. However, if an "other foreign legal entity" is considered to be a Swedish economic association because the Luxembourg rule applies, it will not be transparent for tax purposes. For example, if a Swedish resident individual owns all the shares of a company established in a country with a favourable tax climate and this company pays only a small lump-sum tax which is not of a kind similar to the tax paid by a Swedish company, the foreign company would normally be treated as an "other foreign legal entity" and fully transparent for tax purposes. However, if the Luxembourg rule applies, the company will be deemed to be a Swedish economic association and thus not transparent.

In the original proposal of the Luxembourg Rule there was a suggestion that only companies should be included but in the committee report the wording was changed to "company or other legal entity", in order to bring foreign foundations and other such entities within the scope of the rule.[5]

(2) Condition 2

The activities must consist essentially of holding or trading in *securities or other similar kinds of movable properties*. In the original proposal it was suggested that the rule should also encompass holding of and trading in Swedish real estate. This suggestion was rejected in the committee report as the companies in question are not able to own Swedish real estate without permission from the Swedish authorities. In other respects the rule was to be so worded as to encompass securities in the widest possible sense. This led the Committee to adopt the phraseology "securities or other similar kinds of movable properties". All securities are included, not only Swedish securities. There is no explanation of the meaning of "securities or other similar kinds of movable properties" in the "travaux préparatoires" other than the statement that "securities" is to be interpreted as broadly as possible. One view is that no further explanation is required because the meaning of "similar kinds of movable properties" depends on the meaning of "securities". If the meaning of securities is interpreted widely, there is no need to give a wide meaning to "similar kinds of movable properties". Conversely, if the meaning of securities is interpreted narrowly then "similar kinds of movable properties" becomes a broader category. The broad interpretation to be given to "securities or other similar kinds of movable properties" has the effect of including even trading in trade debtors within the scope of the rule.

Difficulty arises where the holding of securities is combined with another activity, which may take a number of different forms, for example the holding of patents or real estate or consulting activities. The problematic aspect of such side activities was observed by a later Committee.[6] This committee's report acknowledges that comparing the holding activity and the side activity may be difficult. The effect of even a small-scale side activity can be that the holding activity is not the essential activity and that the rule therefore does not apply. The Committee of 1962 suggested that the rule might be more effective if it was enough that the income to a considerable extent originated from the holding activity or if the income essentially consisted of royalties. However, the rule was not amended.

The holding activity must consist *essentially* of holding or trading in "securities or other similar kinds of movable properties". The word "essentially" is not explained in the "travaux préparatoires" to the rule. If there is a side activity, it is necessary to determine whether the holding activity (including trading in securities) is the essential activity. In Swedish tax law a Swedish holding company is defined as an entity which is exclusively or almost exclusively engaged in holding securities or similar kinds of movable properties.[7] In practice, a Swedish holding company may have a side activity constituting 4%-5% of its total activity without losing its character as a holding company. The term "essentially" is less restrictive than "exclusively or almost exclu-

4. A Swedish economic association is a separate legal entity (if registered) in which the liability of its members is limited to an individual member's capital contribution. This form of business association is used by cooperatives. For tax purposes, a Swedish economic association is generally treated as a company.
5. The Standing Committee of Taxation [hereinafter referred to as "BEV.U."] 1933, 64.
6. SOU 1962, 59.
7. SIL, Sec. 7(8).

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sively". In the proposal to change the wording of the Luxembourg rule the Committee said, regarding side activities that the holding activity should be the company's major activity, i.e. it should represent more than half of the total activities.[8]

There is still uncertainty over the meaning of the word "essentially". What seems clear is that side activity on a negligible scale does not preclude application of the Luxembourg rule. It may be observed that the word "essentially" is also used in the Act which governs the tax on the undistributed profits of companies.[9] This Act came into force at the same time as the Luxembourg Rule and one might presume that the word "essentially" would have the same meaning there as in the Luxembourg Rule. Some guidance might therefore be sought from court cases concerned with this Act.[10]

(3) Condition 3

This condition concerns the ownership of the holding company if the Luxembourg Rule is to apply. The holding company must, either directly or through another legal person, be mainly owned or effectively owned by Swedish individuals. In the original proposal it was suggested that the wording should be "the entity (must be) mainly owned by Swedish individuals".[11] However, in the Bill the wording was made more comprehensive to cover the situation where, although the majority of the shares in a holding company are not formally owned by Swedish resident individuals, Swedish individuals have a secured option to buy the shares at a fixed price. Such an arrangement is considered comparable to actual ownership of the shares. Even an arrangement whereby the shares are held in trust – provided that the settlement is not irrevocable – would probably constitute ownership of the shares, that is the shares would be regarded as effectively owned by the settlor.

The Luxembourg Rule does not apply where a foreign holding company is owned by a Swedish company and the shares in the Swedish company are owned by a large number of Swedish individuals. A Swedish listed company can therefore own a foreign holding company without running into problems with the Luxembourg Rule. An isolated individual shareholder in a Swedish listed company has no control over the foreign holding company and therefore no power to dispose of its assets or income. It is difficult to say precisely how many shareholders the Swedish company must have to escape the Luxembourg Rule. There must be a sufficient number of shareholders to prevent one shareholder or a small group of shareholders having such a degree of control over the Swedish company as to give it the same control over the foreign holding company as it would have if it owned the foreign holding company directly. Of course it is also possible for Swedish individuals to own shares in a foreign holding company directly, without activating the Luxembourg rule, provided that no one of the shareholders has any control over the foreign holding company.

The shares in the foreign holding company must be *mainly* owned by Swedish individuals. The meaning of "mainly" is not explained in the "travaux préparatoires" to the Luxembourg Rule. A later Committee understood the meaning to be that more than 50% of the shares of the foreign holding company should be owned, directly or indirectly, by Swedish individuals.[12]

The word "mainly" occurs frequently in Swedish tax law and its meaning varies widely from context to context. Sometimes "mainly" corresponds to 70%-80%, sometimes to other percentages. It must be remembered that the Luxembourg Rule is intended to apply to companies which in reality are Swedish but which are registered abroad. In many cases it is possible to dictate the decisions of the shareholders meeting with a share ownership of just over 50%. As this would allow the board of directors to be appointed and the management to be exercised in Sweden, to interpret "mainly" to mean slightly over 50% would not conflict with the intention of the rule.

(4) Condition 4

This condition requires that the actual management of the entity be exercised in Sweden. It is not absolutely clear what this means. The "travaux préparatoires" to the rule indicates that what are to be taken into consideration are actual facts. The appointment of persons who formally answer for the management of the entity, hold meetings, take care of correspondence and so on, is not relevant. Nor is the place of permanent establishment.

It is as well to remember the context in which "the facts" are to be considered. As pointed out above, the activity of a holding company can be summarized at its simplest as receiving dividends on shares, receiving and forwarding correspondence, preparing an annual report and distributing dividends to shareholders. There is no need for a large-scale organization to perform these duties. The necessary formal organization consisting of a board of directors and possibly a manager or secretary can quite well be set up in the country where the company is established.

The broader strategic decisions are made by the board of directors while the operational procedures are carried on through managers. If the activities of both the board of directors and the managers are carried on in the country where the company is established, it would be difficult to argue that the actual management of the company is exercised in Sweden. The fact that the shareholders of the company are Swedish individual residents is not of itself sufficient to make the Luxembourg Rule apply.

According to the "travaux préparatoires", the introduction of the Luxembourg rule implies the application of a principle, which, though new to Sweden, is already established in the United Kingdom. It is therefore of some interest to consider how the United Kingdom has dealt with the problem of where the "actual management" is located. According to U.K. tax law, a company incorporated abroad is usually regarded as resident for tax purposes in the country where the company's directors meet. However, the location of directors' meetings is not necessarily conclusive. The degree of independence of the directors in relation to the shareholder (often a parent company) is also important. If instructions regarding financing, production, investment, etc. emanate from the parent company and the directors' meetings of the subsidiary are merely a façade and have no substance, the subsidiary may be regarded as centrally managed and controlled in the parent company's country of residence.

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8. SOU 1962, 52.
9. The Tax on Undistributed Profits of Companies Act, Sec. 1.
10. In a case where the value of the securities held by a company slightly exceeded the value of its other assets the Supreme Administrative Court held that the activities of the company consisted essentially of holding securities. See Supreme Administrative Court Reports [RÅ] 1945, ref. 10.
11. Government Bill 1933, 171.
12. See supra, note 6.

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It would seem that such an approach would also sometimes be justified in Sweden. Let us suppose that the board of directors of the foreign holding company consists of Swedish resident individuals, who also own the shares of the company, and that the day-to-day management of the company is carried on by a local trust company – under what circumstances can the actual management be said to be exercised in Sweden? The question arises as to how much weight shall be given to the fact that the day-to-day management of the foreign holding company is carried on by a local trust company. The rights and duties of the trust company can be stipulated in a management agreement. The duties of the manager are to ensure that the company fulfils its obligations and to carry out other specified instructions relating to the activities of the company. Certainly, it can be said that the manager carries out the management, but does this also mean that the "actual management" is carried out by the manager? If this were the case, it would seem that very few foreign holding companies would fall within the scope of the Luxembourg Rule because in practical terms it is very difficult to manage the day-to-day business of a company from Sweden. "Actual management", therefore, would seem to refer more to decision making at the highest level.

We should therefore turn our attention to that part of the company organization where the essential decisions are made. It would seem that in the first instance this should be the board of directors. If the majority of the board of directors consists of non-Swedish resident individuals, if all the board meetings are held in the country where the foreign holding company is established, and if all decisions are taken there and the day-to-day management is carried on there, it would be very difficult to argue that the actual management of the company is exercised in Sweden. Conversely, the fact that the shareholder(s) and some of the board members are Swedish residents would not be sufficient to meet this condition for the operation of the Luxembourg rule. Consideration must be given to all the circumstantial evidence and if this evidence indicates that the board meetings in the foreign country are a façade and have no substance, that decisions are really made in Sweden and that instructions really emanate from Sweden, the rule would apply. The decisive influence must be exercised in Sweden. In the United Kingdom all the evidence is weighed to establish the degree of independence of the directors of the foreign company. It would seem that Sweden should take a similar approach.[13]

(5) The burden of proof

It is incumbent on the tax authorities to submit a report which suggests that the Luxembourg Rule applies to a particular foreign holding company. The company concerned must then show that the conditions for applying the rule are not met. This does not represent any departure from the ordinary rules regarding the burden of proof.

If the rule is found to apply, the difficulties may not end there. The company must present an income tax return and failure to make such a return constitutes a reason for the tax authorities to make a discretionary assessment. It should be noted that a discretionary assessment cannot simply be used as a sanction – the purpose of the discretionary assessment must be to achieve fair assessment.

The majority of the tax treaties concluded by Sweden contain an article providing for an exchange of information on tax matters. In cases where there is such a tax treaty, the treaty may enable the tax authorities to obtain material on which to base an assessment. If there is no tax treaty the tax authorities' task will probably be extremely laborious. Ultimately the effectiveness of the Luxembourg Rule probably depends on the willingness of the taxpayers themselves to provide the necessary information.

(6) Tax treaties

The test for determining the residence of a company in the OECD Model Double Taxation Convention is as follows: "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 his . . . place of management or any other criterion of a similar nature."[14] The fiscal residence of a company is in the first instance to be determined by using the internal rules of both contracting states. If one of the contracting states uses a formal criterion to determine company residence such as the place of incorporation (which would be classed as "a criterion of similar nature") and the other state the place of management criterion, a dual residence situation may arise. A subsidiary rule then comes into play. This subsidiary rule states that where "a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated."[15] The existence of this subsidiary rule in its treaties makes it possible for Sweden to invoke the Luxembourg Rule.

In concrete situations the relevant tax treaty must be studied carefully. Generally the wording of the subsidiary rule is as given above, but there may be variations. Under the tax treaties concluded by Sweden with Japan and the People's Republic of China, a company which, under the main rule, is a resident of both contracting states is deemed to be a resident of the contracting state in which its head office is situated (or in the case of Japan, its head or main office). In many cases the place of effective management is situated where the head office is situated, so that the result is the same as if the expression "effective management" had been used. In other tax treaties, e.g. those concluded with the United States, Canada, Indonesia and Thailand, the subsidiary rule leaves it to the competent authorities to determine the company's fiscal residence by mutual agreement.

In cases where a tax treaty exists, the problem of dual residence (which arises because the Swedish tax authorities

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13. A case in point concerned a holding company established in Switzerland and owned as to 245 out of its 250 shares by a Swedish resident individual. The board of directors consisted of a Swiss resident. The National Tax Board considered that the Swiss company was a company which fell within the compass of the Luxembourg Rule. The Supreme Administrative Court upheld the ruling of the National Tax Board. As no explanation was given for the National Tax Board's ruling, it is only possible to speculate on why the Rule was considered to apply. It is not known where the board meetings were held, but it may be that in any case the board of directors was only a formal body and that the essential decisions regarding the company were taken by the Swedish shareholder in Sweden. The actual management would then have been exercised in Sweden. There is nothing in the case which necessarily contradicts the opinion expressed by the author. See Judicial Commission of the National Tax Board [RN] 1958, 3:7.
14. Revised text of the Model Double Taxation Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital (1977) (as submitted by the OECD Committee on Fiscal Affairs to the OECD Council), Art. 4(1).
15. Ibid, Art. 4(3).

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consider that the Luxembourg Rule applies) may be resolved by reference to the treaty.

(7) Taxation as a Swedish economic association

If the Luxembourg rule applies the foreign holding company is treated as a Swedish economic association for tax purposes. This means that the company is liable to tax in Sweden on its world-wide income. On the other hand, the company is entitled to the benefits which the tax law grants to a Swedish entity.

The income of the holding company will largely consist of dividends on which it will be liable to tax in accordance with Swedish domestic tax law, subject to the provisions of a tax treaty where relevant. Swedish holding companies (including economic associations) are only liable to tax on dividends received from Swedish companies if the dividends are not redistributed the following year.[16] Dividends received from foreign companies are taxable income. Most of the tax treaties concluded by Sweden have the effect of making the provisions of domestic tax law which exempt dividends received from Swedish companies applicable to dividends received from foreign companies. This means that in cases where there is such a tax treaty, dividends from foreign companies will be tax-exempt provided that the dividends are distributed to the shareholders. If there is no tax treaty the tax exemption may still be extended, at the request of the company, to dividends received from foreign subsidiaries, provided that foreign subsidiaries are subject to taxation in their resident country which is comparable to Swedish national income tax. Foreign holding companies which are treated as Swedish economic associations because of the Luxembourg Rule would also be granted this tax exemption for dividends.

As foreign holding companies are sometimes established for the purpose of reducing foreign withholding taxes, they are often incorporated in countries which have an extensive tax treaty network. In these circumstances an interesting question arises where a foreign holding company is designated as a resident of Sweden under a tax treaty between Sweden and another country. Is it possible for the company to be regarded as a resident of this other country for the purposes of a tax treaty between this other country and yet another country? In the Netherlands, the tax authorities have said that a Dutch certificate of residence may not be granted to a company with dual residence in the Netherlands and the United Kingdom, which is actually managed in the United Kingdom. The Dutch tax authorities may also consider the company to be resident in the United Kingdom for the purposes of those treaties which the Netherlands has concluded with other countries which contain an article based on Art. 4 of the OECD model treaty.[17] The tax treaty between Sweden and The Netherlands has an article which is based on Art. 4 of the OECD model.

III. CONCLUSION

In the proposal of the new Swedish tax laws there is a new definition of a Swedish holding entity.[18] A Swedish company or a Swedish economic association holding securities or similar kinds of movable properties which does not, directly or indirectly, carry on any business activity or only carries on negligible business activity will be regarded as a holding company. The activities of the subsidiaries will be taken into account in determining whether the parent company is exclusively or almost exclusively engaged in holding securities. If the subsidiary carries on business, the parent company will be taxed according to the rules for companies carrying on business activities and not according to the rules for holding companies. Dividends received by a holding company, whether or not redistributed, will be tax-exempt.

These new rules will probably have a bearing on foreign holding companies which are deemed to be Swedish economic associations under the Luxembourg Rule. If the subsidiaries of the holding company carry on business, the holding company will itself be taxed according to the normal rules and not according to the rules for holding companies. In cases where a tax treaty has the effect of making dividends received by the company tax-exempt, the exemption will no longer depend on redistribution of the dividends to the Swedish parent company.

In the past, partly because of the Swedish currency regulations the Luxembourg Rule has been of little importance. However, with the liberalization of the currency regulations the rule can be expected to take on increasing significance.

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16. SIL, Sec. 7(8).
17. See Rijkele Betten, "Denial of Certificate of Residence to a Dual Resident Company", 11 *European Taxation* (1989) at 371; see also Professor Dr. Kees van Raad, "Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence", 1 *European Taxation* (1990) at 27.
18. Government Bill 1989/90, 110.

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Controlled Foreign Company (CFC) Legislation in Sweden

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INTRODUCTION

Many countries have adopted a rule to combat the use (or abuse) of low or non-tax jurisdictions in order to defer or eliminate domestic tax in the state of residence. Sweden has 2 such rules, the Luxembourg rule, adopted in 1933,[1] and the more recent (1990) "16:2 company" legislation.[2]

Sweden subjects resident individuals and legal entities to tax on a world-wide basis. Because Sweden has traditionally imposed extremely high levels of taxation, it is not surprising that Swedish residents may be motivated to transfer their tax liability to a milder tax jurisdiction.

The Luxembourg rule was adopted by the Swedish Parliament to prevent the transfer of capital to countries which imposed a lower rate of tax. This intricate tax rule provides that a foreign holding company owned mainly by Swedish citizens and effectively managed by individuals resident in Sweden will be brought into the Swedish tax net and subjected to Swedish tax liability on the same basis as a Swedish economic association.[3]

In other words, the foreign company is effectively considered resident in Sweden for Swedish tax purposes.

When the Luxembourg rule was formulated in 1933 (and it is critical to keep this context in mind), Sweden imposed no restrictions on exchange control. However, with the advent of World War II in 1939, the Swedish Parliament adopted emergency exchange control measures. These regulations, renewed annually, were effectively retained until 1 July 1989. (However, they were abandoned a full year before the EEC recommendation to its member states.) The exchange control regulations rendered the Luxembourg rule more or less obsolete; only one rather uninteresting case was tried by the Swedish Supreme Administrative Court in 1958.[4] Recently, however, the Court published an advance ruling regarding a foreign holding company held by a Swedish quoted company (see below).[5] However, it still is not clear how the various terms in the Luxembourg rule are to be interpreted.

Sweden's next legislative effort to counter the use of low tax jurisdictions went into effect on 1 January 1990.[6] The legislation emerged in a strange and, one is tempted to say, rather surreptitious manner. A one-man government commission that was established in 1981 to scrutinize various aspects of international taxation devised a "solution" to the complex issue regarding the taxation of foreign partnership income. The "solution" was concealed in the commission's final report under the heading "miscellaneous and technical issues". Covering less than 5 pages and disguised as a proposal to clarify the definition of a foreign company, the committee (in a subordinate clause) also suggested sweeping CFC legislation, making similar rules in other countries look tame by comparison. Forceful objections from both the tax administration and the business community ultimately persuaded the Parliament to curtail the far-reaching effects of the commission proposals. An interesting and somewhat unusual aspect of the "16:2 company" legislation is that it applies only to companies established in a non-treaty country and it covers all kinds of income accruing to such companies.

The legislature has made inconsequential attempts to coordinate the Luxembourg rule and the "16:2 company" legislation. Considering that tax practice in these areas is more or less non-existent and that Swedish tax practitioners are unaccustomed to the novelty of unrestricted capital movements, the international tax consequences and certainly the solutions to this problem are obscure. This factor should be taken into account in the following admittedly incomplete presentation of certain aspects of Sweden's CFC legislation.

THE LUXEMBOURG RULE

Three conditions must be met to trigger the Luxembourg rule:

1. National Income Tax Act [hereinafter "SIL"], Sec. 3(3).
2. SIL, Sec. 16(2) [hereinafter referred to as the "16:2 company" legislation].
3. An economic association is a separate legal entity (if registered) in which the liability of its members is limited to an individual member's capital contribution. This form of business association is used by cooperatives and for tax purposes is treated as a company.
4. Judicial Commission of the National Tax Board Reports ("RN") 1958 3:7a.
5. Decision of the Supreme Administrative Court of 25 April 1990, No. 4593-1989.
6. See, supra, note 2.

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(1) the foreign legal entity must be a "holding company", i.e. a company, the "essential" purpose of which is to hold or trade in securities or other similar kinds of movable assets;
(2) the company must be mainly owned or similarly controlled directly or indirectly by Swedish citizens; and
(3) the effective management of the company must be exercised in Sweden.

The fundamental issue regarding the first condition arises in relation to foreign multi-purpose companies. As no definition is provided in the rule, what does the legislator mean by the term "essential", i.e. to what extent can the foreign legal entity engage in side activities? An educated guess would be that when 25% or more of the company's assets consist of "securities or other similar kinds of movable assets", the holding criteria are satisfied. Intangible assets such as patents, know-how, etc., however, are not considered "other similar kinds of movable assets". Otherwise, all securities, whether Swedish or not, are included and the term securities is interpreted broadly.

The major difficulty with the ownership test revolves around the meaning of the term "the company must be mainly owned". In the context of other Swedish tax regulations (e.g. the rules regarding closely held companies), "mainly" is reached at about 70-75%.

The Luxembourg rule is also silent as to whether ownership refers to capital or the voting power carried by the shares in the company. The Supreme Administrative Court has concluded that the ownership test bears only on a situation where a single or limited group of Swedish individual shareholder(s) directly or indirectly have such power over the foreign holding company that they can exercise control over its assets and profits (effectively postponing a realization or distribution).[7] For this reason the Court has held that the Luxembourg rule is not applicable to a foreign holding company owned by a Swedish company quoted on the Swedish stock exchange.[8] The Swedish stockholders of a listed company are not in a position to dictate the management decisions or the dividend policy of the foreign holding company and their interest in that company from a personal tax point of view is negligible.[9] Consequently, it appears that the ownership requirement is ascertained on the basis of the voting power carried by the shares.

The third condition which requires that the effective management of the holding company be exercised in Sweden gives rise to many awkward problems.[10] It also brings into focus tax treaty obligations in treaties where the "place of effective management" is the decisive criteria in determining company residence.

Prevailing opinion in Sweden as to the meaning of the term "effective management" in the context of the Luxembourg rule gives preference to the country where the shareholders are resident.[11] The case cited above equating ownership to the voting power carried by the shares supports this view. It also appears to comport with the purpose of the legislation, i.e. to prevent the deferral or elimination of personal Swedish tax liability.

The text of the Luxembourg rule takes account of the difference between the formal (and foreign) seat of the holding company and the effective management of the company. The "travaux préparatoires" indicate that the determination of where the effective management is exercised must be made on a case by case basis. Formalities such as where staff and board meetings are held or where permanent establishments are located are of little relevance.

The problems inherent in determining the place of effective management in a treaty context are equally difficult. The commentaries on the OECD model on this issue offer little guidance. The Swedish philosophy that the effective management of a foreign holding company is exercised in Sweden when the shareholder(s) is a Swedish resident may be unacceptable to the other contracting state. Certainly there is a risk that a Swedish court will take refuge in Art. 3, para. 2 of the OECD Model Treaty, which allows the interpretation of a domestic court to prevail where a term has not been defined and where the context of the interpretation does not require otherwise.[12]

If all 3 conditions are fulfilled the foreign legal entity will be deemed a Swedish economic association and thus subject to world-wide taxation in Sweden. The Luxembourg rule provides the only exception (in Swedish law) to the basic principle that a company's tax residence is located in the country in which it is registered.

Tax liability is not restricted to passive income, although most of a holding company's income will be in the form of dividends and/or capital gains. Only realized income or income accrued under the normal Swedish rules of business taxation is subject to tax. Thus a "Luxembourg company" is neither transparent nor liable to tax on an imputed basis. The owner/shareholder of the "Luxembourg company" is never required to pay tax on the company's income nor is he responsible for the payment of the company's taxes.[13]

In view of the high level of Swedish foreign investments it is surprising that there is so little case law on the Luxembourg rule. Two factors, however, may account for the paucity of case law: the rule has effectively fulfilled its purpose, that is discouraged Swedish investors from using foreign holding companies, or more likely, the resources of the tax administration to discover and investigate these structures are limited.

The combined effect of the Dutch participation exemption and the Sweden–Netherlands tax treaty has made the latter country a favoured location of Swedish-owned holding companies, particularly for real estate investments in other countries. No doubt many investors have not fully appreciated the pitfalls of the Luxembourg rule.

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7. See, supra, note 4.
8. The main part of the quoted company was, of course, owned by Swedish citizens.
9. For a discussion, see Kent Simon, "Foreign Holding Companies and the Luxembourg Rule", in this issue of the *Bulletin* at p. 395.
10. The distinction between "effective management" and "day to day" management of a company has been of little consequence in Swedish tax jurisprudence. One factor which accounts for the relatively scant interest in the distinction is the fact that a holding company generally does not conduct much day-to-day business.
11. For a contrary view, see Simon, supra, note 9.
12. But note that the Swedish position will not affect the other contracting state's primary right to tax. Sweden will grant the holding company relief from double taxation.
13. The Finance Minister who proposed the Luxembourg rule was cognizant of this obvious administrative shortcoming but expressed the hope that "the companies in question would normally not refuse to pay a tax the legitimacy of which they could hardly dispute".

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THE 16:2 COMPANY

As of 1 January 1990 the Swedish National Income Tax Act (SIL) provides new definitions of the terms "foreign legal person" and "foreign company".

A "foreign legal person" for tax purposes is an association which, according to the domestic law under which it is registered, may claim title, assume liabilities and file suit before courts and other government agencies, and whose property may not be freely disposed of by its individual shareholders or partners.

A "foreign company" for tax purposes is a foreign legal person which:
(a) according to a tax treaty concluded by Sweden is a person to whom the treaty rules restricting taxing rights apply and who is resident in the other contracting state in accordance with the treaty, *or*
(b) is subject in its home jurisdiction to taxation similar to Swedish corporate taxation.

The effect of being considered a foreign legal person having a Swedish resident shareholder/partner is that the legal person will become transparent for tax purposes. Swedish tax liability will be imposed at the shareholder level if the same shareholder is either taxed in this way in the state in which the legal person is resident, or if he owns at least 10% of the capital or voting power of the foreign legal person, *and* at least 50% of the capital or voting power of the foreign legal person is owned or controlled (directly or indirectly) by persons resident in Sweden. When computing the 10% level, controlling holdings of other Swedish companies owning shares in the foreign legal person and shares held by family members are also taken into account.

If the foreign legal person also qualifies as a foreign company, i.e. is located (registered) in a treaty country or located in a non-treaty country *and* subject to a tax regime which is "similar" to the Swedish corporate tax regime, the income of the foreign company is tax-free in Sweden until distributed to its shareholders.

As mentioned above, taxation will be imposed at the shareholder level if the foreign association is considered transparent for tax purposes in its home jurisdiction, with both resident and non-resident shareholders being subject to tax on their share of the company's income. In other words, Sweden simply follows the tax regime of the foreign country in which the company is established. Like most countries, Sweden adheres to the principle which makes partnerships transparent for income tax purposes. However, whether the income of a foreign partnership should be taxed in Sweden on a shareholder basis and/or after distribution has occasioned controversy. This situation has clouded the issue of whether a loss suffered in a foreign partnership should be recognized at the shareholder level in Sweden. The new "16:2 company" legislation resolves the debate. If the foreign partnership is tax transparent in its home jurisdiction, the partnership income is not taxed in Sweden as a dividend when it is distributed, but is charged directly to tax as income derived by the partner. The inevitable double taxation situation will be resolved by Sweden granting credit for foreign income tax paid, or if a treaty so provides, by exempting the foreign income from tax liability in Sweden. Correspondingly, a loss sustained by the foreign partnership is recognized for Swedish tax purposes unless the partnership is located in a country with which there is a treaty providing for double taxation relief by way of exemption.

The "16:2 company" legislation, by defining the terms "foreign legal person/foreign company", has settled the dispute over the taxation treatment of foreign partnership income and losses. However, it does nothing to prevent the accumulation of investment income in no tax or low tax jurisdictions. This is an important tax policy consideration that must be addressed by all countries (particularly those imposing a high level of taxation). For Sweden such considerations are a novel experience which has come with the removal of restrictions on capital movements. The outcome has been the "16:2 company" legislation requiring that foreign legal persons situated in non-treaty jurisdictions must be subject to a domestic tax regime similar to that imposed in Sweden if they are to escape tax transparency in Sweden.

Three elements have to be considered:
(1) the geographical element, i.e. the location of the foreign legal person in a non-treaty country;
(2) the ownership requirement, i.e. only shareholders with substantial holdings (10% or more) are affected; and
(3) the similarity of taxation test.

The first 2 elements are relatively easy to establish. The 10% holding requirement, however, will be troublesome in cases where there is intermediate ownership. The third element – similarity of taxation – will no doubt cause considerable practical difficulties. The problems which arise in comparing corporate tax systems are self-evident. Sweden has indicated that both the level and the structure of the foreign tax jurisdiction must abide by Swedish standards. Of course the principal target of the legislation is the classic tax haven. Sweden has entered into tax treaties with some 50 other countries so the restriction to non-tax treaty countries makes the "16:2 company" legislation a manageable proposition. It is to be hoped that the Swedish tax authorities will provide a blacklist of the countries affected by the legislation.

The new Swedish rules, in contrast to the CFC legislation in other countries (New Zealand is an exception), are not limited to specific types of income. All income of the foreign association, computed in accordance with Swedish tax regulations and allocated proportionally to the relevant shareholders according to the principles of Swedish partnership taxation, is taken into account. Tax credits are not granted for foreign taxes borne by the association in the (blacklisted) jurisdiction. Foreign tax credits are only allowed for taxes borne by the taxpayer, i.e. the Swedish shareholder.

The following example of a Swedish company licensing know-how to a Canadian licensee illustrates the tax consequences of paying Canadian royalties to Sweden, in the first instance directly, and in the second through a subsidiary in a (blacklisted) non-treaty country.

Under the Sweden-Canada tax treaty, Canada may withhold tax at the rate of 15% on the direct payment of royalties to Sweden. This withholding tax may be credited against Swedish tax on a tax base which includes the Canadian royalty. If, however, the Canadian licensee pays a royalty to a company in a non-treaty country, domestic Canadian withholding tax will be imposed at 25% and tax (albeit in a small amount) may also have to be paid in the non-treaty country. The Swedish parent company will be taxed according to the "16:2 company" legislation on the full royalty amount with no credit granted for foreign taxes paid. As a result, in the first situation treaty relief is granted for double taxation; in the second situation triple taxation is imposed with no treaty relief.

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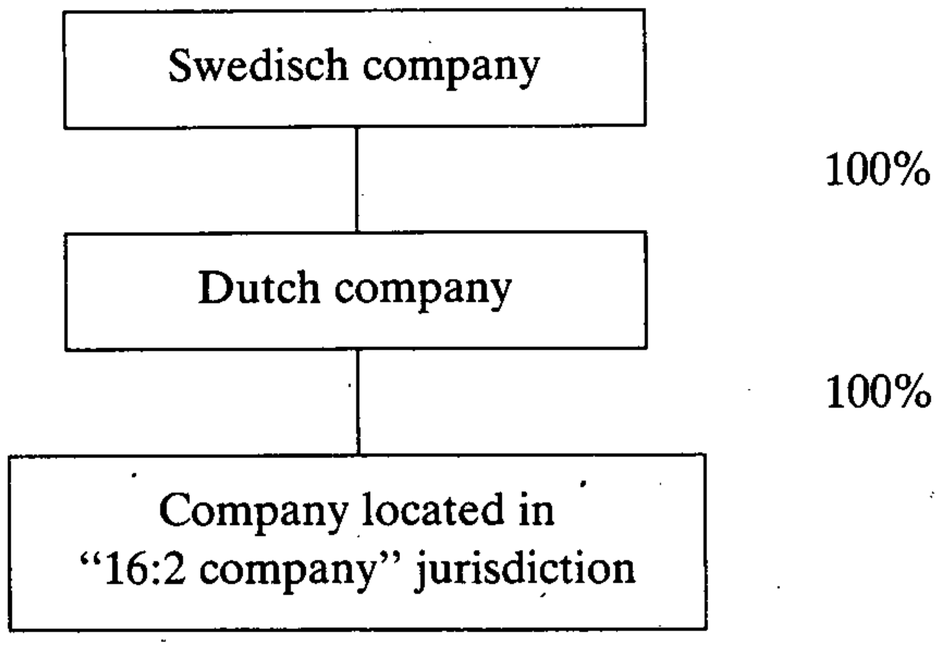
The principles applicable to the taxation of partnerships allow the Swedish partner/shareholder to deduct his share of a foreign transparent company loss. To take one example, this might be an interesting feature for Swedish shipping companies setting up flag of convenience jurisdiction subsidiaries (which will generally fall under the "16:2 company" legislation), allowing the parent company a tax depreciation on the ships owned by its foreign subsidiary.

Losses sustained by a Swedish resident taxpayer in a state with which Sweden has a treaty providing relief from double taxation by the exemption method, are not deductible for Swedish tax purposes. In such a situation it is possible that the "16:2 company" legislation could be exploited by a Swedish investor. For example, the Swedish investor could set up a German permanent establishment through a Jersey company. The Sweden-Germany tax treaty is an exemption treaty and Jersey is almost certain to be a "16:2 company" jurisdiction. The Swedish investor would be subject to the "16:2 company" legislation and thus would be able to deduct (or carry forward) the losses of the German permanent establishment, which would not be possible with a direct German permanent establishment. In order to take advantage of the treaty the permanent establishment could be transferred back to the Swedish investor when it became profitable.

THE LUXEMBOURG RULE VS. THE "16:2 COMPANY" LEGISLATION

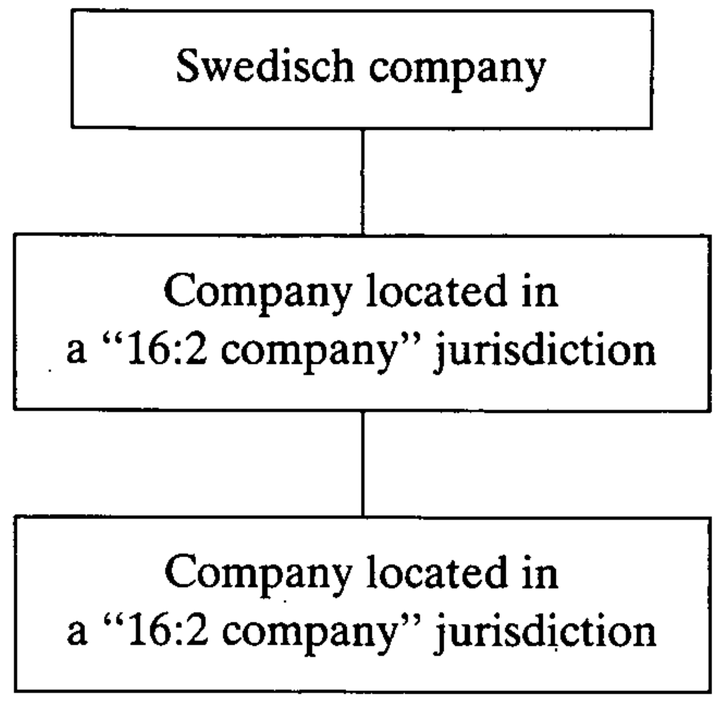
The text of the "16:2 company" legislation provides that a company caught by the Luxembourg rule will not be deemed transparent for tax purposes. Consequently, the Luxembourg rule takes precedence over the "16:2 company" legislation.

An obvious way to circumvent the "16:2 company" legislation, which applies only to non-treaty countries, would be to set up a two-tier investment structure with an intermediate company in a treaty jurisdiction (for example in the Netherlands):



With such a structure the "16:2 company" legislation would not come into operation. However, it must be borne in mind that if the Dutch base company were to fulfil all the criteria necessary to activate the Luxembourg rule, the company could be taxed in Sweden on its share of the transparent "16:2 company" income.

The same result will occur if the following structure is used:



CONCLUSION

Many problems remain unresolved regarding the application of the Luxembourg rule and the "16:2 company" legislation. The Luxembourg rule is outdated and the "16:2 company" legislation suffers from various structural defects. Both pieces of legislation are in need of reconsideration and better integration.

It is expected that once the domestic Swedish tax reform is completed, the government will appoint a committee to scrutinize Sweden's international tax system. An obvious goal for such a committee would be to come up with a proposal for new CFC legislation.

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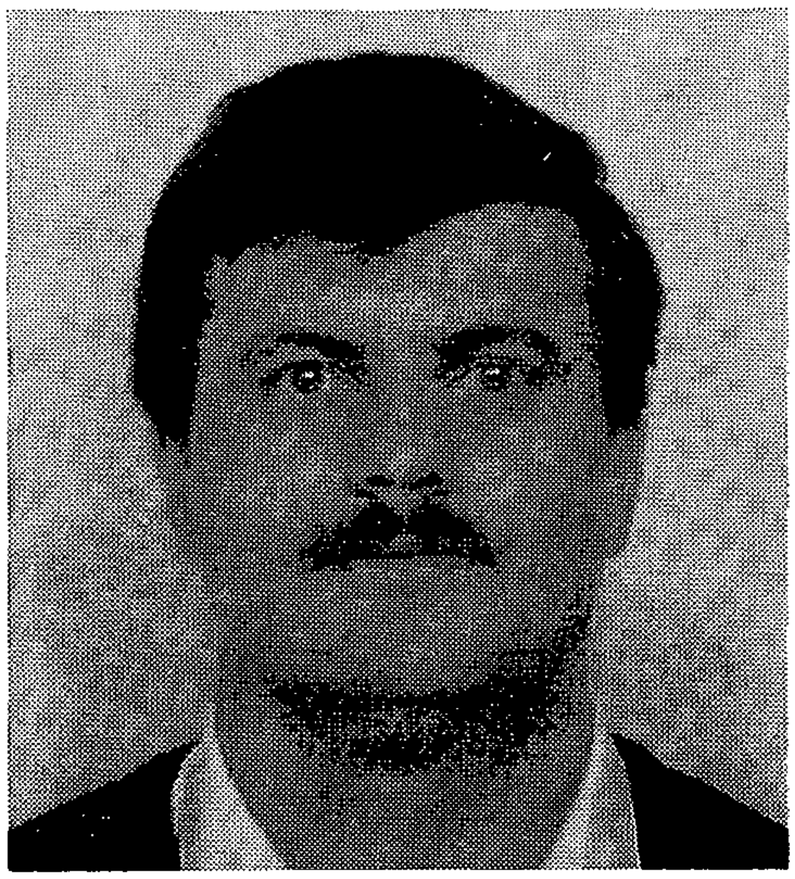

Swedish Transfer Pricing Rules

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This article describes the transfer pricing rules of the Swedish tax system, as they apply under the recent tax reform.[1] Part I briefly reviews some basic rules. Part II examines the arm's length rule and how it applies in practice. Branch transactions are dealt with in part III, and some ideas of what might lie ahead are given in part IV.

I. GENERAL

Sweden levies both a national [SIL] and a municipal income tax [KL]. Computation of the tax base for both taxes is similar. Individuals are liable to both the national and the municipal income tax, while legal entities are subject only to national income tax.

Swedish legal entities and individuals domiciled in Sweden are subject to tax on their world-wide income. Foreign income taxes may be deducted. The foreign tax credit is the usual method used to grant unilateral relief for international double taxation. Creditable foreign taxes are limited to the Swedish income tax levied on the foreign income. Foreign corporations are, in principle, subject to tax on profits derived by a Swedish permanent establishment, on income and gains derived from real estate located in Sweden and on Swedish-source rents and royalties.

Affiliated groups of Swedish companies may internally offset losses against profits, although this result is not achieved through a consolidated return.[2] Each company is separately taxed. However, if one company owns more than 90% of another company, profits may be completely offset by group losses. There is no legislation which allows this offset in respect of affiliated foreign companies, although in some cases the courts have accepted (to a limited extent) that Swedish parent companies may deduct some of the costs incurred by their foreign subsidiaries. Dividends paid between Swedish companies are generally not taxable for the receiving company if that company holds at least 25% of the voting power of the distributing company. Tax treaty provisions extend this exemption to dividends received from distributing companies resident in treaty jurisdictions. The National Tax Board may grant a tax exemption for dividends received from companies resident in non-treaty countries.[3]

II. THE ARM'S LENGTH RULE

A. Introduction

The Swedish arm's length rule is embodied in KL, Sec. 43.[4] Sec. 43 is worded in general terms and does not offer any real guidance in dealing with transfer pricing cases in practice. There are no official regulations or guidelines pertaining to Sec. 43.

Four conditions must be met to activate Sec. 43:

(1) There must be a contract, the terms of which deviate from those which would be found had the contract been at arm's length and which results in lower income for a Swedish enterprise.
(2) The contract must be concluded between a Swedish enterprise and a person not taxable in Sweden on the income which arises as a result of the transfer.
(3) The parties must have common economic interests. (Henceforth, I will use the more practical phrase "common control").
(4) The deviation from arm's length conditions is not for *bona fide* business reasons.

1. The contract

Sec. 43 allows the tax authorities to make a corrective adjustment in respect of transactions entered into at a non-arm's length price. It is unnecessary to invoke Sec. 43 for sham transactions. For instance, if a foreign enterprise sends a fake invoice to its Swedish affiliate, the entire transaction may be disregarded. If a related foreign enterprise acts as a conduit between a Swedish enterprise and a foreign unrelated buyer/seller and the intermediate enterprise has no substance (i.e. it is a "mailbox company"), in my opinion, the conduit may be disregarded. The conduit only functions

1. For a discussion of the reform, see Göran Grosskopf, "The Swedish Tax Reform: Rules and Effects", in this issue at p. 366.
2. For a discussion of group contributions, see Leif Edvardsson, "Restructuring Companies/Groups of Companies" in this issue at p. 386.
3. SIL, Sec. 7(8).
4. KL regulates the municipal income tax but also applies with respect to the national income tax.

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to keep the profits of the unrelated *bona fide* business transaction out of the reach of the Swedish tax authorities.[5]

2. Definition of related parties

The Swedish party must be an enterprise, i.e. it must be obliged to report its income as business income. Historically, this meant that capital gains were not subject to the arm's length rule.[6] However, the tax reform alters the characterization of corporate income. Henceforth, all income, including capital gains, is taxed as business income, so that income from the sale of capital assets can also be reallocated. Holding company income, such as interest and other similar passive income (which has been an area of uncertainty), will also be reallocable in the future.

All Swedish enterprises (sole proprietorships and legal entities) are subject to Sec. 43.

The definition of the other party as a person not subject to Swedish tax on the transferred income serves to protect the Swedish tax base. Sec. 43 is immediately triggered when the business income of a Swedish enterprise is reduced by way of transfer pricing and the party which benefits from the transaction is not subject to Swedish tax. However, the definition of "foreign" party has certain shortcomings. For example, it encompasses (at least in formal terms) Swedish persons who are not taxed on transferred income. The definition also includes non-profit organizations, etc. However, for other reasons, such as the fact that the parties must be under common control for Sec. 43 to apply, it is unlikely that such a situation would arise.

What is normally involved is transactions with foreign related corporations. Foreign corporations are generally not taxed in Sweden unless they have a permanent establishment in Sweden. However, there are 2 circumstances in which the income of foreign legal entities may be taxed in Sweden. First, under the Luxembourg rule,[7] foreign holding companies which are owned (directly or indirectly) by Swedish individuals and which are effectively managed and controlled in Sweden, are deemed to be Swedish legal entities for tax purposes, and thus subject to Swedish tax on their world-wide income.[8] Any income transferred to such a foreign holding company cannot be reallocated to the Swedish enterprise. Since it may be difficult for the Swedish tax authorities to collect tax from foreign companies, reallocation may offer a viable alternative.

Secondly, Sweden has recently enacted rules similar to the U.S. Subpart F legislation.[9] If the foreign legal entity is considered a "16:2 company", the Swedish shareholder/partner will be taxed on his share of the income of the foreign entity. Thus, any income transferred via transfer pricing from a Swedish enterprise to such a related foreign "16:2 company" will be subject to Swedish tax at the shareholder/partner level for shareholders/partners resident in Sweden. It is doubtful whether any reallocation can be made under these circumstances, although it may be possible to reallocate a portion of transferred income attributable to non-resident shareholders/partners and non-qualifying Swedish owners.

Finally, the definition of the other party excludes branch transactions. The income of foreign branches is included in the Swedish tax base of a Swedish corporation (taxed as it is on its world-wide income), and therefore Sec. 43 is not applicable. With regard to the opposite situation, i.e. a foreign corporation with a Swedish branch, one must also conclude that Sec. 43 is not applicable. There are several grounds for this conclusion, the main one being that Sec. 43 allows corrective adjustments to be made in the case of non-arm's length contracts, and a corporation cannot enter into a contract with its own branch. This is not to say that non-arm's length transfers between corporations and their branches are permitted. The legal grounds for adjusting the income in such circumstances are different, and one must rely on general legal principles. Branch transactions will be discussed further below.

3. Common control

As mentioned above, the parties must to some extent be related; in other words, be under common control. Sec. 43 encompasses both the situation where one enterprise directly or indirectly participates in the management or supervision of another enterprise and the situation where one enterprise owns a part of another enterprise. The wording of the statute should be regarded as exemplifying common control, not as enumerating what exclusively constitutes common control. The criterion is not formal ownership but de facto common control. With the exception of normal parent-subsidiary relationships and similar obvious examples, it may be difficult to prove the existence of common control. Generally, the burden of proof is on the tax authorities in transfer pricing cases. However, as regards the existence of common control, the tax authorities need only show the "probability" of common control.

4. Bona fide business reasons

Even if the tax authorities prove that the prices and terms between related parties differ from an open commercial transaction, the taxpayer can avoid a reallocation by producing evidence that the deviating terms were motivated by valid business reasons.[10] As an example of business reasons for charging a price lower than market price, the "travaux préparatoire" cites short-term market penetration. A Swedish manufacturer may sell goods at a reduced price to its foreign sales companies in order to introduce a new product on the foreign market. Whether this implies that the Swedish manufacturer can sell at a price lower than it would have charged to an unrelated foreign sales company remains uncertain.

Underpricing to assist a new foreign subsidiary may also be acceptable during the start-up phase. In one case, a Swedish parent company granted interest-free loans to a Dutch subsidiary. The loans were primarily used for investments in machinery. The Supreme Administrative Court [hereinafter

5. However, the Supreme Administrative Court [hereinafter SAC] has applied Art. 43 in at least one such case. See Supreme Administrative Court Reporter [hereinafter referred to as "RÅ"] 1980 114 (Kentruck).
6. See RÅ 1983, 1:13.
7. SIL, Sec. 3(3).
8. See Kent Simon, "Foreign Holding Companies and the Luxembourg Rule" and Peter Sundgren, "Controlled Foreign Company (CFC) Legislation in Sweden" in this issue at p. 395 and p. 400.
9. For a discussion of Sweden's new rules, see Sundgren, supra, note 8.
10. See KL, Sec. 43(1(c)).

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referred to as "SAC"] concluded that it is reasonable for no interest to be charged during the start-up phase.[11]

B. Pricing of specific transactions

One of the more formidable problems regarding Sec. 43 is how to determine the market price of a specific transaction. The statute provides no guidance, and there are, as stated earlier, no regulations which apply. Case law is also sparse but I will briefly examine several cases which shed light on this issue.

Related companies may extend short-term and long-term loans to each other. This raises the question of thin capitalization. Long-term credits may resemble share capital. KL contains no explicit provisions on thin capitalization. The consensus has been that tax authorities may not inquire into the way a parent corporation finances its subsidiary. In a recent case regarding the Swedish subsidiary of the Norwegian oil company Norsk Hydro (formerly the Swedish subsidiary of Mobil Oil), the SAC held that Sec. 43 cannot be used to rectify thin capitalization.[12] For the taxable year in question no other rules applied. However, later statutes regarding the tax treatment of profit sharing loans may have altered the state of law.[13]

There is no case law which defines an arm's length interest rate. In 1970 it was held that interest should have been charged on a loan extended by a Swedish parent to its English subsidiary.[14] However, no guidance was offered on how to compute an arm's length interest rate. Cases in which the Court accepted that the taxpayer did not charge interest for reasons of, inter alia, set-offs are discussed below.

Intra-group services may be of various kinds, i.e. they may concern research and development (R & D), administration, etc. An enterprise may claim a deduction for payments made to a related enterprise for services rendered, only if there is a strong connection between its trade or business and the services rendered. The service must have the character of a necessary business expense. For example, a Swedish sales company was allowed to deduct a contribution to the R & D carried out by its Belgian parent company. The Court referred to the importance of the R & D for the selling activities in Sweden.[15] It is clear from this that cost-sharing is allowed. It may be argued that parent corporations must charge their foreign subsidiaries for intra-group services, but it is not clear how these costs are to be apportioned on an arm's length basis.

A company can also render services that directly benefit another related company. For example, a parent company may tailor an advertising campaign for its subsidiary. In such a case there is a direct connection between the service and the remuneration. In principle, the subsidiary should pay an arm's length amount. In one particular case, the Swedish company, Upjohn AB, provided marketing and sales promotional services for medical products to its Belgian sister company. The charges for these services covered only the actual costs incurred by Upjohn AB. The tax authorities contended that Upjohn AB should charge the cost plus 10%. The SAC rejected such a standard charge, holding that the price must be judged principally having regard to the circumstances of each individual case.[16]

The situation becomes more complicated with regard to leasing transactions and royalties. According to KL, Sec. 53(3), a foreign recipient of a royalty or periodic fee in respect of tangible or intangible assets is taxed on a net income basis in Sweden if the payor is a Swedish enterprise and if the remuneration constitutes business income. If the royalty or rental charge is excessive, Sec. 43 cannot therefore be applied, since the foreign person is liable to tax in Sweden. If the royalty or rental charge is made by a payor abroad to a Swedish recipient, the payor is not taxed in Sweden and Sec. 43 applies.[17]

Rental charges in respect of tangible assets would not be taxed to the foreign lessor unless there is a permanent establishment in Sweden.[18]

There has been only one case regarding intangible assets, and the point at issue was not the arm's length rule but to which taxable year the transactions related.[19] A Swedish company paid a royalty to an affiliated Swiss company. The royalty constituted consideration for trade marks, etc. assigned in a previous year by the Swedish company to the Swiss company without consideration. The Court held that each contract had to be viewed separately, and that the first assignment without consideration might in itself have been corrected by virtue of the arm's length rule but that, since it occurred in a previous taxable year not under scrutiny, it could not be examined in conjunction with the subsequent royalty. The tax authorities had not challenged the royalty itself.

Currently, there are no SAC cases regarding goods. However, a well-known case concerning the pricing of oil and freight within the Shell group is pending with the SAC and is expected to be decided by the end of 1990. The fiscal authorities were successful at the Court of Appeals level. The judgement reallocated more than U.S.$ 10 million for fiscal years 1977-1982.[20]

C. Set-offs

Sec. 43 does not address the question whether a company may offset a proposed reallocation of overpriced goods against underpriced services. Nevertheless, there is case law on this issue.[21] The reliability of these cases as precedent is dubious because they concern taxable years before the 1982 amendment.[22]

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11. RÅ 1984, 1:16, (EDET). This case concerned the taxable years 1973-1977. The Court had to apply the pre-1982 statute. Under the pre-1982 statute, the Court did not judge pricing transactions between a Swedish parent company and its foreign subsidiary. Special precautions were taken in judging bona fide business reasons that affected such transactions. A 1982 amendment changed this rule, and consequently it is uncertain whether the outcome would have been the same had the case concerned post-1982 taxable years.
12. Decision of the Supreme Administrative Court of 11 April 1990.
13. SIL, Sec. 2(9).
14. RÅ 1970, 923.
15. RÅ 1967, 1247 (Gevaert).
16. RÅ 1984, 1:83.
17. It should be noted that in the near future Sweden may introduce a withholding tax on royalties on intangible assets.
18. A recent committee report proposed such a withholding tax system, but some uncertainty exists as to whether it will be effected.
19. RÅ 1979, 1:98 (FINDUS).
20. Decision of the Stockholm Fiscal Court of Appeal of 26 October 1988.
21. See RÅ 1979, 1:40 (Öberg) and RÅ 1980, 1:59 (LME).
22. See, supra, note 11.

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In one case the Swedish parent company failed to charge interest on loans to its Portuguese manufacturing subsidiary. Almost all the production of the Portuguese subsidiary was sold to the parent company. The Court accepted the lack of an interest charge, reasoning that had interest been charged, the products sold back would have increased in price. The Court held as a general proposition that contract terms between affiliated enterprises which only provide for the covering of actual costs of the manufacturing enterprise should normally be accepted.

In another case, the Court accepted that interest was not charged to an Australian second-tier subsidiary. The Court held (in a 3-2 decision) that application of Sec. 43(1) could not be limited to single events and transactions in the relations between the parties. The Court noted that interest payments were also sometimes waived between unrelated parties, for instance, if other terms in the contract adequately compensated the creditor.

D. Secondary effects of a reallocation

When income is reallocated from a foreign enterprise to a Swedish enterprise by applying Sec. 43, increased taxable income for the Swedish enterprise is not the only result. Such a reallocation also requires a subsequent reduction of the income of the foreign enterprise. This of course cannot be achieved by unilateral measures on Sweden's part, nor is it likely that the foreign tax authorities will make such a reciprocal adjustment voluntarily. A corresponding adjustment of this kind would require a tax treaty between the 2 countries containing a provision equivalent to Sec. 9 para. 2 of the OECD model.

So far as the Swedish tax consequences are concerned, the present state of the law is not absolutely clear and there has been very little discussion of the problem in Sweden. The point at issue is how to take account of the fact, that, despite the reallocation, the money remains with the foreign enterprise. If the transfer is from a Swedish subsidiary to a foreign parent company, it is clear that the transfer has the character of a concealed dividend payment and is therefore subject to Swedish withholding tax on dividends.[23] When the transfer is from a Swedish corporation to a foreign sister corporation and the parent is also a foreign corporation, in my opinion, it is natural to take the same view.

The transfer may be recharacterized as a concealed dividend to the foreign parent company which triggers withholding tax. It is then possible to regard the last step as a contribution to capital from the parent to its foreign subsidiary.

Treating a transfer as a contribution to capital, thereby increasing the base cost of the stock for tax purposes, raises questions both in relation to the Swedish parent/foreign subsidiary transfers and the Swedish sister/foreign sister transfers. In the first case (Swedish parent/foreign subsidiary), the question is simply whether the transfer constitutes a contribution to capital and if so, whether the base cost of the stock should be increased for tax purposes.

In the second case (Swedish sister/foreign sister), a distinction may be made between situations where the parent is Swedish and the situation where it is foreign. Swedish parent companies are generally exempt from tax on dividends received and it is only in extremely unusual circumstances that any withholding taxes are levied on domestic dividends. The main issue for tax purposes is therefore whether the transfer constitutes a capital contribution by the parent to its foreign subsidiary (i.e. the foreign sister corporation). If, on the other hand, the parent corporation is foreign, withholding tax becomes an issue. Whether the base cost of the stock of the foreign corporation is also increased is of little if any interest from a Swedish fiscal standpoint.

III. BRANCH TRANSACTIONS

I have already explained why Sec. 43 cannot be applied to branch transactions, whether the branch is a Swedish branch abroad or a foreign branch in Sweden. No other article explicitly deals with branch transactions, so that it is necessary to rely on general principles.

The most important and useful principles in this context are those embodied in KL, Sec. 22(1). If an enterprise ceases to carry on its business, the sale of inventory, etc. is considered to be the final business activity. If the sale is to a related person, the enterprise is taxed on the sale as if it were made at fair market value. A similar principle applies if an asset is being transferred from a business to a related person at below market price. The difference between the sale price and the market price is allocated to the selling enterprise. In both of these situations Sec. 43 provides for an exception to the rule, which makes it possible to sell assets to related persons at a price between book value and market price if special circumstances exist. A reorganization is one such circumstance, the conversion of a sole proprietorship into a wholly owned corporation is another.

The tax reform introduces a simplification with regard to Swedish branches abroad.[24] The transfer of assets from Sweden to a foreign branch will not trigger taxation. But converting the branch to a subsidiary would, at least in my opinion, mean that the Swedish corporation must report the fair market value of the assets as income.

As regards transfers between a foreign corporation and a Swedish branch, it is helpful to distinguish inward from outward transfers. The transfer of current assets does not trigger taxation – the issue is how to determine their base cost for tax purposes. The main rule will probably be applicable,[25] so that the lower of historic cost increased by transportation costs, customs duties, etc. or replacement cost will constitute the base cost for tax purposes.

If the assets are produced by the foreign enterprise itself, historic costs comprise direct costs and a reasonable part of indirect costs. Replacement cost is based on the cost the branch itself would incur in replacing the asset.

In the context of transfers of business equipment to Sweden, it is the owner who has the right to depreciate the asset. The courts take a formal approach when deciding who is the owner, so that, for example, under all forms of leasing arrangements, it is the lessor and not the lessee who is entitled to depreciate the asset. The transfer of business assets to Sweden is not a taxable event, but such a transfer raises the question of what constitutes the base cost for tax purposes. The answer is probably that it will be the historic cost incurred by the foreign company, increased by transportation costs, customs, etc.[26] Depreciation is based on this new value. If measures have been taken to increase the base

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23. RÅ 1952, 39.
24. For the old law, see my contribution to the 1986 IFA Congress, *Cahiers de Droit Fiscal International,* Vol LXX1a, pp 489-499.
25. See KL, Sec. 24(2).
26. KL, Sec. 23(13).

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cost, and it may be assumed that this has been done to obtain a tax advantage, the base cost can be adjusted.[27]

Outward transfers, meaning that the asset leaves the Swedish permanent establishment, will have to be reported as income based on fair market value.

IV. A GLIMPSE INTO THE FUTURE

The transfer pricing issue is currently of great concern to both the tax authorities and to the government. One might assume that when nominal tax rates fall from 52% (57% if one takes into account the profit-sharing tax) to 30% (or roughly 25% after allocations to the tax equalization reserve) as a result of the tax reform, there would be less incentive to transfer profits out of Sweden. However, if one considers that the effective tax rate for many large corporations (because, for example, of allocations to special reserves) has been substantially lower than 25%, one may, at least with respect to large corporations, suggest that the tax reform does not offer such a great incentive to keep profits in Sweden. Large corporations will actually pay higher taxes in the future. Parenthetically, it is worth pointing out that from a fiscal point of view it is of less importance why a deviation from market price has occurred than the fact that it has occurred.

Great emphasis is currently laid on field examinations of the large corporations. The 200 largest multinational enterprises in Sweden are to be examined every fifth year and the tax authorities consider transfer pricing and related issues to be of exceptional importance.

The Tax Committee of the Swedish Parliament has been interested for some years in the tax treatment of multinational enterprises. This interest was manifested in a preliminary study from 1984. Although this was shelved pending the outcome of ongoing research, it was assumed that the National Tax Board would continue its own work on Sec. 43.[28] In this context it may be noted that the Tax Committee rejected the unitary method as a basis for the taxation of multinational enterprises.

The National Tax Board has responded to the challenge in 2 ways. First an extensive educational programme on transfer pricing issues has been initiated. During the last 2 years field examiners and others (around 25 each year) have undergone a total of almost 3 weeks of training. Teachers are drawn from the International Department of the National Tax Board, supplemented by external teachers. The sincerity of this effort is demonstrated by the engagement of 2 American teachers from the Internal Revenue Service with extensive experience in Sec. 482 of the Internal Revenue Code. Significantly, among the participants in 1990 were representatives from the other Nordic countries.

The National Tax Board has also responded with thorough and extensive studies of transfer pricing problems covering both domestic experience with actual cases and field examinations and foreign regulations. These studies are to be published shortly and will at the very least provide some kind of guidelines to tax authority staff. Although not legally binding, one may safely assume that such guidelines will be of great importance to field examiners, taxpayers and the courts. The National Tax Board, with the backing of the report, will also call for legislative action on transfer pricing. It seems likely that the Finance Department will appoint a committee for a further study of the area before proposing legislation.

27. Id.
28. See Tax Subcommittee [SkU] 1984/85:35, p. 3.

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INTERNATIONAL:

THE OTHER INCOME ARTICLE OF INCOME TAX TREATIES*

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INTRODUCTION

A rarely studied provision of tax treaties, the "other income" article, often lies almost dormant at the end of the provisions dividing the jurisdiction to tax various kinds of income from various sources between the two contracting states. Because the article has not often been the subject of commentary, it seemed an appropriate subject to trace its historical development, its application and its importance to tax treaties. The authors consider this task to be particularly important because a surprising number of treaties have been and are still being negotiated and brought into force without any such article being included, apparently without much thought to the consequences of the omission.

THE OECD MODEL AND ITS PREDECESSORS

Article 21 of the Organisation for Economic Co-operation and Development (OECD) Model Double Taxation Convention on Income and on Capital, 1977,[1] provides:

> 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 immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of the 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 right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

The first appearance of another income article in its modern form[2] dates back to 1960. The third report of the Fiscal Committee of the Organisation for European Economic

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1. Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital: Report of the OECD Committee on Fiscal Affairs* (Paris: OECD, 1977).

2. Early model treaties reflected the principle that income was taxable in the state of residence or domicile while taxation by the state of source was an exception. Viewed in this way, income not taxable by the state of source remained taxable by the state of residence and no express "other income article" was therefore necessary. This pattern was reflected in Art. 1(A) of the League of Nations Draft Convention no. 1b, which was intended to apply between states in which taxation by reference to domicile predominated:

> In principle, income shall be taxable by the state in which the taxpayer has his fiscal domicile, *i.e.*, his normal residence, the term "residence" being understood to mean a permanent home.

(League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion,* Document C.562.M.178.1928 II [Geneva: the league, October 1928] [herein referred to as "Document C.562"], 16, reproduced in United States, Congress, Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions,* vol. 4, *Model Tax Conventions* [Washington, DC: US Government Printing Office, 1962], 4151-93, at 4170. Document C.562 contains draft conventions nos. 1a, 1b and 1c.)

This basic principle was stated at the beginning of this League of Nations draft convention, and the statement of principle effectively applied to taxation of all income, unless the treaty expressly provided otherwise. The commentary stated: "Article 1 provides that, in principle, the state of domicile shall levy its taxes on all kinds of income." (Ibid., at 18;4172). Article 2 then dealt with classes of income taxable "by priority" at their respective sources. The wording of the article and the commentary was not as clear, however, as the later OECD wording became, in indicating that

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Co-operation (OEEC), published in that year, contained the following as Article XVII:

> The items of income not expressly mentioned in the foregoing Articles of the Convention shall be taxable only in the Contracting State of which the recipient is a resident.[3]

The Fiscal Committee commented on this article, saying that it "formulates [the rule] in a form acceptable to all the Member countries".[4] The member countries were Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom. The commentary noted that the article, as proposed, was in use at that time in the same or similar form in most conventions for the avoidance of double taxation. The committee also noted that the application of the article was not limited to income that was subject to tax in the state of residence, but that contracting states were free, when enter-

source taxation was limited only to items mentioned in Article 2. A comment in the report and resolutions of the League of Nations technical experts is helpful in clarifying what was intended: "The general income tax...charged upon the whole income of a taxpayer, from whatever source derived, should, in principle, be imposed only by the state of domicile." (League of Nations, *Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations,* Document F.212 [Geneva: the league, February 7, 1925], 32, reproduced in *Legislative History of the United States Tax Conventions,* supra, 4057-105, at 4092).

This early reflection of an other income article continued with the Mexico draft model and the London draft model as Article XIII, affirming the right of the residence state to tax income on a worldwide basis and again not expressly excluding source state taxation. (See League of Nations, Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text,* Document C.88.M.88.1946.II.A [Geneva: the league, November 1946], reproduced in *Legislative History of United States Tax Conventions,* supra, at 4325-439.

Article 9 of the League of Nations draft convention of 1927, copied as Article 8 of the League of Nations Draft Convention no. 1c, also may reflect an early attempt at an Other Income article but it is not clear how broad these articles were intended to be. They provided:

> Annuities or income from other claims not referred to in the previous paragraphs shall be taxable in the state of fiscal domicile of the creditor of such income.

(League of Nations, *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion,* Document C.216.M.85.1927II [Geneva: the league, April 1927], 11, reproduced in *Legislative History of United States Tax Conventions,* supra, 4115-49, at 4125, and Document C.562, supra, at 20; 4174.)

Article 9 of the League of Nations Draft Convention no. 1a of 1928 made an important linguistic change using the word "sources" instead of the word "claims" and appearing to indicate that all other income was intended to be covered. (Document C.562, supra, at 8;4162). However, the commentary on Article 9 of this draft convention again used the word "claims" instead of "sources", so that it is not clear whether any change in meaning was intended. The commentary stated (ibid., at 13; 4167):

> Contrary to the above-mentioned provisions, annuities or income from other claims not referred to in the previous paragraphs shall be taxable in the state of fiscal domicile of the creditor of such income. The exception which is thus made for annuities is justified by the special nature of this form of income, since the recipient is free to select the country which is to be liable for the payment.

This commentary therefore seems to indicate that all these early articles were intended to have some limited effect, a conclusion that perhaps is confirmed by the following resolution published in Document F.212, supra, at 32; 4092):

> *H Various Credits and Annuities* As regards interest on credits other than those already considered, and on annuities, the State in which the creditor is domiciled shall have the right to impose the schedular tax.

However, there is evidence that a broader coverage may have been intended. A League of Nations study by the late Mitchell B. Carroll says, with reference to Draft Convention no. 1c that it "contains a basket clause allocating all items of income not specifically mentioned to the country of domicile." (Mitchell B. Carroll, *Methods of Allocating Taxable Income,* vol. 4, *Taxation of Foreign and National Enterprises* [Geneva: League of Nations, 1933], 172).

3. Organisation for European Economic Co-operation, *The Elimination of Double Taxation: Third Report of the Fiscal Committee* (Paris: OEEC, August 1960), 25. Klaus Vogel, *Doppelbesteuerungsabkommen* (Munich: Beck, 1983), annotation 12 to Article 21, expresses the view that this wording could be understood to refer only to classes of income not previously mentioned, and not to sources of income. We believe, however, that this was not the intended meaning and that existing treaties using this wording would not be so interpreted. See infra footnote 8.

4. Most German treaties, many Italian and French treaties, several Dutch treaties and at least one Swiss treaty that predated the OEEC report of 1960 included an other income article. The earliest appears to be the Germany–Czechoslovakia Treaty (1921). The old German treaties with Austria (1922), Hungary (1923), and Sweden (1928) also contained an other income article. The 1922 treaty made by Italy with Austria, Hungary, Poland, Rumania and the Kingdom of the Serbs, Croats, and Slovenes also reflected this early trend: Article 6(2) provided that "in the case of any other kind of income, taxation shall be levied in the state in which the taxpayer has his residence." (League of Nations translation, League of Nations Publication C.345.M102.1928II.). The same pattern was followed in the Italian treaties with Czechoslovakia (1924), Germany (1925, and still in force) and Hungary (1925). The Germany–Italy treaty uses the equivalent of the English word "only" to make it clear that only the state of residence may tax other income as did the France–Switzerland treaty (1953, no longer in force). Other early French treaties with an other income article were within the Netherlands (1949), Denmark (1957), Luxembourg (1958), and Germany (1959). Early Netherlands treaties containing such an article were those with Sweden (1935), Hungary (1938), France (1949), Switzerland (1951), Sweden (1952), Ireland (1954), Canada (1957) and West Germany (1959).

The early Belgian treaties adopted a different formulation in dealing with other income providing that the competent authorities should settle the method of taxation of such income having regard to the spirit of the treaty: Belgium–Luxembourg (1931) and Belgium–Italy (1931). Later, however, Belgium adopted a rule paralleling the OECD formulation: Belgium–Sweden (1953) and Belgium–Finland (1954).

In contrast to this continental European history, Canada did not use an other income article until 1957 when it appeared in a treaty with the Netherlands (since superseded). Of 18 comprehensive tax treaties signed by Canada prior to 1975, only the Netherlands treaty contained such an other income article. The United Kingdom was even later than Canada, first using the article in 1961 in its treaty with Sweden. Japan was also later, adopting the article for the first time in the 1964 UK treaty (since superseded).

The United States was still later, the earliest ratified treaty containing such an article (but following the UN formula) being that signed with Belgium in 1970. Some early US treaties, however, included a provision that barred a contracting state from taxing a resident of the other contracting state on income other than income arising from sources in that state: for example, US–France (1967), US–Finland (1970) and US–Trinidad & Tobago (1970). Such a provision has one of the characteristics of an other income article, but does not clearly deal with the issue of dual residence and the application of Article 4, discussed later in this article. With minor modifications, Article 21 in the OECD form appeared in the US Treasury 1977 model treaty and the proposed US Treasury 1981 model.

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ing into bilateral conventions, to so limit the scope of the article.[5]

The article was repeated, in a slightly different form but with no change in apparent meaning, in the OECD Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital of 1963.[6] By then, of course, the OEEC had changed its name, and Canada and the United States had become members of the successor OECD. The commentary on the 1963 draft model noted only one reservation in respect of the article by a member country. Canada reserved its position because the Canadian authorities, in negotiating conventions with other member countries, wished to maintain the right to tax income paid by residents of Canada to non-residents in the form of income from a trust or estate, alimony and certain payments from a registered retirement savings plan (privately funded retirement plans for individuals), as well as certain lump-sum payments to former employees in Canada in respect of their employment in Canada, all as provided for in the Income Tax Act (Canada).[7]

The other income article was reworded and expanded in the OECD model convention of 1977 to include the following significant changes:

- It was made clear that items of other income "wherever arising" would be taxable only in the state of residence.[8]
- It was made clear that such items of income consisted of income "not dealt with in the foregoing Articles."
- Paragraph 2 was added to Article 21 to make it clear that if the taxpayer resident in one state carried on business in the other state through a permanent establishment or performed independent personal services in the other state from a fixed base, and if the right or property in respect of which the other income was paid was effectively connected with the permanent establishment or the fixed base, the other contracting state would be entitled to tax the income under the provisions of Article 7 or Article 14. Paragraph 2 did not, however, extend to income from immovable property.[9]

The 1977 commentary was substantially expanded, and clarified, from that of 1963. Paragraph 1 of the commentary states that the income covered in Article 21 is not only income of a class not expressly dealt with but also income from sources not expressly mentioned.[10] The commentary explains that the scope of the article is not confined to income arising in a contracting state; it extends also to income from third states.

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5. France has 2 treaties in which such a condition appears; Germany has 8, Belgium has 7, and the United Kingdom has 15. The commentary does not indicate the form or wording of such a limitation. It is arguable that such a limitation, where the State of residence is an exemption state, should permit the state of source to tax only if the internal law of the state of residence exempts the income from tax; otherwise, the very fact that the other income is taxed by the state of source means it cannot be taxed by the state of residence – and thereby, in a somewhat circular way, justifies the taxation by the source state. The Belgium–Denmark (1969), Belgium–Greece (1968), Belgium–Luxembourg (1970) and France–Portugal (1971) treaties reflect this wording by referring to the internal law of the state of residence.

6. Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital: Report of the OECD Fiscal Committee* (Paris: OECD, 1963).

7. When Canada first included an other income article in a treaty (with the Netherlands in 1957), interestingly, it did not preserve its right to tax Canadian-sourced other income. However, in a treaty negotiated with Belgium in 1958 (and never brought into force), each state preserved its right to tax other income sourced in its state.

8. As indicated earlier, the 1963 OECD draft model and its predecessor OEEC model described other income as "items of income not expressly mentioned in the foregoing articles." Some commentators (for example, Vogel, supra footnote 3, at annotation 12 to Article 21) suggest that the wording of the other income article in the 1963 draft model could have been interpreted as referring only to classes of income not dealt with. We suggest that this would not be the better interpretation because the article applies to "items of income", and this means that it applies on a case-by-case basis. Accordingly, if a particular item of income is "not expressly mentioned" (the 1963 wording) or "not dealt with" (the 1977 wording) because of its character or because of its source, in either case it must fall within the other income article. The Swiss authors, Kurt Locher, Walter Meier, Rudolf von Siebenthal, *Doppelbesteuerungsabkommen Schweiz-Deutschland 1971 und 1978,* vol. 3, (Basel: Verlag für Recht und Gesellschaft AG, 1985), B.21(1), (hereinafter cited as "Locher") also are of the view that the old wording covers both classes and sources of income not mentioned. If the older wording "not expressly mentioned" were not understood in this way, the other income article would fail to achieve its obvious purpose of providing for the jurisdiction to tax items of income where the jurisdiction was not fixed by other articles of the treaty. The wording change therefore merely clarified that the other income article applied also to categories of income mentioned, but arising in a state not mentioned – that is, in the state of residence of the taxpayer or in a third state in cases where the model treaty referred in the preceding articles only to such income sourced in the non-residence state.
Commencing with the treaty made with Sweden in 1981, except for the treaty with China (1988), Australia has always used the older language, "items of income not expressly mentioned." In the former Belgium–Italy (1970) and Belgium–UK (1967) treaties and the Belgium–Spain (1970), Belgium–Portugal (1969) and Belgium–Denmark (1969) treaties, language even clearer than that used in the 1977 model is used, which describes as other income, items of income "qui sont d'une nature ou proviennent de sources non mentionnées" in the foregoing articles. These clarifications are combined in the UK–Egypt treaty (1977), which describes other income as "[i]tems of income . . . wherever arising, being income of a class or from sources not expressly mentioned." The Belgium–Netherlands treaty (1970) refers to "les éléments du revenu . . ., auxquels les articles précédents de la présente Convention ne s'appliquent pas, . . ."

9. Para. 21/51 of the Belgian Tax Administration Commentaries (*Commentaire général des conventions préventives de la double imposition,* Belgium Ministry of Finance, Brussels, looseleaf) makes the point that, even in the absence of Para. 2, "other income attributable to a permanent establishment or to a fixed base is included in the profits of an enterprise or in the income of independent services and as such is taxable in the state of the permanent establishment or fixed base" (our translation). The US model treaty proposed by the Treasury Department on June 16, 1981, refers to income attributable to a permanent establishment or fixed base rather than to property effectively connected with the permanent establishment or fixed base. This difference in wording is also found in comparing Articles 10(4), 11(4) and 12(3) of the 1977 OECD model with Articles 10(4), 11(4) and 12(3) of the proposed US Model. However, the OECD model in Article 7 uses the verb "attributed" to describe the income arising from property that is described as "effectively connected." The US model does not draw this linguistic distinction, but it is clear that no difference in meaning is intended. See Wm. L. Burke, "Report on Proposed United States Model Income Tax Treaty," (Winter 1983), 23 *Harvard International Law Journal* 219-330, at 259-60, where the author did not comment on the point that the OECD "attributes" income from "effectively connected" property while the US model "attributes" income without using the concept of effectively connected property. We have also noted that Article 21(2) of the 1977 OECD model excludes income from all effectively connected immovable property, whereas Article 6 deals only with the income of a taxpayer from immovable property situated in the other state. The exclusion may therefore, be too broad.

10. This is also clear from the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/41.

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The commentary goes on to explain, as had the 1963 commentary, that the rule set out in Paragraph 1 of Article 21 applies whether or not the right to tax is in fact exercised by the state of residence. It also notes that when income arises in a third state and the recipient of the income is considered to be a resident of both contracting states under their respective domestic laws, the application of Article 4 will result in the recipient being treated as a resident of one state only and being liable to comprehensive taxation only in that state. In this case, the other state may not impose tax on the income arising from the third state even if the recipient of the income is not taxed by the state of which he is considered to be a resident by virtue of Article 4. The commentary, however, further notes that in order to avoid non-taxation, contracting states may agree to limit the scope of the article to income that is taxed in the contracting state of which the recipient is a resident.[11]

By 1977 the number of countries filing reservations had, surprisingly considerably expanded. In addition to Canada, Australia, New Zealand, Portugal, and Spain all generally reserved their positions, noting that they wished to maintain the right to tax income arising from sources in their own countries.[12] Sweden also reserved, stating that it wished to retain the right to tax certain annuities and similar payments to non-residents where the payments were made on account of pension insurance issued in Sweden.[13] As well, the United Kingdom reserved, noting that it wished to maintain the right to tax income paid by residents of the United Kingdom to non-residents in the form of income from a trust.[14]

THE UN MODEL

The United Nations (UN) Model Double Taxation Convention Between Developed and Developing Countries,[15] which was adopted by the ad hoc U.N. Group of Experts[16] in December 1979, added a third paragraph to Article 21 as formulated by the 1977 OECD model:

> Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

The change indicated by Paragraph 3 was consistent with the thrust of the other changes made to the OECD model by the UN Group of Experts. The group objected to the prior "unbalanced" principle that taxation by the state of residence was the rule and source taxation was an exception, and was concerned with enlarging the right of the states of the source of income to levy tax. The change was also consistent with the reservations previously filed to the OECD model. This enlarging of the right of the state of source to impose tax has, however, two notable gaps.

First, the UN model (like the OECD model) contains only limited rules to determine the state within which income can be said to "arise." In dealing with interest, Arts. 11(5) of both the OECD and UN models provide exhaustive rules dealing with the place in which interest is deemed to arise.[17] No similar rules are provided in the OECD model for royalties (and rents for certain equipment included in the royalty article),[18] but Article 12(5) of the UN model does provide "arising" rules for this kind of income.[19] Article 10 refers to dividends paid by a company which is a resident of a contracting state; therefore one may infer that dividends "arise" for purposes of Article 21 in the state of residence of the company paying the dividend.

Because source taxation is prohibited for other income under the OECD model, the absence of general source rules in this model is not of great concern. However, the same is not the case under the UN model which permits source taxation, at unlimited rates.

Where a treaty does not contain specific source or "arising" rules, it is our view that the state that claims that the income arises in that State has the right to apply its own source rules, unless the context otherwise provides, to determine where the income arises, applying Article 3(2) of the OECD and UN models. The state of residence, it is suggested, must accept that the state of source has this right, and must relieve double taxation under Article 23 of the models "[w]here a resident [of that state] derives income . . . which, in accordance with the provisions of [the] Convention, may be taxed in the other Contracting State."

We believe that this approach is required under treaties that follow the UN model permitting source state taxation of other income, even though the state of residence, in applying its own source rules, would not have found the source to be in the other contracting state. The reason is that Article 3(2) is designed to permit the gaps in the definition

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11. See supra footnote 5 and accompanying text.
12. Portugal and Spain had been members of the OECD in 1963 and filed no reservation to Article 21 at that time. In 1977, however, both countries were in the process of restructuring their tax systems, and they filed reservations as a precautionary measure to avoid making a specific commitment not to impose source taxation on other income. They may also have reserved in order to preserve their bargaining positions on future treaty negotiations. However, in treaties signed since 1977, Portugal and Spain have often adopted the OECD formula despite the reservations each filed against it. See, for example, the treaties between Portugal and Italy (1980), Germany (1980), and Czechoslovakia (1978) and the treaties between Spain and Czechoslovakia (1980), Hungary (1984), Luxembourg (1986), Poland (1979), Romania (1979), Tunisia (1982) and USSR (1985).
13. Sweden, also a member in 1963, had filed no reservation at that time. However, Sweden passed legislation in 1975 (Kommunalskattelagen 53§, mom.1) to make non-residents liable to tax on amounts paid on account of pension insurance issued by an insurance business carried on in Sweden.
14. The United Kingdom also had filed no reservation in 1963. Legislation passed in 1973 (Finance Act, 1973, section 17, now Income and Corporation Taxes Act 1988, section 687) made discretionary and accumulating trusts non-transparent, so that the income from such trusts became a separate source of income and thus fell within the other income article. The change in the UK position noted in the commentary on the 1977 OECD model was made to preserve the UK's right to tax such income paid to non-residents. It is arguable that even before this legislative change, a distribution from a trust was an "annual payment", and therefore other income (see infra footnote 49).
15. United Nations Department of International Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: UN, 1980).
16. The ad hoc Group of Experts consisted of tax officials and experts from Argentina, Chile, France, West Germany, Ghana, India, Israel, Japan, Netherlands, Norway, Pakistan, the Philippines, the Sudan, Switzerland, Tunisia, Turkey, the United Kingdom, and the United States.
17. See paragraphs 24 et seq. of the commentary on Article 11 of the 1977 OECD model, which make this clear.
18. This has been noted in the Belgium Tax Administration Commentaries, supra footnote 9, at paragraph 12/31.
19. See paragraph 5 of the commentary on Article 12 of the UN model. In the OECD model, because no tax is imposed by the State in which royalties arise, it was unnecessary to define the source of royalties. The U.N. model, on the other hand, contemplates source taxation; therefore, an "arising" rule became appropriate, and was added. We have noted that Australia usually departs from the UN formulation of the source of royalties to deem royalties also to arise in third states if they are borne by a permanent establishment in a third state.

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of terms used in the treaty to be filled, unless the context otherwise requires, by reference to internal law where the treaty is applied by a contracting state. The state of residence must then recognize that the state that has applied its internal law to establish the source of an item of income has imposed tax "in accordance with the provisions of [the] Convention," requiring the state of residence under Article 23 to grant a credit or exempt the same item of income from tax. Similarly, if the non- residence state, applying its internal law source rules, determines that the item of income does not arise in that state, and the income is thereby not subjected to source taxation under a treaty in the UN model form, the state of residence should recognize the correctness of this conclusion and need not provide relief from any source taxation by way of credit or exemption under Article 23. By this interpretation, the problems of double taxation, or non-taxation by virtue of inconsistent internal law source rules, does not arise under treaties.[20]

Questions may legitimately be raised whether the place where income "arises", in cases where the treaty does not provide its own rules, is the same as the "source" of income that is found in the internal law of some states, such as the United States where source rules have become highly developed by both statute and jurisprudence.[21] On a narrow construction, it might be argued that Article 3(2) cannot be applied unless the precise word used in the treaty is also used in internal law. This, in the authors' view, is not a correct interpretation of Article 3(2) because "term" (in English) and "expression" (in French) have a wider meaning than "word" and embrace a notion or concept.[22] Therefore, although different English words are used ("arising" and "source") because the concepts or notions appear to be the same, the state that claims that the income arises there can, by virtue of Article 3(2) of the UN model, apply its internal law, including its "source" rules and tax the income found to arise there as other income if it is not otherwise dealt with in specific articles of the treaty.[23]

The second notable gap in the UN model is that there is no attempt to limit the rate of tax that may be imposed on the other income in the country of source. The UN model, in dealing with dividends, interest and royalties, contemplates that treaty negotiators, in their bilateral negotiations, will fix the rate of tax which can be imposed by the state of source,[24] but it does not indicate any intended limitation on the rate of tax imposed by the state of source in respect of other income.[25]

INCOME COVERED BY THE OTHER INCOME ARTICLE

In order to determine what items of income fall within the other income article of a particular treaty, it is necessary to review the preceding articles and identify the items of income that are dealt with therein. In the 1977 OECD model, items of income dealt with in the preceding articles are limited to the following:

1) income derived by a resident of one state from immovable property situated in the other state;[26]

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20. See John F. Avery Jones et al., "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model-I" [1984], no. 1 *British Tax Review* 14-54, at 48 et seq., for a discussion of the application of Article 3(2) where characterization of an item of income is an issue that can also arise in considering whether the other income article applies. The same reasoning applies where the source of an item of income is in issue. For a dissent from the views expressed by the authors in this earlier article, see Klaus Vogel, "Double Tax Treaties and Their Interpretation" (Spring 1986), *International Tax and Business Lawyer* 1-85, at 49 et seq.
We have noted that paragraph 13 of the protocol to the Canada–Germany treaty (1981) provides that Germany (as a residence state) may eliminate double taxation of income sourced, and taxed, in Canada caused by inconsistent characterization or attribution by granting credit for Canadian tax, and may eliminate non-taxation by denying its residents the treaty exemption from tax. We have also noted that paragraph 21 of the protocol to the proposed new US-Germany treaty (1989) has a somewhat similar provision which permits the United States to characterize the income item in question consistently with the German characterization to avoid double taxation or non-taxation.

21. See, for example, Michael J. McIntyre, *The International Income Tax Rules of the United States;* (Butterworths, 1989), 3-5 et seq., and Marc M. Levey, *Foreign Investment in the United States* (New York, Wiley 1989), 5.3, et seq. The source rules in sections 861 to 865 of the US Internal Revenue Code of 1986, as amended, cover substantially all items of income, and those not expressly mentioned have their source determined by finding the closest analogy to items expressly dealt with by the Code (see Joseph Isenbergh, *International Taxation, United States Taxation of Foreign Taxpayers and Foreign Income,* Boston and Toronto, Little, Brown & Co. (1989) 4.34, et seq.), considering the nature of the item, the nature of the economic activity that generates it, and the location of the property to which it is related (see Sidney I. Roberts and William C. Warren, *U.S. Taxation of Foreign Corporations and Nonresident Aliens* (New York: Practising Law Institute) (looseleaf), paragraph VI/4D, and Rev. rul. 73-252, 1973-1 CB 337). Other countries represented by the authors do not have such elaborate internal law source rules and manage to deal with the issues without them. Many treaties cover the apparent deficiency in the internal law rules, in part, by including a provision to the effect that where income, profits or gains of a resident of one of the contracting states may be taxed in the other state in accordance with the treaty, such income, profits or gains are deemed to arise from sources in the other state.

22. The *Oxford English Dictionary* defines "term", inter alia, as: "[i]n wider application: Any word or group of words expressing a notion or conception, or denoting an object of thought; an expression (*for* something)." We have noted that Article 3(1) of the French version of the 1977 OECD model uses the word "terme" in reference to the definition of a single word, and the word "expression" when the definition in question applies to two or more words, whereas in all cases the English version uses the same word "term".

23. In paragraph 1 of the commentary on Article 21 of the 1977 OECD model, the English words "but also income from sources" read in French "mais aussi ceux qui proviennent de sources". Thus, the English "sources" corresponds with the French "sources" and the French "qui proviennent de" corresponds with the English "from." Also, the English "income arising in" corresponds with "revenus qui ont leur source dans"; thus "arising" (to arise) stands for "ont leur source" (avoir son source). We have noted that Article 21(1) of the Australia–Denmark treaty (1981) uses the words "source" and "arises" interchangeably; "if such income is derived . . . from sources in the other contracting state, such income may also be taxed in the contracting state in which it arises."

24. This contrasts with the 1977 OECD model, which itself prescribes the rates of source taxation.

25. In practice, however, where treaty negotiators often depart from the model treaties and include separate articles dealing with items of income that would otherwise be other income, often the source state will agree to limit its rate of taxation on these particular items of income thereby reducing the scope of right to tax at an unlimited rate.

26. Article 6(1). It is noted that income from immovable property situated in the residence country or in a third country is not dealt with by Article 6, but rather by Article 21: see paragraph 1 of the commentary on Article 6.

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2) all profits of an enterprise carried on by a resident of a contracting state;[27]
3) profits from the operation of ships or aircraft in international traffic;[28]
4) profits from the operation of boats engaged in inland waterways transport;[29]
5) adjustments to the profits of related or associated enterprises made or imposed because the two enterprises, in their commercial and financial relations, do not deal at arm's length;[30]
6) dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state;[31]
7) interest arising in a contracting state and paid to a resident of the other contracting state;[32]
8) royalties arising in a contracting state and paid to a resident of the other contracting state;[33]
9) gains derived by a resident of a contracting state from the alienation of immovable property situated in the other contracting state;[34]
10) gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a contracting state has in the other contracting state, or of movable property pertaining 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;[35]
11) gains from the alienation of ships or aircraft operating in international traffic, boats engaged in inland waterways transport, or movable property pertaining to the operation of such ships, aircraft or boats;[36]
12) gains from the alienation of property other than those referred to in items (9), (10) and (11);[37]
13) income derived by a resident of a contracting state in respect of professional services or other activities of an independent character;[38]
14) salary, wages, and similar remuneration derived by a resident of a contracting state in respect of an employment;[39]
15) directors' fees and other similar payments derived by a resident of a contracting state in his capacity as a member of the board of directors of a company that is a resident of the other contracting state;[40]

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27. Article 7(1). Also mentioned, of course, are profits of one contracting state attributable to a permanent establishment situated in the other contracting state, but these profits would presumably be only a portion of the total profits of the enterprise.
28. Art. 8(1). Profits from the operation of a ship or aircraft in international traffic include profits from the participation in a pool, a joint business, or an international operating agency: Article 8(4).
29. Article 8(2).
30. Article 9.
31. Article 10(1). The term "dividends" is defined, for the purposes of Article 10, by Article 10(3). The definition is not intended to be exhaustive and refers back to the laws of the state of residence of the company making the distribution: see paragraph 23 of the commentary on Article 10. Dividends paid by a company that is resident of a contracting state to a resident of the same State are not dealt with in Article 10, nor are dividends paid by a company that is resident of a third state. However, in a German decision under the Germany–Switzerland treaty (1971), the profit share of a Swiss resident in a German limited partnership was determined to be a dividend even though the partnership did not come within the treaty definition of a company: decision of Bundesfinanzhof (herein referred to as BFH), January 27, 1982. In the United Kingdom, unit trusts that comply with the conditions in the Directive of the Council of the European Communities dated December 20, 1985 on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (No. 85/611/EEC) are taxable as corporations, but at a reduced rate. A UK resident corporation holding units in such a unit trust is treated as receiving "annual payments" and not dividends, thereby potentially becoming subject to full corporation tax on such income. However, Section 468C of the Income and Corporation Taxes Act 1988 preserves dividend treatment for dual resident corporations, which by treaty are considered to be resident outside the United Kingdom, thereby avoiding other income treatment.
32. Article 11(1). Interest is defined exhaustively by Article 11(3) leaving no room for a reference to internal law: see paragraphs 18 and 19 of the OECD commentary on Article 11. Article 11(5) provides rules to determine when interest is deemed to arise in a contracting state, namely, where the payer is the state itself, or a political subdivision or a local authority thereof, or a resident of that state, and where the person paying the interest (whether or not he is a resident of a contracting state) has in a contracting state a permanent establishment or a fixed base in connection with which the indebtedness on which the interest was paid was incurred and the interest is borne by the permanent establishment or the fixed base. Where excessive interest is paid by virtue of a "special relationship", Article 11(6) provides that article applies only to the amount which would have been paid if the payer and the recipient had been dealing in the absence of such special relationship. The excess part of the payment, however, still remains an item of income that is dealt with by virtue of the last sentence of Article 11(6).
33. Article 12(1). Royalties are defined specifically for these purposes by Article 12(2). Even if the royalties exceed the arm's-length amount when paid between parties who deal with a "special relationship", the excess remains an item of income that is dealt with because of the last sentence of Article 12(4). Source rules are provided for royalties in the UN model, but not in the OECD model.
34. Article 13(1). Gains derived by a resident of a contracting state from the alienation of immovable property situated in the same state or situated in a third state do not, however, constitute other income because these gains are dealt with by Article 13(4).
35. Article 13(2). Included are gains from the alienation of the permanent establishment or the fixed base itself.
36. Article 13(3).
37. Article 13(4). This being a catchall clause, gains from the alienation of property cannot be other income except, perhaps, in exceptional cases. An exceptional case arose in the Australian Federal Court in *Thiel v. FC of T,* 89 ATC 4015 (Full Fed. Ct) (currently on appeal to the High Court), where it was held under the Australia–Switzerland treaty (1980) that a gain on the sale of units in a unit trust
- was not included in Article 7 as business profits because although there was an enterprise, the enterprise was not "carried on", because the transaction of purchase and sale was isolated; and
- was not included in Article 13(3) (analogous to Article 13(4) of the OECD Model) because it did not involve income from the alienation of a *capital* asset of an enterprise.

It should be noted, however, that the Australia–Switzerland treaty uses the word "capital" in Article 13, thereby, in the text of the treaty, narrowing the ambit of that article. The OECD model, however, uses the expression "capital gains" in the heading to the article and throughout the commentary, so that one may conclude that it also applies only to capital properties.
38. Article 14(1). This seems to apply to any source of such income. Professional services is given an "inclusive" definition by Article 14(2).
39. Article 15(1). This seems to apply to any source of salary, wages, or similar remuneration, including third country sources. It is interesting to note that the second sentence of Article 15(1) shortens the reference to "such remuneration" while Article 15(2) shortens the reference even further to "remuneration". It is therefore not clear what meaning is left for the adjective "similar." Also mentioned specifically in Article 15(3) is "remuneration" derived in respect of employment exercised aboard a ship or aircraft operated in international traffic or aboard a boat engaged in international waterways transport.
40. Article 16. Directors' fees derived by a resident of a contracting state as a member of the board of a company that is a resident of the same state or of a third state will constitute other income unless they are considered to fall within Article 15 as salary, wages, or other remuneration. In the Netherlands, such income of a "supervisory" (that is, non-managing) direc-

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16) income derived by a resident of a contracting state as an entertainer, a musician or an athlete from his personal activities as such exercised in the other contracting state;[41]
17) pensions and other similar remuneration paid to a resident of a contracting state in consideration of past employment;[42]
18) remuneration (other than a pension) paid by a contracting state or by a political subdivision or a local authority thereof, to an individual in respect of services rendered to that State, subdivision or authority;[43]
19) any pension paid by or out of funds created by a contracting state or by a political subdivision or a local authority thereof, to an individual in respect of services rendered to that state or subdivision or authority;[44] and
20) certain payments to students or business apprentices who are or were resident in one contracting state and who visit the other contracting state solely for the purpose of education or training, where such payments are received for the purpose of maintenance, education, or training, provided that the payments are from sources outside that state.[45]

As stated above, items of income not dealt with include not only classes of income not dealt with, but also, in respect of classes of income dealt with, income of such classes from sources not dealt with.[46] In a treaty modelled on the OECD or UN form, the other income article would therefore apply to income derived from immovable property situated in the state of residence of the taxpayer, or in a third state,[47] and dividends, interest and royalties that arise in the state of residence of the recipient or in a third state.[48] In addition, the other income article may apply to income from estates or trusts.[49] Also included are prizes and awards,[50] grants from foundations,[51] gambling winnings,[52] alimony payments,[53] distributions from individual retirement accounts,[54]

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tor is considered to fall within Article 14 (Independent Personal Services) because under Netherlands law a supervisory director is not employed by the company he supervises. For Netherlands internal wages and individual income tax purposes, however, he is deemed to be employed. There may be a question whether this deeming provision applies for treaty purposes because of Article 3(2) or whether Article 14 is applicable.

41. Article 17(1). Article 17(2) deals with income of an entertainer or athlete accruing to another person that arises in a contracting state because of the exercise by the entertainer or athlete of his activities in that state. Article 17(2) may deal with income from sources in the state of residence of the entertainer or athlete.

42. Article 18. There is no definition of pensions or similar remuneration. If payments received by a taxpayer who rendered dependent personal services in the past are not classified as pensions or other similar remuneration, they may come within Article 15 (Dependent Personal Services) or Article 16 (Directors' Fees): see, for example, the Dutch case decided by the Hoge Raad, July 22, 1988, BNB 1989/2. The issue whether Article 15 rather than Article 18 applies particularly arises when lump sums are paid on the surrender of pension rights (see Hoge Raad, July 11, 1989, BNB 1989/287). This problem of dealing with what are pensions and other similar remuneration, and what are not, is also referred to in the Belgian Tax Administration Commentaries on Articles 18 and 21. According to the Belgian Tax Administration (Questions et Réponses, Chambre des Représentants, session 1984-5, p. 1430), lump-sum payments to a Belgian resident to satisfy pension liabilities before the normal maturity date, even when received in consideration of past employment in the other contracting state, are taxable under the other income article and, therefore, only in the state of residence under a treaty in the OECD form. However, it would follow that such payments could be taxed in the state of source if the treaty followed the UN form (or the permitted variation to the OECD form, if the state of residence did not impose taxation), even though Article 18 permits only the state of residence to tax pensions and other remuneration. For a contrary view, see *Fiscologue International,* No. 28, 15 April 1986, 1.

43. Article 19(1)(a) and (b).

44. Article 19(2)(a) and (b).

45. Article 20.

46. See Vogel, supra footnote 3, at annotation 11 to Article 21.

47. The reference to income from immovable property in paragraph 2 of the other income article confirms this conclusion.

48. The French Conseil d'État has held that, where certain French distributions are presumed to be "secret" under Articles 109 and 111 of the Code Général des Impôts (that is, distributions made by a company, but not in its interest, where the identity of the recipient is not revealed), they are not dividends and become other income: Conseil d'État, 7th and 9th sous-sections, June 10, 1983, req. No. 27391 (France-Italy Treaty); Conseil d'État, July 27, 1984, req. no. 16649 (France- Belgium Treaty); Conceil d'État, November 26, 1982, req. no. 28177 (France-Germany Treaty); Conseil d'État, October 14, 1985, req. no. 37583, 37585 and 42516-42564 (France-Netherlands treaty); and Conseil d'État, March 30, 1987, req. no. 52754 (France-Switzerland treaty).

49. In Canada, this income from estates and trusts is considered to be a separate source of income because of subsections 108(5) and 212(11) of the Income Tax Act, RSC 1952. c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended: see Canada's reservation in the commentary on Art. 21 of the 1963 draft model treaty. The UK interpretation is that the income distributed by the trust, the income interests in which are vested, retains its original character in the hands of the beneficiary: *Baker v. Archer-Shee,* [1927] AC 844 (HL). However, as mentioned in footnote 14, supra, 1973 amendments to the UK legislation provide that distributions from a discretionary or accumulating trust are a separate source of income. The usual wording of the other income article in UK treaties is that it does not apply to income paid out of trusts. In such a case, this could mean that no treaty provision applies to it, so that, under internal law, the trustees would be liable for 35% tax on it. However, Extra-Statutory Concession B18 preserves transparency and the income is not so taxed. The determination of what would otherwise be other income is not clear where there is a transparent trust to which the *Baker v. Archer-Shee* rule applies if the treaty includes an exception in the other income article for income paid out of trusts. On one view the exception will not apply because the income is not income paid out of the trust, but belongs to the beneficiary as it arises. If this is not the case, however, the normal UK tax rate of 25 percent will apply. In the United States and Australia, income from estates and trusts generally retains both its original character and its original source. Generally, in countries where estate or trust income does not lose its original character when payable to the beneficiary, the determination whether such income falls within the other income article will depend on the classification of the underlying trust income.

50. See the US legislative history of the US-Malta treaty, Technical Explanation of the Agreement Between the United States and the Republic of Malta, in Hearing before the Senate Foreign Relations Committee on Various Treaties, 97th Congress, 1st sess. (September 24, 1981), 347, at 378; the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/26; and the Japanese author, Yoshiakira Komatsu, *Sozei jōyaku no kenkyū [The Study of tax treaties]* (Tokyo: Yūhikaku, 1982), 108. Vogel also mentions scholarships and awards for general artistic or scientific achievements: supra footnote 3, at annotation 10 to Article 21.

51. Decision of the German Tax Court, Münster, EFG 1970, 380. The case concerned recurrent distributions by a Dutch foundation to a German resident.

52. This is implicit from US IRS Letter Ruling 8714055, January 7, 1987, under the US-Canada treaty. A full-time gambler may, however, be engaged in a business, in which case his earnings would be subject to Article 7: see the US Supreme Court case: *Commr. v. Groetzinger,* 87-1 USTC 9191 (Sup. Ct. 1987).

53. See the legislative history of the treaties with Malta (1980) (supra footnote 50) and New Zealand (1982), United States Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty Between the US and New Zealand (May 24, 1983), 14 at 35; the Canadian reservation to the 1963 draft model treaty; Swiss rulings EStV. 29.6.1976 and EStV 9.8.1979, Locher, supra footnote 5, at B21(9) and (11); and the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/27.

54. See US IRS ltr. rul. 8718023B, January 30, 1987, under the US-Canada treaty; Canada's reservation under the 1963 draft model; and the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/23.

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annuity payments,[55] child support payments,[56] certain life insurance income,[57] social security payments,[58] some swap payments,[59] penalty charges,[60] certain currency exchange gains and losses,[61] proceeds of disposition of income interest in trusts,[62] damage awards that do not relate to items of income covered by the treaty,[63] golden handshake awards,[64] and gains realised on repayment of debts denominated in foreign currencies.[65]

Depending upon the wording of the royalty article and the definition of "royalties" in the particular treaty, rentals for tangible personal property also my constitute other income[66] as may royalties paid to an entertainer from his sales of recordings if he is not the composer.[67]

Technical assistance payments that are not royalties may be business profits (dealt with in Article 7) or income from independent personal services (dealt with in Article 14). If, however, none of these articles applies in the particular circumstances, such payments will be other income.[68] In

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55. See the U.S. legislative history of the US-Hungary treaty (1979), United States, Staff of the Joint Committee on Taxation, *Explanation of Proposed Income Tax Convention Between the United States and the Hungarian Peoples' Republic,* Prepared for the Use of the Committee on Foreign Relations (Washington, DC: US Government Printing Office, 4 June 1979), 12. Although many US treaties generally define and deal expressly with annuities, the US-Hungary treaty does not (nor does the OECD or the UN model), hence the statement made in the U.S. legislative history of that treaty that annuities are covered by the other income article. See also Komatsu, supra footnote 50, at 108. Annuity payments made to satisfy the purchase price of a business are considered to be other income in Switzerland: Locher, supra footnote 5, at B21(7). (However, to the extent that the business or its assets are sold to realise a capital gain, Article 13 should apply to the gain). Annuity payments by an estate or trust should be other income under German treaties: BFH decision of July 20, 1971, BStBl, 1972 II 170. It is believed that the same result will obtain in other countries represented here.
Questions may arise whether the interest element of a purchased annuity is taxed as interest under Article 11. Paragraph 21 of the commentary to Article 11 states that annuities ought not to be assimilated as interest. Paragraph 21/24 of the Belgian Tax Administration Commentaries, supra footnote 9, however, states that the income element in annuities that is subject to tax by Article 11(6) of the Belgian Income Tax Code is treated as interest for treaty purposes when the annuities are set up "without the transfer of capital" – that is, if the capital transferred by the beneficiary of the annuity is refunded either to him or to his "ayants droit." On the other hand, income from annuities set up with the transfer of capital is other income. See also Vogel, supra footnote 3, at annotation 10 to Article 21. In Germany, under internal law, the interest element in annuities is taxed as pensions or annuities and not as interest income, so that the interest article becomes inapplicable also on this ground. In the United Kingdom, annuities would also be included as other income. The element representing the return of original capital in certain purchased life annuities is tax-free (Income and Corporation Taxes Act 1988, Section 656), but the interest element is taxed as an annuity and not as interest, and therefore becomes other income.
56. See the US legislative history of the US treaties with Hungary (1979) (supra footnote 55), Malta (1980) (supra footnote 50), New Zealand (1983) (supra footnote 53) and the United Kingdom (1975), Technical Explanation of the Convention Between the Government of the United States of America and the Government of the United Kingdom (Department of the Treasury, Washington news release dated March 9, 1977) at 42-3; the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/27 and Italian ruling no. 12/028 of July 3, 1980 under the Italy-France treaty (1969).
57. See the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/25.
58. See the US legislative history of the treaties with Malta (1980) (supra footnote 50) and the United Kingdom (1975) (supra footnote 56); Swiss rulings EStV 28.10.1974 and EStV 8.4.1980, Locher, supra footnote 5, at B21(4); the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/23; and Vogel, supra footnote 3, at annotation 10 to Article 21.
59. We believe that, in many cases, swap payments will, be properly regarded as business receipts, and thus will be covered by Article 7 if they are made or received in respect of an enterprise carried on by a resident of a contracting state. If the swap contract relates to a non-business asset or activity, in our view the swap payments will fall under the other income article. In Australia the Commissioner of Taxation has ruled in Australian Taxation ruling IT 2050 dated July 13, 1983, that swap payments are not interest. The US position seems to be the same: see U.S. Rev. Ruling 87-5, 1987-1 CB 180. In the United Kingdom, a consultative document issued by the Inland Revenue on March 14, 1989 suggests that it may be a concession of the Inland Revenue that swaps are treated as annual payments. The document tentatively proposes to treat swap payments as interest. In treaties following the OECD or UN form, "interest" is a defined term (Article 11(3)), leaving no room to apply Article 3(2). Such a change in internal law as that proposed by the United Kingdom therefore should not alter the application of treaties if they are in the OECD model form. However, most modern U.K. treaties define interest to include income assimilated to income from money lent, and under such treaties a change of internal law might bring swap payments within Article 11.
60. Penalty charges are excluded from Article 11 (Interest): see the last sentence of Article 11(3) of the 1977 OECD model treaty. If they are not included in business profits (Article 7) they will become other income. See also the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/28, and the instruction of the French Tax Authority to its agents dated January 21, 1987: *Bulletin Officiel de la Direction Général des Impôts* 14 B-1-87 under the France–US treaty.
61. These are discussed in Organisation for Economic Co-operation and Development, *Tax Consequences of Foreign Exchange Gains and Losses,* Issues in International Taxation no. 3 (Paris: OECD 1988), 35 et seq. These gains and losses could be part of business profits (Article 7) or part of capital gains (Article 13), but cases may arise where they would be other income. See the further discussion of foreign currency gains and losses in the text following.
62. In Canada, the gross amount of such payments is included in income, not just the "gain." If only the gain is included in income, Article 13(4) will apply and the gain will not be other income.
63. See Vogel, supra footnote 3, at annotation 10 to Article 21.
64. In Australia such amounts received by an employee will not be considered to be salary, wages, or other similar remuneration derived in respect of employment and therefore not covered by Article 15. Because of the broad definition of income from an office or employment contained in Section 6 of the Canadian Income Tax Act, this view would not likely prevail in Canada. It also would not likely prevail in the United Kingdom.
65. See Komatsu, supra footnote 50, at 108, where profits on redemption of bonds are mentioned as other income. Gains on repayment of debt, if realised in respect of the operation of a business, may fall within Art. 7. Although subsection 39(2) of the Canadian Income Tax Act deems a capital gain on the repayment of debt denominated in a foreign currency to be from the disposition of currency (that is, property), no such currency or property exists and Article 13 will not apply. In the United Kingdom, no gain accrues to the original creditor in these circumstances: section 134 of the Capital Gains Tax Act, 1979.
66. See the US legislative history of the US–Hungary treaty (1979) (supra footnote 56); Komatsu, supra footnote 50, at 108; the decision of the Court of Appeal of Ghent, January 29, 1982 (FJF 82/25), a decision under the Belgium–Netherlands treaty (1970); and the Belgian Tax Administration Commentaries, supra footnote 9, at paragraph 21/28. However, under the 1977 OECD model, rentals for the use of or right to use industrial, commercial or scientific equipment are not other income: Article 12(2) and paragraph 9 of the commentary on Article 12.
67. Conseil d'État, July 3, 1985, req. no. 5609 under the France–United States treaty.
68. Malaysia, after it introduced a sort of withholding tax on such payments, adopted the view that this was a "new" type of income and fell within Article 21, allowing Malaysia to tax on a source basis where its treaties followed the UN Model: See Michael Krause, "Tax Treatment of the Provisions of Technical Services", *Seminar A, International Taxation of Services, 43rd Congress of the Fiscal Association* (São Paulo, Editora Académica, 1989), 32-39 at 37. In Italy, business profits of non-residents are taxable under internal law (Article 20(1)(e) of Presidential Decree of

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Belgium, it has been held that remuneration of a non-resident working partner in a Belgian corporate partnership is other income.[69] In France, remuneration of the managing director ("gerant") who held a majority holding in a German limited liability company was held not to be income from independent professional services or income from employment, and became other income under the France-Germany treaty.[70] Also, the benefit of the lack of interest on a non-interest-bearing loan from a French company (SARL) to a sister German company (GmbH) which was considered to be distributed income under Article 109 of the French Code Général des Impôts became other income under the France-Germany Treaty.[71]

An interesting question can arise as to the treatment of foreign currency gains and losses that accrue to a dual resident company, for the purposes of the treaty between the two states of residence, when, according to Article 4(3) of the treaty, the company is a resident of state R. If all the business of the company is carried on in state R, the other state will have no right to tax by virtue of Article 7. The question is whether the gain or loss in terms of state currency viewed by the other state is (1) allocated by Article 7 to state R,[72] (2) allocated under Article 21 to state R; or (3) not covered by the treaty, with the result that if the other state can tax it under the gain or loss under its internal law, it will be able to do so.[73]

PROBLEMS RELATING TO FISCALLY TRANSPARENT ORGANIZATIONS

Payments by and to partnerships

Although dividends, interest, and royalties are expressly mentioned in the model treaties, the relevant articles are limited to such payments made to a resident of the other contracting state. While it is often debatable whether or not a partnership is a person,[74] a partnership cannot be a resident of a contracting state unless it is liable to tax therein by reason of domicile, residence, place of management, or some other criterion of a similar nature.[75] Therefore, where a partnership is treated as fiscally transparent and the partners, and not the partnership itself, are liable to pay tax on the income of the partnership, the partnership does not meet the criterion for residence.[76] In these circumstances, payments of dividends, interest or royalties to a partnership are not dealt with by Arts. 10, 11 and 12 of the OECD and UN models unless such payments are considered as having been made to the partners[77] and those partners are resident in the other contracting state.

If the payments are not considered as having been made to the partners, these amounts are even beyond the ambit of the other income article, whether in the OECD or UN model form, because they are not items of income of a resident of a contracting state. Therefore, the widely used other income article may not completely cover all items of other income, unless by internal law or by treaty provisions, or both, a partnership is properly considered to be a resident of a contracting state, or the payments made to it are considered to be payments to the partners in whatever proportions.

Payments of interest and royalties by a partnership also raise difficult problems. Both the OECD and UN models have their own exhaustive "arising" rules relating to interest payments, and the UN model has an "arising" rule relating

December 22, 1986, No. 917 only if derived from activities conducted through a permanent establishment. A different provision (Article 20(2)(d) states, by way of exception, that business profits having an artistic or professional character are taxable regardless of the existence of a permanent establishment. Italian ruling no. 12/366 of July 7, 1979 found these artistic or professional business profits to be other income under the Italy-France treaty (1958), but that ruling may have limited effect because the treaty departed from the wording of the OECD model in the "business" profits article.

69. Court of Appeal Brussels, September 19, 1989, Freens FJF 89/164, commented on in *Fiscologue International,* No. 71, October 22, 1989, 1. The court held that a Dutch working partner of a Belgian corporate partnership that carried on business in Belgium could not be said to have a permanent establishment in Belgium for purposes of Article 7, and because the Belgian Tax Administration did not seek to tax under Article 16 (Directors' Fees), the partner's income became other income.

70. Conseil d'État, 8th and 9th sous-sections, November 25, 1968, req. No. 71227.

71. Conseil d'État, 7th and 8th sous-sections, December 19,1986, req. No. 54101. Komatsu, supra footnote 50, at 108 mentions distributions from an anonymous partnership as other income.

72. Because this gain or loss by definition cannot be perceived by state R, the question arises whether it is (at all) within the scope of Article 7.

73. This third alternative is the view of the Dutch government as stated in its reply to a question asked in Parliament in relation to its 1987 Memorandum on General Tax Treaty Policy (Notitie Algemeen fiscaal verdragsbeleid), Tweede Kamer, 1987-88, 20 365, nos. 3 (question 20) and 5 (reply 20).

74. As defined by Article 3(1)(a) of the 1977 OECD model, a person includes a "body of persons." In Padmore v. IRC, [1989] STC 493, (CA), the UK Court of Appeal agreed that a partnership was "a body of persons."

75. See Article 4(1) of the 1977 OECD model.

76. The Swiss view, however, is that although a partnership is treated under Swiss law as fiscally transparent, because the partners are liable for tax, the partnership can meet the criterion for residence under a tax treaty if it is registered and managed in Switzerland, even if some partners reside outside Switzerland: Jean-Marc Rivier, *Droit fiscal suisse, Le droit fiscal international,* Neuchâtel, Editions Ides et Calendes (1983), 118; Walter Ryser, *Introduction au droit fiscal international de la Suisse,* (Berne: Editions Staempfli & Cie SA, 1980), 70 and Kurt Alig, "Personengesellschaften in internationalen Steurrecht", in: *Handbuch des internationalen Steuerrechts der Schweiz,* edited by Ernst Höhn (Berne: Verlag Paul Haupt, 1984), 254-277 at 259. There are exceptions to this rule based on (1) Swiss internal rules preventing treaty shopping contained in Article 2 of the Federal Decree of December 14, 1962, and (2) specific provisions in the treaties with Germany (1971) and Austria (1974). The protocol of June 18, 1971 and Articles 10 to 12 of the former treaty, and Article 28 of the latter provide that a partnership is resident in a state only if at least three-quarters of the partners are resident there.
Article 4(1)(b) of the proposed US–Germany treaty (1989) suggests that a partnership may qualify as a resident of a contracting state, even if it is not taxable as such, but only to the extent that the partners who are residents of the contracting state are taxable on its income. A letter of understanding to this treaty, however, clarifies this provision by suggesting that the states do not view a partnership as resident, but rather grant the treaty benefits to the resident partner. Read in the light of the letter of understanding, Article 4(1)(b) may imply that, to the extent that the income of a partnership is taxable in the hands of a partner who is a resident of a contracting state, the transparency concept applies which would treat the partner as being engaged in the trade or business of the partnership, would treat the partner as having a permanent establishment wherever the partnership has one (see also *Robert Unger,* 58 TCM 1990-15 [1990], under the Canada-U.S. treaty [1942]), and would treat payments made to or by the partnership as having been made to or by the partner.
In France, various forms of "sociétés de personnes et assimilées" do exist which are not all transparent. Some have the option of not paying corporate tax on their income, but rather the income is taxed in the hands of the partners ("associés"). The French view is that it is not clear that such sociétés de personnes, which are not taxed but are subject to complying with certain tax formalities (calculation of income, paying penalties if no return is filed), are not residents for the purposes of its treaties.

77. For a further discussion of a Canadian view, see David A. Ward, "Foreign Investment in Canadian Real Estate", in *Creative Tax Planning*

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to royalties. These rules apply where the payer of the interest or royalty is a resident of a contracting state, or if the payer is not a resident, the interest or royalty is borne by a permanent establishment or fixed base of the payer in a contracting state.[78] If a partnership is not a resident of either state (because it is not subject to tax, as such) and does not have, in either state, a permanent establishment or fixed base that bears the interest or royalty,[79] then the interest or royalty may become other income unless it is considered to be paid by the partners who are residents of one of the states. In these circumstances, where the partnership is considered to be the payer, source taxation is not permitted to either state even if the treaty has an other income article in the UN form, because the interest or royalty would not "arise" in either State.[80]

Payments by and to a European economic interest grouping

On 25 July 1985, the Council of the European Communities passed regulation no. 2137/85 providing for the creation of a European economic interest grouping ("EEIG") which is to be endowed with legal capacity and is to be an "organ", legally separate from its members.[81] The members of an EEIG may be natural persons, companies, firms, or other legal bodies,[82] and they are jointly and severally liable for debts and other liabilities of the EEIG.[83] The regulation provides that profits or losses of an EEIG are to be taxable only in the hands of its members.[84] If (as is the case for all of the countries of the European Economic Community [EEC] other than Germany and Italy), the domestic law of the place of registration makes the EEIG a "body corporate", the EEIG will be a company and a person for purposes of the 1977 OECD model.[85] However, it is not itself taxable and, therefore, like a partnership that is not itself taxable, it cannot be a resident of a contracting state in the EEC. Further, such an EEIG is unlikely to be resident in any contracting state outside the EEC.[86]

As an EEIG is not a resident of a contracting state, virtually none of the provisions of Arts. 6 to 20 of the OECD model will apply to income that it earns or receives. Article 1 of the 1977 OECD model clarifies this exclusion.[87] Further, quite apart from Article 1, even the other income article cannot apply in respect of the taxation of an EEIG on such income because it too deals only with items of income of a resident of a contracting state.[88] Therefore, in non-EEC

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for Real Estate Transactions – Beyond Tax Reform and into the 1990s, 1989 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1989), 10:1-51 at 10:39 et seq. Under Article 87 of the Italian Consolidated Tax Act, a foreign partnership is an entity for tax purposes, and consequently a payment to a foreign partnership cannot, for Italian tax purposes, be considered to be a payment to the partners. In contrast, Australian Taxation ruling IT-2540 dated June 24, 1989, treats a capital gain on the disposition of partnership assets as gains on assets owned by the respective partners, in proportion to their interests.

78. Article 11(5) of the 1977 OECD and UN models and Article 12(5) of the UN model.

79. It might be questioned whether a partnership can have a permanent establishment, which is a fixed place of business of an "enterprise", presumably "carried on by a resident of a contracting state": see Article 3(1)(c) and Article 5(1) of the 1977 OECD model.

80. In Italy, a partnership is not liable for corporation tax (imposta sul reddito delle personne giuridiche (IRPEG)) but it is liable for local tax (imposta locale sui redditi (ILOR)). Therefore, a payment by a partnership may fall within Article 11 (Interest) or Article 12 (Royalty) for ILOR purposes but fall within Art. 21, or completely outside the treaty for IRPEG purposes. The situation is made more complex because under Italian internal law, interest and royalties are subject to a withholding tax in lieu of both ILOR and IRPEG.

81. A grouping is to have the capacity, in its own name, to have rights and obligations of all kinds, to make contracts or accomplish other legal acts, and to sue and be sued: Article 1(2) of the regulation. The member states are to determine whether or not groupings registered at their registries have legal personality: Article 1(3). The U.K. European economic interest grouping regulations, 1989 (SI 1989/638), which implements this regulation in the United Kingdom, provides that from the date of its registration in Great Britain, an EEIG shall be a body corporate: regulation 3. In the Netherlands, the Act for the Implementation of regulation no. 2137/85 of the Council of the European Communities of July 25, 1985 Providing for the Creation of European Economic Interest Groupings became law on June 28, 1989, Stb. 245 and entered into force on July 3, 1989. Germany implemented the directive on April 22, 1988: EWIV-Ausführungsgesetz. Under the German law, an EEIG is not a legal entity but, like a partnership, it has legal capacity to act, contract, sue and be sued in its own name. France has also adopted legislation (law of June 13, 1989, no. 89-377; J.O. June 15, 1989) to implement the directive, which provides that an EEIG has legal personality as soon as it is registered in the Registre du Commerce et des Sociétés. Denmark (Law no. 217 of April 5, 1989), Ireland (EEIG Regulations 1989; SI no. 191), and Belgium (law of July 12, 1989) also have implemented the directive and legislation to do so is pending in Spain, Italy, Greece, Luxembourg and Portugal.
Apart from Germany, Italy appears to be the only EEC country in which the EEIG will not be a legal entity. Both Germany and Italy chose not to give the EEIG legal personality because to do so would have conflicted with their respective internal laws which deny fiscal transparency to legal persons: Koen Geens, "Le Groupement Européen d'Interêt Economique", a paper delivered to the Harmonization of Company Law in Europe seminar, Brussels, November 2, 1989, 12.

82. Membership is a minimum of 2 and maximum of 20: Regulation no. 2137/85, Articles 4(2) and (3).

83. Ibid., at Article 24(1)

84. Ibid., at Article 40.

85. Articles 3(1)(a) and (b) of the model. If, however, by the law of the place of registration, the EEIG is not a body corporate, it will not be a company because, as its profits are taxed to its members, it will not be "an entity which is treated as a body corporate for tax purposes." It may, however, still be a "person" if it is considered to be a "body of persons."

86. See Article 4(1) of the model. Although Article 40 of the regulation of the Council of the European Communities provides that the members of an EEIG are taxable on its profits or losses, it appears that this rule binds only member states of the EEC. If a contracting state that is not a member of the EEC recognizes an EEIG as a body corporate, and under its internal law it taxes bodies corporate, then notwithstanding Article 40 of the EEC Council's regulation, the EEIG could be subject to tax on its profits or income derived in such a state except where limited by treaty. However, because an EEIG is created under laws of member states of the EEC and only by members who are (1) companies or firms formed in accordance with the laws of member states with registered or statutory offices and central administration within the EEC, and (2) natural persons who carry on business or provide services in the EEC, it is highly unlikely that an EEIG could be liable for unlimited taxation in a state outside the EEC by virtue of its domicile, residence, place of management or some other criterion of a similar nature. Therefore, although an EEIG may be subject to source taxation in a state outside the EEC, it is unlikely to be a resident of any state as provided in Article 4(1) of the 1977 OECD model.

87. Article 1 provides that the model convention applies to persons who are resident in one or both of the contracting states. Even Article 8 (Shipping, Inland Waterways Transport and Air Transport) probably does not apply even though it does not expressly refer to a "resident" because it refers to an "enterprise" (but not an "enterprise of a contracting state"), which, by virtue of Article 3(1)(c), may imply the concept of a resident.

88. Stefaan Van Crombrugge, "Het Fiscaal Statuut van de Economische Samenwerkingsverbanden", in special issue, 1989, *Tijdschrift voor Rechtspersoon en Vennootschap, De Europese en Belgische Economische Samenwerkingsverbanden,* Kalmthout, Biblo. 1989 III, 1-37 at 18 expresses the view that because the treaty articles do not apply to payments received by an EEIG, Belgian internal law applies to permit withholding taxes on dividends, interest and royalties paid to an EEIG, notwithstanding the EEC directive that an EEIG should be treated as fiscally transparent. In

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states where an EEIG may be taxable by internal law on income as a body corporate, taxation seems to be unaffected by the provisions of any treaty in the OECD form.

Where the taxing state is a member of the EEC, it is bound to follow the regulation of the Council of the European Communities and, we believe, can tax only the members of the EEIG. Where the taxing state is the source state, if the EEIG is considered by it to be a body corporate, odd results occur in applying the treaty in that state in respect of taxation to be imposed on the members of the EEIG for the following reasons:

○ In respect of business profits, because the enterprise carried on by the EEIG is not an "enterprise of a Contracting State", Article 7 appears not to deal with taxation of the members on their respective shares of business profits, even though the members do not have a permanent establishment in the source state but the EEIG does, or would have if it were a resident.[89]

○ In dealing with dividends, interest, and royalties received by an EEIG, Arts. 10, 11 and 12 cannot apply because the person who receives the payment is the EEIG and it is not a resident of either state.

Such items of income received or earned by an EEIG would appear, however, to be other income – that is, "[i]tems of income of a resident of a Contracting State . . . not dealt with" in Articles 6 to 20 of the OECD model – from the perspective of a member state of the EEC, because a member state may tax the profits or losses of the EEIG only in the hands of its members who are persons and those members will be residents of some state for treaty purposes. It seems, therefore, that source taxation will be prohibited under a treaty modelled on the OECD form, and taxation at unlimited rates in the state in which the income arises will be allowed under a treaty modelled on the UN form. Both results, although apparently legally sound, appear to be unacceptable and contrary to the underlying intent of the treaties.

Where an EEIG pays interest to a resident of the other contracting state, Article, 11 does not apply unless the interest is borne by a permanent establishment or fixed base of the EEIG in a contracting state (assuming an EEIG can have a permanent establishment or a fixed base), so that the interest will "arise" in a contracting state.[90] If it is received by a resident of the other state, it is then dealt with by Article 11 and does not become other income. As no "arising rule" in respect of royalties appears in the 1977 OECD model,[91] internal law source rules will have to be applied to determine whether royalties paid by an EEIG and received by a resident of the other contracting state arise in the contracting state for purposes of Article 12.[92] Dividends or other distributions to members made by an EEIG that is a body corporate do not seem to fit Article 10 because the EEIG is not a resident. Therefore, if a member of an EEIG receiving such a distribution is a resident of a contracting state, only the state of his residence can tax the income if the relevant treaty is in the OECD form. If it is accepted that such a distribution to members "arises" only in the state where the EEIG is resident, because the EEIG is not resident anywhere, source taxation appears to be precluded under Article 21 even under a treaty in the UN form.

As these results are contrary to the general pattern of income taxation under treaties, special treaty provisions seem necessary to deal with EEIGs.

THE PERMANENT ESTABLISHMENT OR FIXED BASE EXCEPTION

An obvious question is why did the OECD, in the 1977 model treaty, add paragraph 2 to Article 21 dealing with the permanent establishment or fixed base exception? Specifically, it can be asked whether this exception is implicit in any event because:

○ all business income of a resident of a contracting state is dealt with in Article 7(1) and therefore cannot be other income, and

○ income (other than income from immovable property) of a resident of one contracting state who carries on business in the other state through a permanent establishment or

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other words, he is of the view that the fiscally transparent provision applies only to taxes on profits of an EEIG, not to taxes which a payer of an item of income must withhold.

89. See supra footnote 79. Van Crombrugge, supra footnote 88, at 20 and 27, expresses the other view, but seems to base his opinion on an analogy to a partnership where the partners are generally considered to have a permanent establishment whenever the partnership does. In Belgium this is also true of partnerships that are, in Belgian law, legal entities, but which prior to 1986 could elect to be treated as fiscally transparent. Van Crombrugge's view is that because the EEIG is fiscally transparent, its permanent establishment should be considered to be that of its members even though the EEIG is a separate legal entity in law. However, the Belgian author, Malherbe, expresses the view that the permanent establishment of the EEIG cannot be considered to be that of its members when the EEIG has legal personality: Jacques Malherbe, "Régime Fiscal du Groupement Européen d'Interêt Economique en Belgique", in *Fiscalité Approfondie des Sociétés,* (Brussels, De Boeck Professional Publishing, 1989), 187-201 at 192. It should be noted that Article 34 of the Law of July 12, 1989 (MB 22.08.89), which implements regulation no. 2137/85 in Belgium, provides that Belgian-incorporated EEIG's are deemed not to have legal personality for purposes of liability for income tax. Such a deeming provision might be broad enough to attribute to members of a Belgian EEIG (but not a non-Belgian EEIG) the permanent establishment of the EEIG, making Article 7 of the OECD model treaty applicable.

There are 2 published views as to whether (1) the treaty between the source state and the state of incorporation of an EEIG applies to business profits of an EEIG attributed to a permanent establishment or (2) the treaty between the source state and the state of residence of the member of the EEIG applies. Malherbe, supra, at 195, expresses the view that the treaty with the state of incorporation of the EEIG applies, whereas Gert Sass, "Tax Aspects of the European Economic Grouping", (January 1986), 13 *Tax Planning International Review* 3-5, at 4, is of the view that the treaties with the various states of residence of each member of the EEIG apply.

It is difficult to apply either treaty because, in the first place, the EEIG is not a resident of any state and, in the second place, if the EEIG is a body corporate, the permanent establishment is not a permanent establishment of its members and the members do not seem to constitute an "enterprise of a contracting state" because they do not carry on the enterprise carried on by the EEIG.

A UK Inland Revenue consultative document advances an interesting legislative solution by proposing to amend the internal tax legislation to deem an EEIG, whether formed in the United Kingdom or elsewhere in the EEC, for tax purposes to be acting solely as an agent of its members whose activities are to be regarded as those of its members and further provides that where an EEIG carries on a trade or profession, for tax purposes the EEIG is to be regarded as a partnership (but without the application to it of section 111 and section 114(4) of the Income and Corporation Taxes Act 1988). The consultative document includes a request for response before February 28, 1990.

90. Van Crombrugge, supra footnote 88, at 24, agrees.

91. A rule, similar to that dealing with interest, appears in the UN model as Article 12(5).

92. If the royalty does not "arise" in the contracting state for purposes of Article 12, it will be taxable only by the state of residence of the recipient by virtue of Article 21.

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performs independent personal services in the other state from a fixed base, is dealt with in Article 7 or Article 14 and includes income from a right or property that is effectively connected with a permanent establishment or fixed base.

This conclusion is implicit, of course, in Article 10(4) in respect of dividends, Article 11(4) in respect of interest and Article 12(3) in respect of royalties. However, the specific paragraphs dealing with effectively connected shareholdings, debt claims, or rights or property in respect of which the dividends, interest and royalties are paid are limited to dividends, interest, or royalties arising in one contracting state and paid to a resident of the other contracting state; they do not deal with dividends, interest or royalties arising in a third state or arising in the state of residence. It is suggested, therefore, that this is why the OECD Committee on Fiscal Affairs chose specifically to clarify the other income article so that it will not include income arising in a third state or arising in the state of residence from property effectively connected with a permanent establishment or a fixed base in the state in which the permanent establishment or fixed base is situated.[93]

It should also be noted that Article 6, in dealing with income from immovable property, makes no reference to the case of such property being effectively connected with a permanent establishment or a fixed base. Therefore, all income of a taxpayer from immovable property situated in the other state is taxable in the other state by virtue of Article 6, not Articles 7 or 14, and income from immovable property situated in the state of residence or in a third state is other income, even if the immovable property is effectively connected with the permanent establishment in the other state.[94]

Because of the permanent establishment exception, if interest or dividends are paid by a resident of state A to a taxpayer also resident in state A, but they are paid in respect of property that is effectively connected with a permanent establishment of the taxpayer in state B, state B may tax such income and state A is required to give relief for such tax either by Article 23A (exemption) or 23B (credit). If state A is an exemption state, it cannot tax such income, even though it would have had a right to tax if the dividends or interest had been paid to a taxpayer resident in state B. Paragraph 5 of the OECD commentary to Article 21 recognizes this problem and offers a solution for contracting states that find this result to be unacceptable. The contracting states may include provisions in the treaty authorising the state of source to impose tax in these circumstances at rates consistent with the rates or range of rates prescribed in Articles 10 and 11, and providing for a credit by the state in which the permanent establishment is situated.[95]

VARIOUS FORMS OF THE OTHER INCOME ARTICLE

The countries represented by the writers of this article display quite a varied practice in adopting or not adopting other income articles in particular treaties. Eleven of Canada's treaties[96] contain no other income article.[97] The United States has signed 22 treaties with no other income article.[98] The Netherlands has signed 11 such treaties;[99] the United Kingdom, 19[100] (in addition to many old "colonial treaties"); France, 8;[101] Germany, 9;[102] Japan, 12;[103] Switzerland, 8;[104] Italy, 7;[105] Australia, 1;[106] and Belgium, 3.[107]

Where Canada does include an other income article in its treaties, it invariably follows the UN position, reserving to itself (and usually the other treaty partner) the right to tax other income arising in Canada (or the other state), but often providing for a 15 percent limitation of such tax on income from estates and trusts.[108] Canada and Australia

93. See paragraph 5 of the OECD commentary on Article 21. Vogel, supra footnote 3, at annotation 25 to Article 21, makes the same point. The US legislative history of the US-Belgium Treaty (1970) (Technical Explanation of the US-Belgium Income Tax Convention, signed 9 July 1970, in Hearings before the US Senate Foreign Relations Committee, 91st Cong., 2d sess. [October 6 and November 19, 1970, 69]) indicates, however, that the negotiators of that treaty thought that the permanent establishment exception was implicit. The negotiators of the US-Hungary treaty (1979) (see supra footnote 55) also presumably felt the same way; they left an explicit rule out of the other income article but covered the rule by an exchange of notes. It is interesting to note, however, that in the US model treaty the permanent establishment exception is not considered to be implicit, since the treaty provides for an explicit permanent establishment exception in wording that approximates the 1977 OECD model.

94. If, however, the other state, by applying Article 3(2) and the meaning of business profits in its internal law, characterized income from immovable property as part of the business profits of the enterprise, such income might fall within the business profits article (Article 7), not the other income article. In this respect, the "context" of the Treaty is not as strong in displacing the internal law characterization as might be the case when other more specific articles of the treaty (Articles 6 to 20) are in issue.

95. Paragraph 21/51 of the Belgian Tax Administration Commentaries, supra footnote 9, refers to the settlement, presumably by mutual agreement, of the right of the state of residence, in limited cases, to impose tax on dividends and interest paid in these circumstances under the Belgium-France treaty (1964).

96. Denmark (1955) Finland (1959), Guyana (1985), Ireland (1966), Italy (1977), Netherlands (1986), Norway (1966), Switzerland (1976), Trinidad and Tobago (1966), USSR (1985), and UK (1978). In this section, lapsed treaties and treaties which are no longer in force are not referred to.

97. In the treaties with Ireland (1966) and Norway (1966), however, Canada limited the rate of tax on unearned income and on estate and trust income to 15 percent.

98. Austria (1956), Bermuda (1986), Cyprus (1984), Egypt (1980), Greece (1950), Iceland (1975), Indonesia (1988), Ireland (1949), Israel (1975), Japan (1971), Korea (1976), Luxembourg (1962), Morocco (1977), Netherlands (1948), Norway (1971), Pakistan (1957), Philippines (1976), Poland (1974), Romania (1973), Sweden (1939), Switzerland (1951), and USSR (1973).

99. Canada (1986), Denmark (1957), India (1988), Italy (1957), New Zealand (1980), Pakistan (1982), Philippines (1989), South Korea (1978), Sri Lanka (1982), Thailand (1975), and US (1948).

100. Bangladesh (1979), Botswana (1977), Canada (1978), China (1984), Fiji (1975), Gambia (1980), Ghana (1977), Greece (1953), India (1981), Italy (1960), Korea (1977), Malaysia (1973), New Zealand (1983), Nigeria (1987), Pakistan (1986), Philippines (1976), Singapore (1966), Sri Lanka (1979), and Thailand (1981).

101. Austria (1970), Brazil (1971), India (1969), Kuwait (1982), Malaysia (1975), Saudi Arabia (1982), Sweden (1936), and Venezuela (1978).

102. Egypt (1959), Greece (1966), India (1959), Ireland (1962), Korea (1976), Pakistan (1958), Romania (1973), Sri Lanka (1979), and Thailand (1967).

103. Australia (1969), Austria (1961), Egypt (1968), India (1960), Korea (1970), Malaysia (1970), New Zealand (1963), Pakistan (1959), Romania (1976), Sri Lanka (1967), Thailand (1963), and US (1971).

104. Canada (1976), Egypt (1987), Malaysia (1974), Pakistan (1959), Singapore (1975), Trinidad and Tobago (1973), US (1951), and USSR (1986).

105. Canada (1977), UK (1960), Israel (1968), Netherlands (1957), Thailand (1977), Trinidad and Tobago (1971), and USSR (1985).

106. Japan (1969).

107. India (1974), Morocco (1972), and Tunisia (1975).

108. Australia (1980), Austria (1976), Bangladesh (1982), Barbados (1980), Belgium (1975), Brazil (1984) (the Brazilian treaty is unusual in that it does not provide that the state of residence only may tax other income), Cameroon (1982), China (1986), Cyprus (1984), Dominican Republic (1976), Egypt (1983), France (1975)), Germany (1981), India (1985), Indonesia (1979), Israel (1975), Ivory Coast (1983), Jamaica (1978), Japan (1986), Kenya (1983), Korea (1978), Liberia (1976), Luxem-

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have no treaties in force with an other income article in OECD form – that is, in which the state of source is precluded from taxing other income. Other countries represented here do not have the same propensity to follow the UN model and usually do so only when dealing with less developed countries. However, there are some remarkable exceptions. The United States has adopted the UN approach which permits source taxation in 11 of its treaties;[109] and the Netherlands in 1;[110] Japan in 3;[111] France in 7;[112] Belgium in 7;[113] Germany in 5;[114] Australia in 13;[115] Italy in 2;[116] and Switzerland in 1.[117] The United Kingdom has no treaties that follow the UN model.[118]

The great majority of treaties made by countries represented by the authors follow either the 1963 or the 1977 OECD form, perhaps using some different wording but having the same effect of giving the state of residence the exclusive right to tax other income – with or without an express permanent establishment exception. The United States has signed 11 such treaties;[119] the Netherlands, 31;[120] Italy, 31;[121] the United Kingdom, 42 some of which do not extend to income paid out of trusts and some of which have a proviso that the state of residence must impose tax on the income before the state of source is excluded);[122] Japan, 19;[123] France, 47;[124] Switzerland, 21;[125] Germany, 34;[126] and Belgium, 18.[127] In addition, Belgium has 7 treaties in force in which a condition is inserted in the other income article that prohibits source state taxation of other income only if the state of residence imposes tax on such income.[128]

There are also some examples of treaties that depart from the OECD and UN models and give each of the contracting states an unlimited right to tax all other income, regardless where it arises.[129] Two treaties provide that other income is

bourg (1989), Malaysia (1976), Malta (1986), Morocco (1975), New Zealand (1980), Pakistan (1976), Papua New Guinea (1987), Philippines (1976), Poland (1987), Romania (1978), Singapore (1976), Spain (1976), Sri Lanka (1982), Sweden (1983), Thailand (1984), Tunisia (1982), US (1980), and Zambia (1984).

109. Argentina (1981), Australia (1982), Bangladesh (1980), Barbados (1984), Belgium (1970), Canada (1980), China (1984), Finland (1970), Jamaica (1980), New Zealand (1982), and Sri Lanka (1985).

110. China (1987).

111. China (1983), Canada (1986), and Sweden (1983).

112. Canada (1975), China (1984), Jordan (1984), Korea (1979), New Zealand (1979), Philippines (1976), and Quebec (1987).

113. Canada (1975), China (1985) (which permits source taxation but does not prohibit taxation by the state of residence), Korea (1977), New Zealand (1981), Philippines (1976), Thailand (1978), and US (1970).

114. Canada (1981), China (1985), New Zealand (1978), Philippines (1983), and Turkey (1986).

115. Austria (1986), Canada (1980), China (1988), Denmark (1981), Finland (1984), Ireland (1983), Korea (1982), Malta (1984), Norway (1982), Papua New Guinea (1989), Sweden (1981), Thailand (1989), and US (1982). See also infra footnote 133.

116. China (1986) and Kenya (1979).

117. New Zealand (1980).

118. The UK-Lesotho Treaty (1949), however, provides in Article 13: Subject to the provisions of paragraph 3(3) [which deals with permanent establishments] of this Arrangement, a resident of the United Kingdom whether carrying on business in Lesotho or not, shall be exempt from Lesotho tax in respect of any income received or accruing from any country outside Lesotho in respect of which he is subject to United Kingdom tax." This rule provides the same result as the UN model for UK residents but not for Lesotho residents.

119. Aruba (1986), British Virgin Islands (1981), Denmark (1980), France (1967), (the other income article was added in 1983), Germany (1989), Hungary (1979), Italy (1984), Malta (1980), Netherlands Antilles (1986), Tunisia (1985), and UK (1975) (but with the usual U.K. proviso that the article does not apply to income paid out of trusts).

120. Austria (1970), Belgium (1970), Czechoslovakia (1974), Finland (1970), France (1973 and a new proposed treaty signed in 1979), Germany (1959), Greece (1981), Hungary (1986), Indonesia (1973), Ireland (1969), Israel (1973), Japan (1970), Luxembourg (1968), Malaysia (1988), Malta (1977), Morocco (1977), Norway (1966), Poland (1979), Romania (1979), Singapore (1971), South Africa (1971), Spain (1971), Surinam (1975), Sweden (1968), Switzerland (1951), Turkey (1986) UK (1980) (but the clause does not apply to income paid out of trusts), USSR (1986), Yugoslavia (1982), Zambia (1977), and Zimbabwe (1989, not yet in force).

121. Austria (1981), Belgium (1983), Cyprus (1974), Czechoslovakia (1981), Denmark (1980), Ecuador (1984), Egypt (1979) (with an exception for management fees), Finland (1981), France (1958), Germany (1925), Greece (1965), Hungary (1977), Ireland (1971)(but the Other Income Article does not extend to income from third States), Ivory Coast (1982), Japan (1969), Luxembourg (1981) Malta (1981), Morocco (1972), Norway (1985), Philippines (1980), Portugal (1980), Romania (1977), Spain (1977), Sri Lanka (1984), Sweden (1980), Switzerland (1976), Tanzania (1973) (with an exception for management fees), Tunisia (1979), United States (1984), United Kingdom (1988), US (1984), and Yugoslavia (1982).

122. Austria (1969), Barbados (1970), Belgium (1987), Bulgaria (1987), Cyprus (1974), Denmark (1980), Egypt (1977), Falkland Islands (1984), Finland (1969), France (1968), Germany (1964), Hungary (1977), Indonesia (1974), Ireland (1976), Israel (1962), Italy (1988), Ivory Coast (1985), Jamaica (1973), Japan (1969), Kenya (1973), Luxembourg (1967), Mauritius (1981), Morocco (1981), Namibia (1962), Netherlands (1980), Norway (1985), Poland (1976), Portugal (1968), Romania (1975), South Africa (1968), Spain (1975), Sudan (1975), Swaziland (1968), Sweden (1983), Switzerland (1977), Tunisia (1982), Turkey (1986), US (1975), USSR (1985), Yugoslavia (1981), Zambia (1972), and Zimbabwe (1982).

123. Belgium (1968), Czechoslovakia (1977), Denmark (1968), Finland (1972), France (1964), Germany (1966), Hungary (1980), Indonesia (1982), Ireland (1974), Italy (1969), Netherlands (1970), Norway (1967), Philippines (1980), Poland (1980), Spain (1974), Switzerland (1971), UK (1969), USSR (1986), and Zambia (1970).

124. Algeria (1982), Argentina (1979), Belgium (1964), Benin (1975), Burkina Faso (1965), Cameroon (1976), Comoro Islands (1970), Congo (1987), Cyprus (1981), Czechoslovakia (1973), Denmark (1957), Finland (1970), Gabon (1966), Germany (1959), Greece (1963), Hungary (1980), Indonesia (1979), Iran (1973), Ireland (1968), Italy (1958 and a new proposed treaty signed in 1989), Ivory Coast (1966), Japan (1981), Luxembourg (1958), Madagascar (1983), Malta (1977), Mauritania (1967), Mauritius (1980), Morocco (1970), Netherlands (1973), New Caledonia (1983), Niger (1965), Norway (1980), Poland (1975), Portugal (1971) (with a provision that the state of residence must tax before the other state is excluded), Romania (1974), Saar (1959), Senegal (1974), Singapore (1974), Spain (1973), Switzerland (1966), Togo (1971), Tunisia (1973), UK (1968) (with a provision that the state of residence must tax before the other state is excluded), US (1967) (the other income article was added in 1983), USSR (1985), and Yugoslavia (1974).

125. Austria (1974), Belgium (1978), Denmark (1973), France (1966), Germany (1971), Greece (1983), Hungary (1981), Iceland (1988), Ireland (1966), Italy (1976), Ivory Coast (1987), Japan (1971), Netherlands (1951), Norway (1987), Portugal (1974), South Africa (1967), South Korea (1980), Spain (1966), Sri Lanka (1983), Sweden (1965), and UK (1977).

126. Austria (1954), Belgium (1967), Bulgaria (1987), Czechoslovakia (1980), Denmark (1962), Ecuador (1982), Finland (1979), France (1959), Hungary (1977) Iceland (1971), Indonesia (1977), Iran (1968), Israel (1962), Italy (1925), Jamaica (1974) Japan (1983), Kenya (1977), Luxembourg (1973), Malaysia (1977), Malta (1974), Morocco (1972), Netherlands (1959), Norway (1958), Poland (1972), Portugal (1988), Singapore (1972), South Africa (1973), Spain (1966), Sweden (1959), Switzerland (1971), UK (1964), US (1989), USSR (1981), and Yugoslavia (1987).

127. Austria (1971), Czechoslovakia (1975), Finland (1976), France (1964), Germany (1967), Hungary (1982), Indonesia (1973), Israel (1972), Italy (1983), Japan (1968), Malta (1974), Netherlands (1970), Pakistan (1980), Poland (1976), Romania (1976), Sri Lanka (1983), Switzerland (1978), and Yugoslavia (1980).

128. Denmark (1969), Greece (1968), Luxembourg (1970), Norway (1967), Portugal (1969), Spain (1970), and Sweden (1965).

129. Australia–Singapore (1969), Italy–Argentina (1979), Italy–Brazil (1978), Italy–India (1981), Italy–Malaysia (1984), Italy–New Zealand (1979), Italy–Pakistan (1984), Italy–Singapore (1977), U.K.–Trinidad (1982), Japan–Brazil (1967) Japan–Singapore (1971), France–Egypt (1980), France–Sri Lanka (1981), France–Trinidad and Tobago (1987),

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taxable only in the contracting state in which it arises and give neither state the right to tax income arising in a third country.[130] The France–USSR (1985), Japan–Ireland (1974), Italy–Ireland (1971), Belgium–Ivory Coast (1977), Belgium–Sweden (1965) and Belgium–Ireland (1970) treaties adopt a different formulation, limiting the other income article to income from sources in the non-residence state and providing that the resident is not liable in that state to tax on other income from sources in that state. However, there is no mention of income arising in third states or arising in the state of residence of the taxpayer. In the Germany–Trinidad and Tobago treaty (1973), the other income article is limited in its operation to income from sources in a third state.

IMPORTANCE OF THE OTHER INCOME ARTICLE

As the previous discussion has shown, it is not unusual for states to conclude tax treaties without an other income article. Perhaps this results from a lack of appreciation of the consequences of omitting the article. For example, the Memorandum on General Tax Treaty Policy submitted by the Netherlands Finance Minister to Parliament on December 3, 1987, in dealing with other income, states (our translation):

> [I]n the tax treaties the various categories of income are so extensively covered that the importance of the other income article is generally restricted. This is particularly true if a separate rule is included in the preceding treaty articles for annuities and social insurance benefits. . .
>
> Whether the Netherlands is prepared to consider the UN approach depends on the degree of completeness with which the various sources of income have been covered by the preceding articles. To the extent the importance of the other income article is smaller, our country has less objection to following the UN model in this respect. In cases where the sources of income have been practically fully covered, it is sometimes decided not to take up the other income article at all.[131]

Although specific articles can be, and often are, inserted to deal with important categories of income not dealt with in the models which are of specific interest to the negotiating states, there will still remain uncovered, the problems of taxing income of categories not mentioned, and certainly problems in respect of income mentioned (notably dividends, interest, and royalties) arising in the state of residence and in third states. Clearly, a tax treaty without an other income article is incomplete, since it does not address the treatment of items of income not dealt with expressly by virtue of the character of the income, or its source or both. However, the article in the usual OECD or UN form may also be ineffective in dealing with payments to (and in some cases, payments by) partnerships and EEIGs if the partnership or the EEIG is a person but cannot be considered to be a resident of either contracting state.

Where a treaty does not include an other income article in any form, unfortunate effects can also occur for taxpayers who, under internal law, are residents of both contracting states for tax purposes. Although the dual resident article[132] provides a series of rules by which the taxpayer is considered to be a resident of only one of the two states for purposes of the treaty, the absence of the other income article means that the treaty does not extend to this other income of the taxpayer. Therefore, for taxation purposes in respect of this other income, the taxpayer continues to be a resident of both states and may be liable to full double taxation on all such income, including that arising in each state and in third states.

Interestingly, Australia in several of its treaties[133] seems to recognize this problem by limiting the other income article to cases where the taxpayer, in the absence of the treaty, would be a dual resident but, by virtue of the treaty, is deemed to be resident of only one state. In these treaties the other income article (usually called the income of a dual resident article) provides that such taxpayer is taxable only in the state of his treaty residence in respect of other income from sources in that state or in third states, and grants the source state a concurrent right to tax.

Where a treaty includes an other income article in the UN form, the non-residence state will be able to tax other income by applying its own source rules only where the treaty does not provide its source or arising rules in respect of such income. The effect is to reduce the taxation that would otherwise be imposed by the non-residence state, by limiting, to some extent, the application of internal law source rules and, perhaps more important, by limiting taxation imposed by internal law where such taxation is not based on source of income rules.

Although it may appear that an other income article giving both states an unlimited right to tax such income regardless

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Belgium–Brazil (1972), Belgium–Malaysia (1973), Belgium–Singapore (1972), and Germany–Brazil (1975). In the UK treaty with the Faroe Islands (1950), the non-residence state is entitled to tax income from sources in that state but is not excluded from taxing income from sources in third states. The treaties between Italy and Tanzania (1973) and Egypt (1979) give each state the unlimited right to tax management fees as other income.

130. France-Lebanon (1962) and France-Thailand (1974).

131. The *Tweede Kamer,* vergaderjaar 1987-1988, 20 365, No. 2, p. 23-24. A similar comment about the unimportance of the other income article was made in the Netherlands Parliament during debates on the treaty with Canada (1986): see Handelingen *Tweede Kamer,* December 11, 1986 (TK 35) p. 35 – 1987. Here the importance of such an article is heightened by the absence, in that treaty, of a corporate residence tie-breaker clause. This position has been criticized: see M.J. Ellis, "Het Nederlandse Standaardverdrag" (The Netherlands Standard Convention), March 1988 Maandblad Belastingbeschouwingen, Samson Bedrijfsainformatia, 100-109, at 100 et seq (our translation):

> The ease with which an item, which should be a cornerstone of treaty policy, is disposed of, is emphasized by the recent treaties: of the eleven treaties signed in the eighties, four do not contain an "other income" article. Although the article's position in the treaty is that of a tailpiece, it contains in fact the main rule.

See also F.W.G.M. van Brunschot, "Algemeen Fiscaal Verdragsbeleid" (General Tax Treaty Policy) (March 1983), *Maandblad Belasting beschouwingen,* 91-9 at 98 (our translation):

> The reasoning that the other income article may be left out because the categories of income to be dealt with have been dealt with virtually completely, is fallacious. If indeed all categories have been dealt with, no reasonable argument can be made against the inclusion of an other income article, regardless of its contents. For that reason alone, a respectable treaty negotiator is unlikely to leave out an other income article.

132. Usually Article 4(2) and (3).

133. UK (1967), Singapore (1969), New Zealand (1972), Germany (1972), Netherlands (1976), France (1976), Belgium (1977), Philippines (1979), Switzerland (1980), Malaysia (1980), Italy (1982) and Norway (1982). Germany, in its treaties with Liberia (1970) and Argentina (1978), has used a similar provision but in the latter treaty there is also a provision allowing the non-residence state to tax income from sources in third states if the state of residence does not tax it.

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of its source[134] may have the same result as if the treaty had omitted the article entirely, this is not the case. Where a taxpayer is a dual resident and Article 4 restricts his residence for treaty purposes to one of the states, and also where a taxpayer is in any event resident of only one of the states, that state is required by Article 23 to grant relief against double taxation by way of exemption or credit. In the absence of an other income article, it is doubtful whether other income is taxed in the source state "in accordance with the provisions of [the] Convention." If this cannot be established, Article 23 will not apply, and double taxation relief by credit or exemption will be available only if such relief is provided by internal law.[135]

Where a treaty includes an other income article in a form that entitles each contracting state to tax other income in accordance with its own law,[136] it can be argued that the treaty is not applicable to the taxation of these items of income, so that the treaty source rules (if any)[137] and even the residence tie-breaker rules may not be applicable.

SOME PROBLEMS IN THE APPLICATION OF THE OTHER INCOME ARTICLE

Although in most cases only 2 states, the state of source and the state of residence of the taxpayer, would attempt to tax any particular item of income, this is not always the case. It is possible that, in the absence of a treaty two or more non-residence states may claim a right to tax the income on the basis of source or on some other basis while the residence state may also claim the right to tax. Even if there are tax treaties in existence between the source states and the state of residence, which contain an other income article in one form or another, problems can arise through the application of differing source rules.

For example, assume that a taxpayer is resident for tax purposes only in state A and that there are tax treaties between state A and state B and between state A and state C. States B and C both claim the right to tax an item of income on the basis of source under their internal laws. Under the A-B tax treaty, other income is taxable only in state A provided that such income is taxed in state A, otherwise state B is entitled to impose tax on such income.[138] The A-C treaty follows the UN form, and state C has a right to tax income from sources in state C, either under specific articles or under the other income article. If state C exercises this right, the income may not bear tax in state A because state A either grants a credit or exempts the income from tax under Article 23.

In these circumstances both state B and state C will impose tax on the same income and, because the taxpayer is resident in neither state, neither state will exempt or grant credit for the other state's taxes. Even if there is a tax treaty between states B and C, the taxpayer cannot claim any rights under the other income article of that treaty because he is not a resident of either state and therefore the items of income in question are not "of a resident of a contracting state." For the same reason, he cannot claim any relief under the exemption or credit article.[139]

The problems of payments by and to transparent partnerships and EEIGs, which have already been mentioned, also are not dealt with by the other income article in its present form.

CONCLUSION

The authors do not know why so many tax treaties have been brought into force without the inclusion therein of an other income article, whether in the OECD, the UN or some other form. Early history of tax treaties shows that the principle of including an article in a treaty defining the right of the 2 states to tax income not expressly dealt with was so fundamental that it was the first clause in one of the 1928 League of Nations models, but became a tail-end article in the Mexico and London draft models. With the resumption of the work on model treaties by the OEEC and its successor OECD, the other income article again became the last or, some believe, a catchall article, having lost its apparent connection with a basic principle of international taxation that clearly excluded source taxation. The work of the UN ad hoc committee of experts has, of course, changed the conception that the state of residence has the primary right to tax and that source taxation is the exception, and this is reflected in the other income article in the UN model.

One reason why the other income article may be left out of a treaty is that the negotiators believe that they have covered virtually all income by specific articles. This certainly is the view of the Dutch Minister of Finance, and, as we have noted, it has been rightly criticized.

The authors suspect that the absence of an other income article may more usually result from the refusal of some states to recognize the legitimacy of the UN view, and the views of those states that filed reservations with the OECD,

134. See supra footnote 129 for a list of such treaties.

135. Vogel agrees with this conclusion: supra footnote 3, at annotation 15 to Article 21. It may be argued that taxation at source of a resident of a contracting state by the other contracting state in accordance with its internal law is also "in accordance with the provisions of [the] Convention" if there is no other income article, because nothing in the convention prohibits such taxation and such taxation is not therefore in violation of the convention. This argument is not, however, as strong as it appears to be because of the use of the phrase "conformément à" in the French version of the 1977 OECD Model, a phrase with more force than the equivalent English phrase. In attempting to clarify this point, another expression is sometimes used, as in Article 23(1) of the Switzerland–Denmark Treaty (1973): "conformément aux dispositions des articles précédents". The US–Switzerland treaty (1951) (which has no other income article) provides relief in Article XV(1)(b) for Swiss residents, corporations and other entities in respect of U.S. taxation by exempting from Swiss tax "such items of income as are dealt with in this Convention, derived from the United States and not exempt from, and not entitled to the reduced rate of, United States tax under this Convention." In a decision dated March 18, 1955 the Swiss Federal Tax Administration held that the exemption related only to items of income mentioned in the treaty, and not to other items of income. Because of the difference in wording between this treaty and the OECD and UN models, this case may have limited application.

136. Such treaties do exist in the United States – for example, US–Finland (1970) and US–Trinidad and Tobago (1970).

137. For example, the US–Cyprus Treaty (1984) and the US–France treaty (1967) do not follow the OECD or the UN models, but contain a provision with effect somewhat similar to the UN model by stating that a resident of a contracting state may be taxed by the other state only on income from sources in that state, and the treaty source rules apply to determine the source of income.

138. This treaty would be in accord with a permissible variation of the 1977 OECD model: see paragraph 3 of the OECD commentary on Article 21.

139. If there is a permanent establishment in state B or C and the income is from property that is effectively connected, a credit or exemption should be available in the state where the permanent establishment exists: see paragraph 51 of the OECD commentary on Article 24.

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that source taxation of other income is reasonable. It seems likely that many treaties have omitted the article because one state insisted on the UN approach whereas the other state insisted on the OECD approach; since neither state was prepared to alter its position, no article was included in the treaty. Leaving the treaty unfinished by refusing to include an other income article permitting source taxation does, effectively, grant the state that insists on this right the power to levy such tax and would be the equivalent, for treaty negotiating purposes, of agreeing to the inclusion of the other income article in the UN form. However, when the article is omitted entirely, the power of the non-residence state to tax is not restricted to source taxation as it would be under the UN model because that state can also tax certain third-state-sourced or resident-state-sourced other income without restriction, whether by applying its own source rules or by virtue of any other principle of its internal law.

Where a treaty does not contain an other income article, there are serious questions whether the state of residence must afford under the treaty, whether by credit or exemption, relief for double taxation where the so-called source state imposes tax on other income. It is also doubtful whether such double taxation could be relieved by mutual agreement procedures because such double taxation may, in fact, be "in accordance with the provisions of [the] Convention."[140] If this is the case relief would appear to be available only through a so-called "legislative" mutual agreement procedure, with the competent authorities "consult[ing] together for the elimination of double taxation in cases not provided for in [the] Convention."[141]

Because such legislative competent authority procedures are rarely undertaken, and some states believe that treaties cannot effectively be amended in this way by the competent authority, this remedy is usually not practical.[142] Treaties following the OECD form do not permit source taxation of other income except in circumstances where the treaty may permit it because such income would escape tax in the state of residence. Treaties following the UN form do permit source taxation. However, in neither case does the model contemplate any limitation to the rate of taxation in the state of source, notwithstanding that the OECD prescribes rates of source taxation for dividends, interest, and royalties and the UN model indicates that these rates are to be settled by negotiation. It is the view of the authors that whenever source taxation is permitted, a rate of tax should be provided, consistent with the rates or range of rates of source taxation provided in the dividend, interest or royalty articles. If treaty negotiators believe that particular kinds of other income should be taxed at source at different rates, particular treaties should so provide (thereby narrowing the scope of the residuary other income article) but the other income article should also provide a limitation on the rate of source taxation in respect of whatever income comes within it.

It is the view of the authors that the other income article is important to the full functioning of the treaty to achieve its objective of eliminating double taxation. It is therefore to be hoped that negotiators, in the future, will be able to agree on the inclusion of such an article, in whatever form, and that taxpayers will be faced with fewer treaties in which, to their detriment, this gap has been left open.

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140. Article 25(1) of the 1977 OECD model.
141. Article 25(3) of the 1977 OECD model. The United Kingdom does not use this provision.
142. See John F. Avery Jones et al., "The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention" [1980], no. 1 *British Tax Review* 13-27.

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Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

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SWEDEN:

THE TAXATION OF INDIVIDUALS AND CORPORATIONS

The following description of the taxes to which corporations and individuals are subject in Sweden forms part of one of the standard published works of the International Bureau of Fiscal Documentation. This country chapter is extracted from SUPPLEMENTARY SERVICE TO EUROPEAN TAXATION, Section A (Taxation of Corporations) and Section B (Taxation of Individuals), a loose-leaf publication. These sections contain similar summaries of the tax systems of 31 European countries and are updated monthly. Seventeen of these country chapters (the EEC countries plus Austria, Finland, Norway, Sweden and Switzerland) are published separately in a hardback version entitled *European Tax Handbook 1990*. This is an annual publication for desk top use updated to 1 January 1990. A supplementary booklet issued in the second half of the year describes the latest changes in the countries concerned.

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I. TAXATION OF CORPORATIONS

A. Introduction

Companies are subject to the national income tax, the national profit-sharing tax and certain special taxes. No local income taxes are levied on corporate profits. The national net worth tax is not levied on resident companies.

B. Corporate income tax (Statlig inkomstskatt)

1. Type of tax system

In principle, corporate profits are subject to double taxation. However, various measures have been taken to alleviate the total tax burden on such profits and to promote wider share ownership. These measures include the limited deductibility of dividends paid and the total exemption of dividends received by corporate shareholders.

2. Taxable persons

The following types of corporate taxpayer are liable to the national income tax:
- companies limited by shares (aktiebolag, AB), hereinafter "companies";
- economic associations;
- life insurance associations; and

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– certain other associations and groups enumerated in the law.

Certain companies and enumerated types of activities are exempt from income tax. Among these are certain activities of national and local governments, certain government enterprises, churches, schools and hospitals.

Partnerships are not recognized as separate taxable entities and their profits are taxed in the hands of the partners. This survey, however, is restricted to the taxation of companies.

a. *Residence*

The residence of a company is normally determined by whether or not the company is registered in Sweden. A company registered in Sweden is considered to be a Swedish company and therefore a resident taxpayer.

In addition, a company which is not registered in Sweden may be treated as a resident taxpayer if its effective management is in Sweden, its shares are held mainly by Swedish individuals (directly or indirectly) and its activities mainly consist of the administration of and trading in securities and similar movable property.

b. *Non-residents*

Non-resident companies are considered below.

3. Taxable base

The taxable base with respect to resident companies is their world-wide profits less allowable deductions. To alleviate double taxation caused by the worldwide tax liability, relief may be granted unilaterally or pursuant to treaty provisions.

The following types of income are exempt:
– qualifying intercompany dividends;
– capital contributions by shareholders; and
– tax refunds and interest paid on the refunded amount.

Proceeds from the sale of property classified as inventory of the company are included in the taxable business profits and taxed accordingly. In the same manner, proceeds from the sale of fixed business assets are included in the computation of taxable business profits, except in the case of immovable property.

In principle, the proceeds received from the sale or other disposal or loss of machinery and equipment are included in taxable business profits. However, an equal amount is deducted from the aggregated depreciable base. This means, in effect, that actual tax liability is postponed, in whole or in part, through reduced depreciation allowances in subsequent years. If assets in this category are sold or destroyed in the year of acquisition, their cost is fully deductible in that year and any proceeds of sale or insurance indemnity received are included in taxable business profits.

Sales proceeds on goodwill are taxable as business profits in the same manner as machinery and equipment, regardless whether or not disposed of in connection with the business.

Special capital gains rules apply in respect of immovable property and shares and other securities not forming part of inventory.

All business expenses incurred in obtaining or safeguarding income subject to taxation are deductible. Allowable expenses include wages, pensions and other remuneration to employees and the payroll taxes levied thereon. Interest and royalties are deductible but where the payment is between affiliated companies, it must equate to one in an arm's length transaction. Operational losses are also deductible.

Direct taxes are not deductible with the exception of the profit-sharing tax. Indirect taxes (e.g. import duties, etc.) are deductible. Foreign taxes not covered under unilateral or treaty relief provisions are also deductible.

Dividends paid are, in principle, not deductible (but see below).

Taxable income of a company is determined by adding together the net income from each category. The following are the main categories of income (applicable to companies):
– income from agriculture;
– income from immovable property;
– income from business;
– income from occasional economic activities (certain capital gains); and
– income from movable property.

a. *Depreciation*

Machinery and equipment are normally depreciated by the declining-balance method. For taxpayers maintaining adequate accounting records, the maximum depreciation allowance is 30% of the aggregate book value of all assets at the beginning of the tax year, plus the cost of assets acquired, less the amount received for assets sold or lost during the year. Should a straight-line depreciation of 20% per annum on all assets result in a lower book value in any year, the annual depreciation allowance may be increased correspondingly. If the taxpayer can prove that the real value of machinery and equipment is lower than that resulting under the above-mentioned depreciation methods, depreciation may be allowed in an amount resulting in the real value. For taxpayers not maintaining adequate accounting records, the annual allowance is subject to a maximum of 25% of book value. The 20% straight-line depreciation does not apply in this case.

Assets with a useful life not exceeding 3 years and assets of minor value may be fully depreciated in the year of acquisition.

Several types of intangible assets with limited economic life may be depreciated. Such assets include all types of intellectual property, trade marks, goodwill and leasing rights. The methods of depreciation are the same as those used for machinery and equipment.

For buildings, only the straight-line method is permitted. In general, depreciation is based on the cost price and useful life. The rates vary between 1.5% and 5% per annum as agreed by the taxpayer and the tax authorities. Buildings which are intended for use only during a few years may be written off in the year of acquisition.

b. *Valuation of stock*

Under the main rule, stock (inventory) may not be valued at less than 60% of cost of acquisition or replacement value at the date of the balance sheet, whichever is lower, after unsaleable goods have been deducted first (in practice, a deduction of 5% for unsaleable goods is normally granted without proof from the taxpayer). In determining the cost of acquisition, the FIFO (first in, first out) method should be used.

A supplementary rule is designed to avoid adverse tax con-

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sequences when the taxpayer's inventory is reduced below the average level of preceding years, which would imply a reduction of the "reserve" hidden in the inventory valuation. This rule permits valuation of the taxpayer's inventory at cost of acquisition or lower replacement value (less unsaleable items) less 40% of the average cost of acquisition or lower replacement value at the end of the 2 preceding years.

A second supplementary rule is designed to reduce the risk of sharp fluctuations in the market prices of raw materials and staple commodities. These goods may be valued at 70% of the lowest market price in the year of income and the 9 preceding years. The first and second supplementary rules are mutually exclusive.

The normal rules for the valuation of inventory do not apply to shares and other securities and immovable property. Generally speaking, shares and other securities may not be valued below a value which is reasonable with a view to any existing risk of a fall in value, taking the cost of acquisition as the starting point. Immovable property classified as inventory may not be valued at less than 90% of its acquisition cost. However, a lower value is acceptable if the taxpayer is able to prove that it is required with a view to an actual or expected fall in price.

If the taxpayer has made an allocation to a profit equalization reserve, he may not value his inventory at less than 70% of cost or replacement value under the main rule and may not use the supplementary rules. In addition, immovable property may not be valued at less than 95% of cost.

c. *Reserves and provisions*

(1) *Profit equalization reserve*
Taxpayers engaged in agriculture or a business may deduct allocations to a profit equalization reserve by which they can compensate for fluctuations in annual profits. The annual allocation may not exceed 15% of wages paid during the year (for financial years ending before 31 December 1989 the maximum was 20%). The allocation to the reserve is deductible in computing taxable profits of the year during which it is made. The allocation is added back to the profits of the following year, but in that year a new reserve may be created.

The profit equalization reserve is primarily intended for those taxpayers who are unable to avoid fluctuations in annual profits, despite the lenient provisions regarding the valuation of inventory. For that reason, those valuation rules impose certain restrictions on taxpayers making allocations to the profit equalization reserve.

(2) *Replacement reserves*
To avoid or postpone the tax liability for proceeds or compensation received from the sale or loss of fixed assets of the company, various replacement reserves may be created. Allocations to such reserves are usually deductible for tax purposes but the reserve must be used within a stated period of time for the acquisition of replacement assets. To the extent that the reserves are used, no depreciation allowances or deductions as expenses are available; this avoids a double deduction.

(3) *Provision for future guarantee obligations*
Amounts reserved in the balance sheet to provide for future liabilities under guarantees given to customers may, in principle, also be deducted for taxation purposes, subject to a general limit equal to the actual expenditure incurred on guarantees during the year and provided such actual expenditure is separately accounted for. The general limit need not apply if the taxpayer is able to prove that a larger provision must reasonably be made, e.g. in case of a new business or in case of a small number of larger guaranteed projects.

The National Tax Board may issue rulings concerning specific branches of industry, e.g. under one ruling which applies to building construction, handicraft and consulting engineering, a guarantee provision equal to 1% of invoices, exclusive of VAT, is generally allowed, provided the work has been completed and the final invoice presented before the end of the year, and there are outstanding guarantees at that time.

(4) *Pension reserves*
Pensions may be provided for in various ways, e.g. by direct payment of pensions to former employees and their relatives, by contributions to a personnel or pension fund, by the payment of the necessary premiums to an insurance company and by the creation of a reserve on the liabilities side of the balance sheet. The creation of such a reserve is allowed, subject to certain legal requirements. For example, the actual pensions to be paid are subject to maximum amounts.

4. Capital gains

a. *Immovable property*

With respect to immovable property owned by building contractors, dealers in immovable property and other businesses in which property constitutes inventory, any proceeds derived from its disposal are classified as business profits and taxed accordingly.

In other cases, the special capital gains provisions apply and the taxable gains are computed as the difference between the sales price and the acquisition cost (reduced by any depreciation taken), subject to indexation adjustments. The computed gain is included in the taxable income from occasional economic activities and taxed at normal rates.

b. *Shares and other securities*

If shares and other securities are classified as inventory of the seller, any proceeds from their disposal are included in business profits. This applies, inter alia, to securities owned by banks, insurance companies and other financial institutions, unless held for organizational reasons (e.g. shares in a subsidiary).

Gains from the sale of shares or other securities not classified as inventory are taxable under the special capital gains rules. Securities affected include shares in a company and issue certificates connected therewith, participations in an economic association or a partnership and other comparable rights. Convertible debentures and option rights are also subject to the same rules, but bonds and debentures without conversion rights are treated as "other assets" (see below).

Under the capital gains rules, gains derived from the sale or other disposal of shares, etc. are fully taxable if they are owned for less than 2 years ("new shares"). If they are owned for at least 2 years ("old shares"), only 50% of the gain is taxable. The taxable gain is included in the taxable income from occasional economic activities and taxed at normal rates.

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A standard deduction of 2,000 Skr. is allowed from the net gains on old shares for the tax year, i.e. gains less losses from the disposal of old shares. For new shares the corresponding standard deduction is 1,000 Skr.

c. *Other assets*

Special rules govern the tax treatment of gains from the sale of titles to condominium units. Such gains are subject to tax by inclusion in taxable income in proportions varying between 25% and 100% depending on the period of ownership.

Capital gains realized on the sale of assets other than immovable property, condominium rights and shares, are taxable only if the assets are acquired for consideration and are owned for less than 5 years. This category also includes certain securities, such as bonds and debentures without conversion rights.

Depending on the length of ownership, the following proportions of the actual gains are taxable:

Period of ownership	*Taxable proportion*
less than 2 years	100%
2 years to 3 years	75%
3 years to 4 years	50%
4 years to 5 years	25%
5 years or more	nil

5. Tax incentives

a. *General investment reserve*

For financial years ending before 31 December 1989, Swedish companies, economic associations and savings banks engaged in business or agriculture may allocate 50% of pre-tax profits to a general reserve. The annual allocations to the reserve are deductible in computing profits for purposes of the national income tax, but at least the amount of the allocation must be deposited in a special interest-free investment account with the Swedish National Bank.

The amount of the reserve can be used with government approval, or must be used if the government so directs, for the purchase of machinery and equipment to be used in Sweden, the purchase of business premises, the repair of ships and aircraft, and to meet the cost of exploration for and exploitation of mines, quarries and other natural resources, of research and development generally, and education and training of workers, export market development, and a few other qualifying purposes.

Five years after the allocation to the reserve has taken place, 30% may be withdrawn for any of the above qualifying purposes except research and development, education and training of workers and export market development (the "free sector").

When the reserve or part of it is used for qualifying purposes, the corresponding amount of the deposit is released. To the extent that the reserve is used for qualifying expenditure, no further deduction or depreciation is allowed. If the reserve is used for non-qualifying purposes or if the company ceases to carry on a business or is liquidated, the amount of the reserve still outstanding is added back to taxable profits, increased by a penalty of 20%. In respect of allocations made in the books for tax assessments of 1990 and 1991, the penalty is 70%.

b. *Investment allowances*

An investment allowance is available under the investment reserve regime discussed above. This allowance is granted upon use of the investment reserve. The investment allowance is equal to 20% of the amount of the reserve which is used for the purchase of machinery and equipment to be used in Sweden, including means of transportation employed in international traffic, or for the cost of repair and reconstruction of ships and aircraft, and 10% of the amount for other qualifying purposes.

The main characteristic of this allowance is that it constitutes a deduction from taxable income which has no effect on the basis for depreciation. Therefore, this allowance permits certain investment assets to be depreciated more than 100%, and the deduction of more than 100% of other qualifying expenses.

6. Losses

Companies may deduct a net operational loss incurred in an income category from the positive results of other categories for the same tax year. If the loss cannot be totally offset against the positive results of other categories, the balance may be carried forward for 10 years. No carry-back is permitted.

Losses from the sale or other disposition of capital assets, i.e. losses relating to assets which produce capital gains classified as income from occasional economic activities, may only be set off against capital gains realized in the same year or any of the following 6 years. Capital losses may not be set off against income from any other category. If, due to a specified period of ownership, only part of the capital gains that could arise from the disposal of assets would be taxable, the deduction for a loss incurred with respect to such assets is allowed only in a corresponding amount. Only 50% of losses relating to shares and other securities referred to in 4.b. above is deductible regardless of the period of ownership.

7. Rate

For financial years ending on or after 31 December 1989, the corporate income tax is imposed at a flat rate of 40%. Previously the rate was 52%; a further reduction to 30% is due for 1991.

8. Assessment

a. *Pre-assessment*

Every company is issued with a preliminary assessment, showing the estimated income for the year of income and the tax due. This tax is payable in instalments every 2 months (March, May, July, September, November and January). This assessment is based on a preliminary return filed by the company on or before 1 December of the year before the income year.

b. *Final assessment*

Tax returns are generally due by 15 February of the assessment year, i.e. the year following the income year (the income year is the calendar year preceding the assessment year, or the financial year which ends before 1 March of the assessment year). If the taxpayer's income year ends later than 31 August of the year before the assessment year, the due date is 31 March of the assessment year. The return must be accompanied by the balance sheet and profit and

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loss statement as well as the annual report of auditors. The assessment committee may also require any additional information pertinent to the return but may not, however, require the company to open its books.

The final assessment based on the annual return is issued in December of the assessment year. The company's preliminary tax payments are credited against the final tax liability. If preliminary tax payments exceed the amount of final taxes due, refunds are made in December of the assessment year. Any balance due must be paid in March and May of the following year.

Late filing penalty is imposed in the case of companies in the amount of 1,000 Skr. The penalty for incorrect reporting of income is 40% of the tax due on the hidden income (20% if the required information is otherwise available to the tax authorities).

9. Groups of companies

a. *Group treatment*

In Sweden consolidated balance sheets are not recognized for tax purposes. However, the law allows shifting of income within an affiliated group through group contributions. In the case of a qualifying group contribution, the company paying such contribution is entitled to deduct the amount from its taxable income and the recipient company must include such contribution in its taxable income.

The most important conditions for an allowable group contribution are as follows:

- both the payor and the recipient must be resident legal entities;
- the parent company must be a company, an economic association or a mutual insurance institution;
- the subsidiary must be a company;
- the parent must hold more than 90% of the shares of the subsidiary companies for the entire fiscal year;
- the main activity of the company paying or receiving the group contribution must be concerned with immovable property or be a trade or business (other than life insurance business);
- the payor and recipient companies must make full disclosure of the contribution in their tax returns for the same year;
- if the contribution is paid from a subsidiary to the parent, the parent must be exempt from tax on dividends received from the subsidiary company.

The contribution must be made before the annual profit and loss statement for the year in which the contribution is made has been prepared by any of the companies involved.

b. *Intercompany dividends*

(1) *Exemption for dividends received*
Swedish dividends are generally exempt if the recipient is a company which owns or holds shares that represent at least 25% of the entire voting power of the distributing company. If the voting power of the shares owned or held is less than 25%, the dividends received may nevertheless be exempt if the recipient company proves that the shares are acquired for organizational reasons.

The exemption may be extended, subject to approval by the National Tax Board, to dividends received from foreign companies, provided that the distributing company is subject to a tax in its home country which is similar to the Swedish national and local income taxes and that the dividends would have been exempt if the distributing company were resident in Sweden. Under treaty provisions, the exemption is also extended to dividends received from companies resident in the treaty country.

Banks and similar financial institutions are not entitled to an exclusion of dividend income. Special rules apply for closely held companies and holding companies.

(2) *Deductibility of dividends distributed*

(i) *Dividends on newly-issued shares*
Dividends paid are, in principle, not deductible from the gross income of the distributing company. However, dividends paid on new shares may be deducted in an annual amount up to 5% of the consideration paid for the shares. The deduction is allowable for any 10 years falling within a period of 15 years after the shares have been paid up.

With respect to shares issued after 31 December 1978, the annual deduction is increased to 10% and it is available for a maximum period of 20 years, provided that the aggregate deduction over that period does not exceed 100% of the qualifying paid-in capital.

Generally, the deduction is not granted if more than 50% of the shares are held by other Swedish companies which are exempt from income tax on the dividends and/or by foreign companies wholly exempt from the dividend withholding tax by virtue of tax treaty provisions. Other restrictions apply.

(ii) *Dividends on non-quoted shares*
Another deduction is granted which applies exclusively to companies whose shares are not quoted on the Stock Exchange. The deduction amounts to 70% of dividends, subject to a maximum of 700,000 Skr. or 15% of share capital whichever is less. Dividends distributed to other companies do not qualify for this deduction. Dividends on newly-issued shares which qualify for the deduction under the rules explained in (i) above are excluded from this deduction.

c. *Thin capitalization*

Swedish tax law does not include specific rules concerning thin capitalization of companies. However, the Companies Act contains rules regarding the equity capital of a company and rules on the debt/equity ratio as far as the threat of impending liquidation is concerned.

As regards the equity capital, the Companies Act provides that a company must establish and maintain a statutory reserve which may be reduced only in accordance with a decision by the general shareholders' meeting and for specific purposes only.

To avoid liquidation, the company's equity capital must normally be at least one half of the registered share capital.

d. *Transfer pricing*

Profit shifting among related resident companies through intercompany pricing is generally permitted. The main rule is that if open group contributions of unlimited amounts are allowed, the same result may also be reached through intercompany pricing. A mixture of both is also possible, i.e. part through group contribution and part through intercompany pricing.

Where, as a result of an agreement to conditions which deviate from what would have been agreed between independent persons, the profits of a company are transferred to a person (including a company) who is not subject to tax in Sweden in respect of that income, the income of the

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company taxable in Sweden is computed as the amount that it would have been if those deviating conditions had not existed, provided that:
- there are reasonable grounds to assume that an economic relationship exists between the persons concerned; and
- the existing circumstances do not suggest that the deviating conditions have been agreed upon for reasons other than the economic relationship.

10. Double taxation relief

According to unilateral relief provisions, foreign national, provincial and local income taxes imposed on foreign-source income may be credited against the Swedish national income tax, profit-sharing tax and one-off tax on corporate profits, provided the foreign taxes are finally assessed or withheld. The credit may not exceed the Swedish income tax attributable to the foreign-source income (overall limitation).

Foreign taxes not eligible for the above credit relief may be deducted in computing taxable income. Foreign taxes eligible for the credit relief may also be deducted, but the available credit is then reduced by the amount of Swedish tax saved.

For tax exemption for intercompany dividends from abroad, see above.

The extensive network of bilateral and multilateral tax treaties concluded by Sweden provides relief from double taxation of income and capital. Treaty provisions normally allow either a credit for foreign tax or an exemption for foreign income.

C. Other income taxes

1. Profit-sharing tax (Vinstdelningsskatt)

The profit-sharing tax is imposed on most Swedish companies in order to finance the wage-earner funds. The taxable base is the profits adjusted for inflation. The company may claim a fixed exemption of 2,000,000 Skr. or an exemption equal to 6% of the company's payroll expenditure, whichever is greater. Companies within a group are treated as one company if they opt for the fixed exemption. The tax is deductible for income tax purposes in the following year. The tax rate is 20%.

2. Tax on distribution of capital (Utskiftningsskatt)

A special tax is imposed at the rate of 40% on distributions made by companies through reduction of their share capital, or in the course of liquidation to the extent that such distributions are not a mere repayment of paid-in capital and do not represent distributions of profits which are taxed as dividend income in the hands of shareholders. A typical example of a taxable event is the purchase by a company of its own shares or of shares issued by a parent company. The tax is imposed on the company making the tainted distributions.

3. One-off tax on corporate profits (Särskild vinstskatt)

Swedish companies, economic associations, savings banks and mutual damage insurance institutions must pay to the State a one-off surtax on their profits for the next financial year which commences after 31 December 1988. The tax is not imposed on companies whose first financial year commences after 31 December 1989. The taxable base is the profits as computed for the purposes of the profit-sharing tax, subject to certain adjustments. In special cases the Government may grant an exemption from this tax or reduce the taxable base in respect of an enterprise. The tax rate is 15%.

D. National net worth tax (Statlig förmögenhetskatt)

Resident companies are not subject to a tax on net worth.

E. Payroll taxes

No payroll taxes are imposed on companies, other than the social security contributions.

F. Social security contributions

The aggregate amount of the various social security contributions payable by employers is approximately 39% (1990) of wages paid. However, the contributions are reduced by 10 percentage points for employers in the northern development regions. The major items are the general sickness insurance (sjukförsäkring), the old age pension insurance (folkpension) and the general supplementary pension insurance (tilläggspension). The contributions are computed on the remuneration of each employee as adjusted by certain deductions.

G. Withholding taxes

1. Dividends

No withholding tax is levied on dividends paid to residents. Dividends paid to non-residents are subject to a withholding tax (kupongskatt) of 30%.

2. Interest

There are no withholding taxes on interest.

3. Royalties

There are no withholding taxes on royalties, but income tax is assessed.

4. Treaty chart

Under the tax treaties concluded by Sweden, the following Swedish withholding tax rates apply:

	Dividends		Royalties and certain rentals[2]
Country	*Individuals, companies* (%)	*Qualifying companies*[1] (%)	(%)
Argentina	30	30	15
Australia	15	15	10
Austria	10	10	10 (nil)
Bangladesh	15	10	10
Belgium	15	15	nil
Brazil	25	15	15
Bulgaria	10	10	5

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	Dividends		Royalties and certain rentals[2]
	Individuals, companies	*Qualifying companies*[1]	
Canada	15	15	10
China (People's Rep.)	10	10	10
Cyprus	15	5	nil
Czechoslovakia	10	nil	5
Denmark[4]	15	nil	nil
Egypt (U.A.R.)	nil	nil	nil
Faroe Islands[4]	15	nil	nil
Finland[4]	15	nil	nil
France	nil	nil	nil
Germany (Dem. Rep.)	15	10	10
Germany (Fed. Rep.)	15	5	nil
Greece	nil	nil	5
Hungary	15	5	nil
Iceland[4]	15	nil	nil
India	25	15	20
Indonesia	15	10	15(10)
Ireland	15	5	nil
Israel	15	5	—[3]
Italy	15	10	5
Jamaica	22.5	10	10
Japan	15	10	10
Kenya	25	15	20
Korea (Rep.)	15	10	15 (copyright) 10 (patent)
Luxembourg	15	5	nil
Malaysia	nil	nil	nil
Malta	15	5	10
Morocco	nil	nil	nil
Netherlands	15	nil	nil
New Zealand	15	15	—[3]
Norway[4]	15	nil	nil
Pakistan	30	15	10
Peru	30	30	20
Philippines	25	15	25(15)
Poland	15	5	10
Romania	10	10	10
Singapore	15	10	nil
South Africa	30	30	—[3]
Spain	15	10	10
Sri Lanka	15	15	—[3]
Switzerland	5	5	nil
Tanzania	25	15	20
Thailand	30	20(15)[5]	15
Trinidad and Tobago	20	10	nil (20)
Tunisia	20	15	5(copyright) 15 (patent)
U.S.S.R.	15	15	nil
United Kingdom	5	nil	nil
United States	15	5	nil
Yugoslavia	15	5	nil
Zambia	15	5	10

Notes:

1. Usually a 25% ownership limit is decisive, but the particular treaty should be consulted to determine whether the reduced rate for dividends applies to payments to companies which have the requisite control.
2. Royalties paid by Swedish licencees are treated as income taxable in Sweden at the reduced rates shown above, but taxes are not withheld at source.
3. Royalties and certain rentals may be partly or wholly treated as income taxable in Sweden and may be taxed at full rates. The particular treaty should be consulted to determine the exact provisions which apply.
4. Multilateral Nordic treaty.
5. Dividend withholding tax is 15% if the recipient company owns at least 25% of the capital of the paying company which engages in an industrial undertaking; for other companies with at least 25% holding, the rate is 20%; in all other cases it is 30%.

H. Non-resident companies

1. Tax on income

Non-resident companies are subject to the national income tax at the same rate as resident companies, but only with respect to business income attributable to a Swedish permanent establishment, income from immovable property located in Sweden, and capital gains from the sale of real property or business assets located in Sweden.

Dividends paid to non-resident companies and effectively connected with a business carried on through a permanent establishment in Sweden are included in the business income and taxed accordingly. Otherwise, dividends paid to non-resident companies are only subject to a coupon tax (kupongskatt) of 30%, unless a treaty provides otherwise. This withholding tax is final and replaces the national income and net worth taxes.

Royalties and other periodic payments for the use of tangible or intangible assets are regarded as business income derived from a permanent establishment in Sweden, and thus subject to tax, if they are paid by an enterprise engaged in business using a permanent establishment in the country (as is normal).

A Swedish subsidiary of a foreign company is treated in the same manner for tax purposes as any other Swedish company. Both the national law and the treaties contain provisions designed to prevent the shifting of income by ensuring that transactions are carried out at arm's length. A headquarters office of a foreign company established in Sweden constitutes a permanent establishment and a proportion of the total profits of the company is attributed to the headquarters.

2. National net worth tax

Non-resident entities, in general, are subject to the net worth tax with respect to their property (whether movable or immovable) located in Sweden at the end of the calendar year. However, pursuant to non-discrimination provisions in tax treaties, companies resident in a treaty country are normally exempt from this tax.

As the coupon tax on dividends also covers the net worth tax, the shares on which dividends are paid are not included in taxable assets (if not connected with a permanent establishment in Sweden).

The tax is assessed on the basis of the fair market value of the assets at the end of the calendar year. However, shares and other securities which are quoted on Swedish or foreign stock exchanges are, if not exempt, valued at 75% of their quoted value. Shares not officially quoted on a stock exchange but otherwise exchanged with regularly published prices (mainly OTC shares and shares on the list for unofficial quotations) are valued at 30% of their published value.

A non-resident company is entitled to a deduction for debts only insofar as they are attributable to assets which are taxable in Sweden.

The rates are as follows:

Net worth (Skr.)	Rate (%)
under 800,000	nil
800,000 – 1,600,000	1.5
1,600,000 – 3,600,000	2.5
over 3,600,000	3

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I. Value added tax (VAT) (Mervärdeskatt)

1. Taxable persons

Registered entrepreneurs are subject to VAT in respect of their sales of goods and services within Sweden. In addition, all persons are subject to VAT in respect of their imports.

2. Taxable base

The taxable base is the consideration received for sales of goods and certain services rendered in relation to goods or, at importation, the value for purposes of customs duty, including the customs duty itself. In computing the final tax liability, VAT paid on purchases of goods and services may be deducted so that, in effect, only the value added is taxed.

There are 2 types of exemptions, i.e. a full exemption with a refund of the tax paid on purchases and a limited exemption without such a refund.

3. Rate

The rate is 19% computed on the price including tax (effective rate: 23.46% on the price excluding tax). For certain goods and services, the above rate is applied to 60% or 20% of the price paid which implies rates of 11.4% and 3.8% of the price including tax (effective rates: 12.87% and 3.95% of the price excluding tax).

II. TAXATION OF INDIVIDUALS

A. Introduction

Individuals are subject to income taxes levied on behalf of the State (national income tax) and the municipalities (municipal income tax). In addition, the State imposes a net wealth tax and an array of indirect taxes. Inheritances and gifts are subject to inheritance and gift duties imposed by the State.

B. National income tax (Statlig inkomstskatt)

1. Taxable persons

Residents are liable to the national income tax on their world-wide income, non-residents on their income from sources in Sweden. Non-residents are considered in J. below.

a. *Residence*

An individual is considered a resident if he has his principal home in Sweden or is present there at least for 6 consecutive months, even if he has no intention to stay permanently. In addition, Swedish nationals and previous Swedish residents are deemed to remain residents, even if not permanently present in Sweden, so long as they maintain essential ties with Sweden. According to a rule allocating the burden of proof, nationals and individuals who have been resident of Sweden for at least 10 years are deemed to be resident during the 5 years following their departure unless they can prove that they have not maintained essential ties with Sweden (the 5-year rule).

2. Taxable base

a. *Taxable income*

The taxable base with respect to individual taxpayers is their worldwide income less allowable deductions. There is no positive definition of the term "income". In principle, all income received by the taxpayer in money or money's worth is income subject to tax, unless particularly exempt. To alleviate double taxation caused by world-wide tax liability, relief may be granted unilaterally or pursuant to treaty provisions (see 8. below).

An imputed income is computed on the taxable value of single or double family houses used by the owner or his family as a residence or for recreation. The rate applied to the value of the property is 1.5%. Only interest on loans and mortgages is deductible from the imputed income.

The following are the categories of income:
- income from employment;
- income from agriculture;
- income from immovable property not used in agriculture;
- income from business;
- income from occasional economic activities (certain capital gains); and
- income from movable property (investment income).

Each category of income is computed according to the applicable rules and the results are added together to arrive at the taxpayer's adjusted gross income. That aggregate amount is further modified by personal deductions. Spouses are taxed separately on all types of income.

Income spreading is allowed if the taxpayer has received in the tax year income which relates to 2 or more preceding or following years (including the current year). The qualifying income is spread for purposes of tax computation over a maximum of 10 preceding tax years (4 years for capital gains from immovable property taxed as income from occasional economic activities).

The most important types of exempt income are:
- certain social distributions;
- proceeds received from sickness, accident or unemployment insurance, unless in the form of a pension;
- amounts received as periodic payments for maintenance, provided the payment is not deductible for the payer (maintenance for children may be tax-free despite its (limited) deductibility);
- scholarships and other support received for studies;
- income derived from employment abroad exercised continuously for at least one year, or for at least 6 months provided the remuneration is borne by a permanent establishment situated in the country in which the work is performed; and
- tax refunds and interest thereon.

b. *Fringe benefits*

In principle, fringe benefits (i.e. any remuneration in kind received by an employee from his employer for services rendered) are taxable at their fair market value. Taxable benefits include options granted by the employer to purchase shares in a corporation for a price lower than their fair market value. Certain types of fringe benefits are not taxable if they are customary and reasonable, e.g. benefits from a general health service programme of the employer and free life and sickness insurance.

The value of free lodging is determined annually by the National Tax Board. The value of a free car which is added to the employees' taxable income is fixed at 30% of the purchase price of a similar new car at the end of the preceding year; if the car is older than 3 years, the value is 25% of such price.

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c. *Directors' remuneration*

Directors' fees and other remuneration are taxed as ordinary income.

d. *Pension income*

Pensions received in respect of prior employment and the various national pensions (including old-age, early retirement, disability and widow's pensions) are fully taxable. Annuities based on sickness or accident insurance and annuities not based on insurance and not being part of consideration for property sold are also taxed in full. Pensions received on the basis of life insurance are tax-free.

3. Capital gains

a. *Immovable property*

Gains derived from the sale or other disposal of immovable property not related to a business are taxable. The gain is computed as the difference between the sale price and the acquisition cost, subject to adjustments which mitigate the effects of inflation. The whole gain is included in taxable income from occasional economic activities and taxed at normal rates.

Taxation of the gain from the sale of a single or double family house as well as a farm may, however, be deferred under the following conditions:
- the gain must be at least 15,000 Skr.;
- the property sold must have been occupied by the owner for at least 3 years during a period of 5 years preceding the sale;
- the taxpayer must either have purchased a replacement single or double family house or farm or do so within 4 years after the sale of the original dwelling; and
- the replacement dwelling must be occupied by the owner for at least one year after purchase.

The deferral is granted only on that part of the gain which does not exceed the purchase price of the replacement dwelling. On a subsequent sale of the replacement property, the deductible acquisition cost of the replacement property will be reduced by the amount which has earlier escaped taxation.

b. *Shares and other securities*

Gains from the alienation of shares held for private investment are taxed under special capital gains rules. Apart from shares in a company, the same rules apply to issue certificates connected with such shares, participations in an economic association or a partnership and other comparable rights. Convertible debentures and stock options are also subject to these rules but bonds and debentures without conversion rights are not (see d. below).

Gains are computed as the difference between the purchase and sale price less costs related to the sale. The gain realized is fully taxable if the shares, etc. are owned for less than 2 years ("new shares"). If they are owned for at least 2 years ("old shares"), only 50% of the gain is taxable.

A standard deduction of up to 2,000 Skr. is allowed from the net gains on old shares for the tax year, i.e. such gains less losses from the disposal of old shares. For new shares the corresponding standard deduction is up to 1,000 Skr.

c. *Condominium rights*

Gains from the sale of titles to condominium units (bostadsrätter) are taxable in the following proportions:

Period of ownership	Proportion of gain taxed
less than 2 years	100%
2 to 3 years	75%
3 to 4 years	50%
4 years or more	25%

d. *Other assets*

Capital gains realized on the sale of assets other than immovable property, condominium rights and shares are taxable only if the assets are acquired for consideration and are owned for less than 5 years. This category also includes certain securities, such as bonds and debentures without conversion rights.

Depending on the length of ownership, the following proportions of the actual gains are taxable:

Period of ownership	Taxable proportion
less than 2 years	100%
2 to 3 years	75%
3 to 4 years	50%
4 to 5 years	25%
5 years or more	nil

4. Allowances, deductions and credits

a. *Deductions for expenses*

In computing the net result of each income category, all necessary expenses incurred in earning or preserving that income are taken into consideration. No deduction is allowed for expenses related to exempt income. Interest is deductible from the income of the appropriate category, and, if not related to any category, from investment income.

A standard deduction is granted to taxpayers with employment income to cover assumed expenses incurred in earning or preserving that income. The amount of this deduction is 3,000 Skr., or, if the income is less than 29,010 Skr., 10% of the income (rounded up to the next 100 Skr.). Actual expenses may be deducted to the extent they exceed the allowable standard deduction.

Travel costs and increased living expenses caused by work-related travel or work-related need to maintain 2 residences are not deemed to be covered by the standard deduction, but are deducted separately.

Trade union fees are not deductible from income. However, 40% of their amount up to 1,200 Skr. may be deducted from the tax due, i.e. the maximum credit is 480 Skr. (1,200 × 40%).

b. *Personal deductions*

These are deductions which the taxpayer may claim from the aggregate net results of his various income categories (adjusted gross income). The balance is the taxable base to which the tax rates are applied. For a taxpayer who has not been resident in Sweden for the whole tax year, the deductions dealt with in (1) to (3) are allowed only in an amount attributable to the period he has been resident.

(1) *Child deduction*
The taxpayer is entitled to deduct amounts paid as maintenance for children under the age of 18 or 21 if still attending school who are not members of the taxpayer's household. The maximum amount deductible is 3,000 Skr. per child. No deductions are allowed for children living with the tax-

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payer, but tax-free child subsidies are provided by the State.

(2) *Alimony deduction*
The taxpayer is entitled to deduct the amount paid as alimony to a former spouse.

(3) *Pension insurance premiums*
Premiums for work-related pensions paid by employers for their employees are deductible as business costs. Premiums for a private pension insurance paid by the taxpayer may be deducted if the taxpayer is the holder of the insurance policy. In general, the deduction is allowed as follows:
- up to 10% of that part of employment income which does not exceed 594,000 Skr.;
- for earned income from business and agriculture, up to 35% of the first 594,000 Skr. of such income and up to 25% of such income between 594,000 and 891,000 Skr. Alternatively, the deduction is a base amount of 29,700 Skr. plus 30% of earned income from business or agriculture up to 89,100 Skr. For 1990, the taxpayer may deduct only 75% of the amount resulting from the above computations.

(4) *Basic allowance*
A basic allowance is granted to all taxpayers. This allowance is 10,000 Skr. for taxpayers who have been resident of Sweden for the entire tax year. For other taxpayers the deduction is allowed in an amount representing ½ of 10,000 Skr. for each month during which they have been resident.

(5) *Allowance for reduced ability to pay taxes*
Taxpayers whose ability to pay taxes is considerably reduced for a specific reason, such as an accident, lengthy illness, old age, maintenance obligation or other similar hardship, may be granted an allowance in addition to the above-mentioned basic allowance. The amount of this allowance varies according to the severity of the case, subject to a maximum of 10,000 Skr.

c. *Tax credits*

A deduction of 1,800 Skr. is granted from the amount of national taxes to a resident single taxpayer with a child under 18 years living in his household.

A resident married taxpayer whose spouse has no income is entitled to a credit of 1,800 Skr. For a taxpayer whose spouse has income of less than 6,000 Skr., the deduction amounts to 30% of the difference between 6,000 Skr. and the spouse's income.

5. Losses

The individual taxpayer may deduct a loss incurred in an income category from the positive result of his other categories for the same tax year. If the entire loss cannot be so set off, the balance may be carried forward for 6 years. No carry-back is permitted.

Losses from the sale or other disposal of capital assets, i.e. losses relating to assets which produce capital gains classified as income from occasional economic activities, may only be set off against capital gain realized in the same year or any of the 6 following years. If, due to a specified period of ownership, only part of the capital gains that could arise from the disposal of assets would be taxable, the deduction for loss incurred with respect to such assets is allowed only in a corresponding amount. Only 50% of losses relating to shares and other securities referred to in 3.b. is deductible regardless of the period of ownership.

6. Rates

The national income tax is imposed according to 2 tables of progressive rates, i.e. the basic rates table and the supplementary rates table. Certain deductions, e.g. the basic allowance, a negative balance of any income category for the current year and losses incurred in previous years, which are allowed in computing income subject to the basic rates of tax are disallowed for purposes of the supplementary rates, so as to limit the effect of such deductions on the total amount of national income tax payable.

The rate brackets for the national income tax are expressed in basic units (basenhet), currently 10,000 Skr.

The basic rates for 1990:

basic amount of tax 100 Skr. plus:	
on the first 7.5 basic units (0 – 75,000 Skr.)	3%
on the excess (more than 75,000 Skr.)	10%

The supplementary rates for 1990:

on the first 14 basic units (0 – 140,000 Skr.)	nil
on the next 5 basic units (140,000 – 190,000 Skr.)	14%
on the excess (more than 190,000 Skr.)	25%

7. Assessment and collection

The tax year is normally the calendar year. Tax returns forming the basis for national and municipal income tax as well as national net wealth tax are due by 15 February of the assessment year, i.e. the year following the year of income. However, if the tax year of a taxpayer carrying on a business ends later than 31 August of the year before the assessment year, the due date is 31 March of the assessment year. Taxes are generally collected during the tax year by withholding and preassessment, with a final assessment in the next year.

a. *Preassessment*

All taxable income not subject to preliminary tax payment by withholding is subject to a preassessment. The preliminary tax is normally based on the amount of final tax imposed for the preceding tax year. The preliminary tax payable equals 120% of the final tax for the preceding tax year or, if the final tax for that year was less than the preliminary tax for that year, 110% of the final tax. In no case may the preliminary tax be less than that for the preceding tax year. If no final tax was imposed for the preceding year, or if the taxpayer's estimated income is at least 20% and at least 2,000 Skr. more or less than his assessed income for the preceding year, a preliminary assessment will be imposed based on the estimate. The preliminary tax is collected in instalments during the tax year.

b. *Final assessment*

The final assessment is issued in December of the assessment year. The taxpayer's preliminary tax payments are credited against the final tax liability and any excess is refunded.

Penalties are payable if the final tax exceeds the preliminary tax paid, for late filing and incorrect reporting of income.

8. Double taxation relief

According to unilateral relief provisions, foreign national, provincial and local income taxes imposed on foreign-source income may be credited against Swedish national and mu-

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nicipal income tax provided the foreign taxes are finally assessed or withheld. The credit may not exceed the Swedish income tax attributable to the foreign-source income.

Foreign taxes not eligible for the above credit relief may be deducted in computing taxable income. Foreign taxes eligible for the credit relief may also be deducted, but the available credit is then reduced by the amount of Swedish tax saved through the deduction.

The extensive network of bilateral and multilateral tax treaties concluded by Sweden provides relief from double taxation of income and capital. Treaty provisions normally allow either a credit for foreign tax or an exemption for the foreign income.

C. Wages tax

No wages tax exists, but employers are obliged to withhold tax from salaries and other remuneration paid to their employees as an advance payment of tax. Pensions, annuities and certain other periodic payments are also subject to a withholding tax. The tax is withheld according to special tables designed to cover the taxpayer's final tax liability as precisely as possible.

D. Other taxes on income

1. Municipal income tax (Kommunalskatt)

a. *Taxable base*

The taxable base is equal to the taxable base for purposes of the national income tax. This tax is not deductible in computing income subject to the national income tax.

b. *Rates*

The municipal income tax is imposed at a flat rate, usually about 30%, depending on the municipality.

c. *Assessment*

See 7. above.

d. *Double taxation relief*

See 8. above.

E. National net wealth tax (Statlig förmögenhetsskatt)

1. Taxable base

The net wealth tax applies to world-wide capital owned by resident individuals. The capital of husband and wife is added together in computing the net wealth tax. The tax so computed is levied proportionally on each spouse. Taxpayers with children under 18 living in their household are also taxed on the children's capital, unless the child's taxable income is 100 Skr. or more.

The tax is, in principle, assessed annually on the basis of the fair market value of assets at the end of the calendar year. However, shares and other securities quoted on Swedish or foreign stock exchanges are valued at 75% of their quoted value. Shares not officially quoted on a stock exchange, but otherwise exchanged with regularly published prices (mainly OTC shares and shares on the list for unofficial quotations), are valued at 30% of their published value.

2. Rates

The aggregate family net wealth, held on 31 December 1990, is subject to the following rates of net wealth tax:

Taxable net wealth (Skr.)	Rate (%)
under 800,000	nil
800,000 – 1,600,000	1.5
1,600,000 – 3,600,000	2.5
over 3,600,000	3.0

3. Assessment

See 7. above.

4. Double taxation relief

See 8. above.

F. Social security contributions

The major items of the Swedish social insurance scheme are the general sickness insurance (sjukförsäkring), the old-age pension insurance (folkpension), and the general supplementary pension insurance (tilläggspension). In respect of income from employment, only the employer pays social security premiums. The aggregate amount of the various social security contributions is approximately 37% of wages paid by the employer.

Self-employed individuals, i.e. taxpayers having earned income other than employment income, must pay their own social security contributions (egenavgifter). The types of income subject to these levies are income from business and income from agriculture. The aggregate amount of the premiums is approximately 32% of the income in question. These premiums are deductible for national and municipal income tax purposes.

G. Maximum burden of taxes

The national income and net wealth taxes of an individual who was resident in Sweden for at least part of the tax year are reduced if the aggregate amount of those taxes and the municipal income tax exceeds the ceiling which is:

- 50% of the taxable income to which the basic tax rates are applied as increased by any special investment allowance deducted, plus
- 25% of the taxable income as adjusted for purposes of the supplementary rates of the national income tax, increased by any special investment allowance deducted.

The municipal income tax is never reduced. Reduction with respect to the supplementary amount of national income tax and net wealth tax is subject to certain restrictions.

H. Inheritance and gift taxes (Arvskatt och gåvoskatt)

Inheritance and gift tax is imposed by the State on property acquired by inheritance or gift. The tax is not imposed on the estate of the deceased or the donor but separately on each beneficiary in respect of his share in the estate or on each donee.

The value of assets included in the inheritance or gift is, in principle, fixed at their fair market value at the time of death or donation. However, shares and other securities are valued in the same manner as for net wealth tax purposes.

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1. Taxable persons

The inheritance and gift tax is imposed on the beneficiary or donee. The liability for inheritance tax arises at the time of death and the liability for gift tax at the time of receipt of the gift.

2. Taxable base

a. *Inheritance tax*

Taxable inheritances include all immovable and movable property situated in or outside Sweden if the deceased was a resident of Sweden at the time of death. In general, the rules of income taxation apply in determining residence (see B.1.a. above). With respect to property derived from a Swedish national or his spouse living abroad, this general tax liability also applies for the first 10 years after their departure from Sweden.

Property passing on the death of a non-resident in other than the above-mentioned cases is subject to tax in Sweden if it is:
(i) immovable property situated in Sweden;
(ii) movable property in Sweden pertaining to a business of the deceased, as well as any right to a royalty or other periodic payment on such property;
(iii) shares or participations in Swedish housing associations or companies; and
(iv) shares and participations in Swedish companies, economic associations and mutual funds if left by a Swedish national.

The following deductions are allowed from the beneficiary's share in the estate:
- the surviving spouse or cohabitant may deduct 200,000 Skr.;
- any other close relative in category I, below, may deduct 50,000 Skr.;
- beneficiaries falling in categories II and III may deduct 15,000 Skr.

b. *Gift tax*

Taxable gifts include all immovable and movable property situated in or outside Sweden if the donor was a resident of Sweden at the time of the donation. As in the case of inheritance tax, the rules of income taxation apply in determining residence. With respect to donors who are Swedish nationals or their spouses living abroad, this general tax liability continues for the first 10 years after their departure from Sweden. The general tax liability also applies to all gifts received from Swedish legal persons.

Property derived from a donor in other cases is subject to tax in Sweden if it is:
(i) property referred to in H.2.a(i) to (iii); or
(ii) shares or participations in Swedish companies, economic associations or mutual funds derived from a national of Sweden or by a national of Sweden or a Swedish legal entity.

No gift tax is due on furniture and appliances, for use in the donee's or his family's household, worth less than 10,000 Skr. per annum, or any other gifts received from one donor up to 2,000 Skr. of aggregate value per annum.

For the computation of the gift tax all gifts received by the donee from the same donor within 10 years prior to the date of the gift concerned are accumulated and a credit is granted for any gift tax paid on a prior gift. This accumulation applies only to gifts in excess of the above-mentioned annual tax-free amount.

3. Rates

The following tax tables apply to both inheritance tax and gift tax:

Category I

Taxable share (Skr.)	Tax on the lower excess (Skr.)	Plus % on the amount
up to 100,000	–	10
100,000 – 200,000	10,000	20
200,000 – 400,000	30,000	30
400,000 – 800,000	90,000	40
800,000 – 8,000,000	250,000	50
8,000,000 and over	3,850,000	60

The rates above apply if the beneficiary/donee is a close relative of the deceased/donor, i.e. a spouse or a cohabitant similar to a spouse for tax purposes, child and any lineal descendant of a child as well as a child's spouse or cohabitant.

Category II

Taxable share (Skr.)	Tax on the lower excess (Skr.)	Plus % on the amount
up to 25,000	–	15
25,000 – 50,000	3,750	25
50,000 – 100,000	10,000	35
100,000 – 200,000	27,500	45
200,000 – 2,000,000	72,500	55
2,000,000 and over	1,062,500	65

These rates apply if the beneficiary/donee is any other individual or any legal entity other than a public body or a charitable organization.

Category III

Taxable share (Skr.)	Tax on the lower excess (Skr.)	Plus % on the amount
up to 30,000	–	10
30,000 – 60,000	3,000	20
60,000 and over	9,000	30

These rates apply rates apply if the beneficiary/donee is a public body or a charitable organization.

4. Double taxation relief

In the absence of tax treaty relief, where the same property is subject to inheritance or gift tax both in Sweden and abroad, an exemption or a reduction of tax due may be granted in Sweden.

Sweden has concluded treaties for the avoidance of double taxation of inheritances with Austria, Belgium, Denmark, Finland, France, Germany (Fed. Rep.), Hungary, Israel, Italy, the Netherlands, Norway, South Africa, Spain, Switzerland, the United Kingdom and the United States. The treaties with Denmark, the United Kingdom and the United States also cover gift duties.

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I. Expatriates

Special tax relief is granted to qualifying foreign research workers who are temporarily employed by Swedish organizations or enterprises. To qualify for the relief the research worker must obtain the approval of the Board on Taxation of Researchers.

The relief is granted in respect of qualifying research or development work in fields or levels of expertise in which there are considerable difficulties of recruitment inside the country. The relief is granted for a maximum period of 2 years or, in special cases, 4 years. The relief is granted only if the person concerned was not a resident of Sweden before the commencement of his work in Sweden.

The main relief granted is the exclusion from taxable income of 30% of the wages from the research work. In addition, reimbursements for housing costs, moving costs to and from Sweden, travel costs and children's school costs are excluded from the taxable income of such a researcher. The benefit of free housing is also tax-free.

J. Non-residents

Non-resident individuals are subject to the regular national and municipal income taxes only on Swedish-source income, i.e. business income derived through a permanent establishment in Sweden, income from immovable property situated there and income from personal services performed there. However, remuneration derived by a non-resident in respect of employment exercised in Sweden is not taxable in Sweden provided that the recipient is not present there for more than 183 days in any period of 12 months, the remuneration is paid by, or on behalf of, an employer not resident in Sweden, and the remuneration is not borne by a permanent establishment or a fixed base which the employer has in Sweden. Remuneration derived in respect of services rendered to the Swedish Government or municipalities is always regarded as taxable in Sweden.

Directors' fees and other similar payments derived by a non-resident in his capacity as a member of the board of directors of a Swedish company or other legal entity are taxable in Sweden regardless of where the related work is performed or where the meetings are held.

Pensions paid on the basis of services rendered for the Swedish State or a Swedish municipality are taxable in Sweden. The same applies to pensions paid under the national pension insurance scheme (allmän försäkring) to the extent that it exceeds 10,000 Skr. Other pensions based on employment are taxable if the employment has mainly been exercised in Sweden. Pensions based on private insurance policies are taxable in Sweden if purchased from a Swedish insurance company.

The rates of national income tax are the same as apply to residents. Personal allowances, however, are not available to non-resident individuals. Non-resident individuals are subject to the municipal income tax at a special 10% rate, rather than at the normal rate (about 30%).

Payments to non-resident artists performing in Sweden are subject to a withholding tax of 30%. This tax (bevillningsavgift) is final and replaces the national and municipal income taxes.

Dividends paid by Swedish companies to non-resident individuals are subject only to a coupon tax (kupongskatt) imposed at 30% on cash dividends and dividends in kind, unless a treaty provides otherwise. This withholding tax is final and replaces the national income tax and the net wealth tax. No municipal tax is imposed on dividends paid to non-residents.

Capital gains realized from the sale or other disposal of shares and other securities by a non-resident individual are generally not subject to Swedish taxation. However, gains from the disposal of shares and participations in Swedish companies, partnerships and economic associations are taxable if realized by an individual who has been a resident of Sweden at any time during the 10 calendar years preceding the disposal.

Non-resident individuals are subject to the national net wealth tax only on immovable property situated in Sweden and assets used in a business in Sweden. Note that the above-mentioned coupon tax on dividends replaces the net wealth tax on the underlying share or participation. A non-resident individual is entitled to a deduction for debts only insofar as they are attributable to assets which are taxable in Sweden. The net wealth tax is levied at the same rates as apply to a resident taxpayer.

K. Value added tax (Mervärdeskatt)

See Part I, Taxation of corporations.

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CONVENTION BETWEEN THE NORDIC COUNTRIES FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

(Unofficial translation)

Date of Conclusion: 12 September 1989.

Entry into Force: In accordance with Article 31 of this Convention, it entered into force on 31 December 1989. The provisions of the Convention apply from 1 January 1990 with respect to taxes on income and withholding taxes, and from 1 January 1991 with respect to taxes on capital.

The Government of Denmark, in conjunction with the Local Government of the Faroe Islands, and the Governments of Finland, Iceland, Norway and Sweden,

Desiring to conclude a Convention for the avoidance of double taxation with respect to taxes on income and capital,

Establishing that, with respect to the Faroe Islands, dealing with these matters also in relation to foreign countries is within the jurisdiction of the Faroe Islands,

Have agreed as follows:

Article 1
Personal scope

This Convention shall apply to persons who are residents of one or more of the Contracting States.

Article 2
Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are:

(a) in Denmark:
  (1) the income tax to the State (indkomstskatten til staten);
  (2) the municipal income tax (den kommunale indkomstskat);
  (3) the income tax to the county municipalities (den amtskommunale indkomstskat);
  (4) the special income tax (den særlige indkomstskat);
  (5) the church tax (kirkeskatten);
  (6) the tax on dividends (udbytteskatten);
  (7) the tax on interest (renteskatten);
  (8) the tax on royalties (royaltyskatten);
  (9) the taxes imposed under the Hydrocarbon Tax Act (skatter i henhold til kulbrinteskatteloven); and
  (10) the capital tax to the State (formueskatten til staten)

  (hereinafter referred to as "Danish tax");

(b) in the Faroe Islands:
  (1) the provincial income tax (skat til landskassen);
  (2) the municipal income tax (kommunal indkomstskat);
  (3) the church tax (kirkeskat);
  (4) the tax on dividends (udbytteafgift); and
  (5) the tax on royalties (royaltyafgift)

  (hereinafter referred to as "Faroese tax");

(c) in Finland:
  (1) the national income and capital tax (valtion tulo- ja varallisuusvero);
  (2) the municipal tax (kunnallisvero);
  (3) the church tax (kirkollisvero); and
  (4) the withholding tax on non-residents' income (lähdevero)

  (hereinafter referred to as "Finnish tax");

(d) in Iceland:
  (1) the national income tax (tekjuskattur til ríkisins);
  (2) the municipal income tax (útsvar til sveitarfélaga); and
  (3) the national capital tax (eignarskattur til ríkisins)

  (hereinafter referred to as "Icelandic tax");

(e) in Norway:
  (1) the income tax and capital tax to the State (inntekts- og formuesskatten til staten);
  (2) the income tax and capital tax to the municipalities (inntekts- og formuesskatten til kommunene);
  (3) the income tax to the counties (inntektsskatten til fylkene);
  (4) the contribution to the tax equalization fund (fellesskatten til Skattefordelingsfondet);
  (5) the taxes imposed under the Petroleum Tax Act (skattene i henhold til petroleumsskatteloven); and
  (6) the tax to the State on remuneration of foreign artistes (avgiften til staten på honorarer til utenlandske kunstnere)

  (hereinafter referred to as "Norwegian tax");

(f) in Sweden:
  (1) the income tax to the State, including the sailors' tax and the coupon tax (den statliga inkomstskatten, däri inbegripet sjömansskatten och kupongskatten);
  (2) the tax on public entertainers (bevillningsavgiften för vissa offentliga föreställningar);
  (3) the tax on undistributed profits of companies (ersättningsskatten);
  (4) the tax on distribution in connection with reduction of share capital or the winding-up of a company (utskiftningsskatten);
  (5) the profit-sharing tax (vinstdelningsskatten);

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(6) the municipal income tax (den kommunala inkomstskatten); and
(7) the capital tax to the State (den statliga förmögenhetsskatten)

(hereinafter referred to as "Swedish tax").

4. 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. With respect to the Faroe Islands, the Convention shall furthermore apply to such general tax on capital as the Faroe Islands may introduce after the date of signature of the Convention. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws.

5. The Convention shall not apply, as regards any of the Contracting States, to special taxes on lottery prizes and gambling winnings or to taxes on inheritances and gifts.

Article 3
General definitions

1. For the purposes of this Convention, unless the context otherwise requires, the terms below shall be defined as follows:

(a) the term "Contracting State" means Denmark, Finland, Iceland, Norway or Sweden; for the purposes of this Convention the term also includes the autonomous region within the Kingdom of Denmark of the Faroe Islands; to the extent that the provisions of this Convention concern the relationship between Denmark and the Faroe Islands only, the terms "a part of the Kingdom" and "the other part of the Kingdom" shall be used, as the context requires;
- the term also comprises any area outside the territorial sea of a State within which that State under its legislation and in accordance with international law has rights with respect to the exploration for and the exploitation of the natural resources of the seabed and subsoil;
- the term "Denmark" does not comprise the Faroe Islands and Greenland; the term "Finland" does not comprise, with respect to the Finnish municipal tax, the county of land; the term "Norway" does not comprise Spitsbergen (including Bear Island), Jan Mayen and the Norwegian dependencies ("biland") outside Europe;

(b) "person" includes an individual, a company and any other body of persons;

(c) "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

(d) "enterprise of a Contracting State" and "enterprise of another Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of another Contracting State;

(e) "national" means an individual possessing the nationality of a Contracting State; for the purposes of this Convention, an individual who is a national of Denmark and who is a resident of the Faroe Islands under the Law of Home Rule shall be deemed to be a national of the Faroe Islands only; the term also includes any body corporate or other entity deriving its status as such from the law in force in a Contracting State;

(f) "international traffic" means, for the application of this Convention in a Contracting State, any transport by a ship or aircraft operated by an enterprise which has its place of effective management in another Contracting State, except when the ship or aircraft is operated solely between places in the first-mentioned State;

(g) "competent authority" means:
(1) in the case of Denmark: the Minister of Taxes;
(2) in the case of the Faroe Islands: the Local Government;
(3) in the case of Finland: the Ministry of Finance;
(4) in the case of Iceland: the Minister of Finance;
(5) in the case of Norway: the Ministry of Finance and Customs;
(6) in the case of Sweden: the Minister of Finance;
or the authority in any of these States to whom the task of dealing with questions concerning the Convention has been delegated.

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article 4
Fiscal domicile

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 his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of more than one Contracting State, 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 more than one State, he shall be deemed to be a resident of the State with which his personal and economic relations are closest (centre of vital interests);

(b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in any of the States, 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 more than one State or in none of them, he shall be deemed to be a resident of the State of which he is a national;

(d) if he is a national of more than one State or of none of them, the competent authorities of the Contracting States concerned shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of more than one Contracting State, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

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, construction, installation or assembly project, or activities consisting of planning, supervising, consulting or other auxiliary work by personnel connected with such a project, constitute a permanent establishment, but only if the project or the activities last more than 12 months in a Contracting State.

4. For the calculation of the time referred to in paragraph 3, an activity carried on by an enterprise which is associated with another enterprise shall be deemed to be carried on by the enterprise with which it is associated if the activity is substantially similar in character to the activity carried on by the last-mentioned enterprise and the activities of both enterprises are concerned with the same project. Enterprises shall be regarded as associated if one enterprise participates directly or indirectly in the management, control or capital of the other enterprise or if the same persons participate directly or indirectly in the management, control or capital of both enterprises.

5. Notwithstanding 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

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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 activities mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

6. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 7 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, that 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 5 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.

7. 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.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of another Contracting State, or which carries on business in such 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 immovable property

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

2. (a) Subject to the provisions of sub-paragraph (b), the term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.
(b) The term "immovable property" shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, buildings, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.

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

4. Insofar as the ownership of shares or other corporate rights in a company, the principal object of which is to own immovable property, entitles the owner of such shares or corporate rights to the enjoyment of immovable property owned by the company, the income derived from the direct use, letting, or use in any other form of such entitlement to enjoyment may be taxed in the Contracting State in which the immovable property is situated.

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

Article 7
Business profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in another Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the 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 another Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No 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.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

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

Article 8
Shipping and air transport

1. 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.

2. If the place of effective management of a shipping enterprise is aboard a ship, then it shall be deemed to be situated in the Contracting State of which the operator of the ship is a resident.

3. Profits derived by an enterprise which is a resident of a Contracting State from the use, maintenance or rental of containers (including trailers and other equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated, unless the containers are used solely between places in another Contracting State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from the participation 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 another Contracting State, or
(b) the same persons participate directly or indirectly in the management, con-

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trol or capital of an enterprise of a Contracting State and an enterprise of another Contracting State,

the following shall apply.

If 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 would, but for those conditions, 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. If in a Contracting State an issue as referred to in paragraph 1 arises, the competent authority of another Contracting State which is involved in the issue shall be informed with a view to considering an adjustment to the computation of the profits of the enterprise which is a resident of that other State. The competent authorities may, if necessary, conclude a reasonable agreement as regards the apportionment of profits.

Article 10
Dividends

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

2. If a recipient of dividends who is a resident of a Contracting State has a permanent establishment or a fixed base in a Contracting State other than the State of which he is a resident, and the holding by virtue of which the dividends are paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, dividends paid by a company which is a resident of a Contracting State to such a recipient may, notwithstanding the provisions of paragraphs 1 and 3, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State where the permanent establishment or fixed base is situated.

3. Dividends from a company which is a resident of a Contracting State to a resident of another Contracting State 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 the tax so charged shall not exceed 15% of the gross amount of the dividends. However, such dividends shall be exempt from tax in the first-mentioned State if the recipient is a company (excluding partnerships and estates of deceased persons) which owns directly at least 25% of the capital of the company paying the dividends. Notwithstanding the provisions of the second sentence of this paragraph, dividends paid by companies which are residents of the Faroe Islands may also be taxed in the Faroe Islands and according to the laws of the Faroe Islands, but if the recipient is a company (excluding partnerships and estates of deceased persons) which owns directly at least 25% of the capital of the company paying the dividends, the tax so charged shall not exceed 5% of the gross amount of the dividends.

4. Notwithstanding the provisions of paragraph 3, Icelandic tax on dividends may be increased to a maximum of 15%, to the extent that such dividends have been deducted in computing the profits of the company paying the dividends for the purpose of determining the Icelandic tax due.

5. Notwithstanding the provisions of paragraph 3, Norwegian tax on dividends may be increased to a maximum of 15%. This provision applies as long as Norwegian companies are entitled to a deduction for distributed dividends for the purpose of computing the tax due to the State.

6. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of the limitations under paragraphs 3 to 5.

The provisions of paragraphs 3 to 5 shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

7. The term "dividends" as used in this Article means income from shares, certificates or other rights, not being debt-claims, participating in profits, as well as other income derived from a company 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.

8. Notwithstanding the provisions of paragraph 1, dividends from a company which is a resident of a Contracting State to a company which is a resident of another Contracting State, other than Denmark, the Faroe Islands, Finland or Sweden, shall be exempt from tax in that other State, to the extent that they would have been exempt if both companies had been resident there.

Notwithstanding the provisions of paragraph 1, dividends from a company which is a resident of a Contracting State other than Denmark to a company which is a resident of Denmark shall be exempt from tax in Denmark in accordance with Danish law.

Notwithstanding the provisions of paragraph 1, dividends from a company which is a resident of a Contracting State other than Finland to a company which is a resident of Finland shall be exempt from tax in Finland if the recipient controls directly at least 10% of the voting power in the company paying the dividends.

Notwithstanding the provisions of paragraph 1, dividends from a company which is a resident of a Contracting State other than Sweden to a company which is a resident of Sweden shall be exempt from tax in Sweden to the extent that the dividends would be exempt from Swedish tax, in accordance with the laws of Sweden, if both companies had been Swedish companies. Nevertheless, such exemption shall be granted only:

(a) if the profits out of which the dividends are paid have been subject to a general income tax on companies in that Contracting State or in any other State, or
(b) if the dividends paid by the company which is a resident of that Contracting State are derived exclusively or almost exclusively from dividends received by that company in the year concerned or in any previous year in respect of shares or other corporate rights which it owns in a company resident in a third State, and such dividends would be exempt from Swedish tax if the shares or other corporate rights in respect of which the dividends are paid had been owned directly by a company which is a resident of Sweden.

However, to the extent that the amount of dividends distributed with respect to a year of income by a company which is a resident of Denmark or the Faroe Islands, to a company which is a resident of another Contracting State, corresponds to dividends which the first-mentioned company, directly or through the intermediary of a legal person, in the same or a preceding tax year has derived from shares or other corporate rights in a company which is a resident of a third State, the exemption from tax in another Contracting State under the first sub-paragraph shall apply only if:

(a) the dividends which have been derived from shares or other corporate rights in a company which is a resident of a third state have been subjected to tax in Denmark, or the Faroe Islands, as the case may be, or
(b) if this is not the case, if the dividends would be exempt from tax in another Contracting State, if the shares or other corporate rights in the company which is a resident of a third State had been owned directly by the company resident in the other Contracting State.

With respect to dividends from a company which is a resident of Iceland to a company which is a resident of another Contracting State, the exemption from taxation in that other Contracting State under the first subparagraph of this paragraph shall apply only to the extent that the dividends are not deductible from the profits of the Icelandic company in computing Icelandic tax.

9. Notwithstanding the provisions of paragraphs 3 to 5, the competent authorities of the Contracting States may agree that dividends which accrue to an institution identified by name in the agreement, which has charitable or other general benevolent purposes and which, according to the laws of the Contracting State of which the institution is a resident, is exempt from tax with respect to dividends, shall be exempt from taxes imposed in another Contracting State on dividends from companies in that other State.

10. Where a company which is a resident of a Contracting State derives profits or income from another Contracting State, that

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other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed based situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

11. In this Article, the term "partnership" means:

(a) with respect to Denmark: "interessentskab", "kommanditselskab" and "partrederi";
(b) with respect to the Faroe Islands: "interessentskab", "kommanditselskab" and "partrederi";
(c) with respect to Finland: "avoin yhtiö", "kommandiittiyhtiö", "laivanisännistöyhtiö" and any other body referred to in paragraph 1 of Article 5 of the Income and Capital Tax Act (1240/88) if they are not taxed as a separate taxable person;
(d) with respect to Iceland: "sameignarfélög" and "samlög", which are not taxed as a separate taxable person;
(e) with respect to Norway: any body of persons, with the exception of "aksjeselskap";
(f) with respect to Sweden: "handelsbolag", "kommanditbolag" and "enkelt bolag", if they are not taxed as a separate taxable person.

Article 11
Interest

1. Interest arising in a Contracting State and paid to a resident of another Contracting State shall be taxable only in that other State.

2. If a recipient of interest who is a resident of a Contracting State has a permanent establishment or a fixed base in a Contracting State other than the State of which he is a resident, and the debt-claim in respect of which the interest is paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, the interest arising in a Contracting State and paid to such a recipient shall, notwithstanding the provisions of paragraph 1, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State where the permanent establishment or fixed base is situated.

3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage. The term comprises, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

4. Where, by reason of a special relationship between the payer and the recipient 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 recipient 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 involved, due regard being had to the other provisions of this Convention.

Article 12
Royalties

1. Royalties arising in a Contracting State and paid to a resident of another Contracting State shall be taxable only in that other State.

2. If a recipient of royalties who is a resident of a Contracting State has a permanent establishment or fixed base in a Contracting State other than the State of which he is a resident, and the right or property in respect of which the royalties are paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, the royalties arising in a Contracting State and paid to such a recipient may, notwithstanding the provisions of paragraph 1, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State where the permanent establishment or fixed base is situated.

3. The term "royalties" as used in this Article 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 (including cinematograph films and films and tapes for radio and television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

4. Where, by reason of a special relationship between the payer and the recipient 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 recipient 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 involved, due regard being had to the other provisions of this Convention.

Article 13
Capital gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in paragraph 2 of Article 6 and situated in another Contracting State may be taxed in that other State.

2. Gains derived by a resident of a Contracting State from the alienation of shares or other rights referred to in paragraph 4 of Article 6 may be taxed in the Contracting State in which the immovable property is situated.

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

4. Gains from the alienation of ships or aircraft operated in international traffic by an enterprise of a Contracting State or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

5. Gains from the alienation of containers (including trailers and other equipment for the transport of containers) used by an enterprise of a Contracting State for the transport of goods or merchandise shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated, unless the containers are used solely between places in another Contracting State.

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

7. Notwithstanding the provisions of paragraph 6, a Contracting State may tax gains derived by a resident of another Contracting State from the alienation of a share or other right in a company which is a resident of the first-mentioned State, and gains from the alienation of any other security which are subjected in that State to the same taxation treatment as gains from the alienation of such share or other right.

Article 14
Independent personal services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State. However, such income may be taxed in another Contracting State if:

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(a) he has a fixed base regularly available to him in that other State for the purpose of performing his activities, but only so much of the income as is attributable to that fixed base; or
(b) he stays in that other Contracting State for a period or periods exceeding in the aggregate 183 days in any period of 12 months, but only so much of the income as is attributable to the activities performed in such period or periods.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15
Dependent personal services

1. Subject to the provisions of Articles 16, 18, 19, 20 and 21, 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 another Contracting State. If the employment is exercised in that other State, such remuneration as is derived therefrom may be taxed in that State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in another Contracting State shall be taxable only in the first-mentioned State if:
(a) the recipient is present in that other State for a period or periods not exceeding in the aggregate 183 days in any period of 12 months; and
(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other State; and
(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in that other State; and
(d) the employment is not a case of hiring out of labour.

3. Notwithstanding the foregoing provisions of this Article, remuneration derived in respect of work performed aboard:
(a) a Danish, Faroese, Finnish, Icelandic, Norwegian or Swedish ship shall be taxable only in the Contracting State of which the ship has the nationality; as regards the application of this provision, a foreign ship chartered on a "bareboat basis" by an enterprise of a Contracting State shall be considered as a Danish, Faroese, Finnish, Icelandic, Norwegian or Swedish ship;
(b) aircraft operated in international traffic shall be taxable only in the Contracting State of which the recipient of the remuneration is a resident;
(c) a fishing, seal-hunting or whaling vessel shall be taxable only in the Contracting State of which the recipient of the remuneration is a resident, even in cases where the remuneration in respect of the work is paid in the form of a part or share in the profit of the fishing, seal-hunting or whaling business.

Article 16
Directors' fees

Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors or similar body of a company which is a resident of another Contracting State may be taxed in that other State.

Article 17
Artistes and athletes and sportsmen

1. Notwithstanding the provisions of Articles 14 and 15, 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 or sportsman, from his personal activities as such exercised in another Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete or sportsman in his capacity as such accrues not to the entertainer or athlete or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete or sportsman are exercised.

3. The provisions of paragraphs 1 and 2 shall not apply to income derived from activities which an entertainer or athlete or sportsman who is a resident of a Contracting State exercises in another Contracting State, if his visit to that other Contracting State has mainly been financed by public funds of the first-mentioned State. In such case the income shall be taxable only in the first-mentioned State.

Article 18
Pensions, etc.

1. Pensions and annuities paid from a Contracting State and payments made from a Contracting State under the social security legislation of that State to a resident of another Contracting State shall be taxable only in the first-mentioned State.

2. Notwithstanding the other provisions of this Convention, maintenance payments made by a resident of a Contracting State to his spouse or former spouse or his children resident in another Contracting State, shall be exempt from tax in that other State if the payment would have been exempt from tax in the first-mentioned State in case the recipient had been a resident of that State.

3. The term "annuity" means a stated sum payable periodically at stated times during the life of the person insured, or during a specified or ascertainable period of time, under an obligation to make the payments in return for a corresponding full consideration in money or money's worth.

Article 19
Government service

1. Remuneration (excluding pensions) paid by a Contracting State, a political subdivision, a local authority, or a public institution thereof to an individual in respect of services rendered to that State, political subdivision, local authority or public institution shall be taxable only in that State.

2. However, if the remuneration referred to in paragraph 1 is paid to the recipient for services rendered in a Contracting State other than the Contracting State from which the remuneration is paid, the remuneration shall be taxable only in the State where the services are rendered if the recipient is a resident of that State, and:
(a) is a national of that State; or
(b) did not become a resident of that State solely for the purpose of rendering the services.

Article 20
Students and apprentices

A person who is visiting a Contracting State solely for the purpose of:
(a) study at a university or other educational institution in that Contracting State; or
(b) business, fishery, industrial, agricultural or forestry training in that Contracting State,
and who is, or immediately before his visit was, a resident of another Contracting State, shall not be taxed in the first-mentioned State in respect of payments received from sources outside that State for the purpose of his maintenance, education or training.

Article 21
Activities in connection with surveying and exploration for or exploitation of hydrocarbon deposits

1. Notwithstanding the other provisions of this Convention, with the exception of the provisions of Article 8, the provisions of this Article shall apply if a resident of a Contracting State carries on activities in another Contracting State in connection with surveying and exploration for or exploitation of hydrocarbon deposits situated in that other State.

2. (a) A resident of a Contracting State who carries on activities as referred to in paragraph 1 offshore in another Contracting State shall be deemed to carry on the activities through a permanent establishment or a fixed base in that other State.
(b) If such a person carries on his activities in an exploration or exploitation area which extends from a place offshore in that other State to the onshore territory of that State, and the activities are not carried on exclusively in the onshore territory, sub-paragraph (a) shall apply correspondingly.

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(c) Activities concerning the construction or installation of pipelines for the transportation of unrefined hydrocarbons and construction work directly related to such activities shall be deemed to be carried on through a permanent establishment in that other State, even in case of activities carried out onshore, if the activities are part of a project which extends from a place offshore in that State to the onshore territory of that State.

3. The provisions of paragraph 2 shall not apply if the activities are carried on for a period or periods not exceeding in the aggregate 30 days in any period of 12 months.

4. For the calculation of the time referred to in paragraph 3, an activity carried on by an enterprise which is associated with another enterprise shall be deemed to be carried on by the enterprise with which it is associated if the activity is substantially similar in character to the activity carried on by the last-mentioned enterprise and the activities of both enterprises are concerned with the same project. Enterprises shall be regarded as associated if one enterprise participates directly or indirectly in the management, control or capital of the other enterprise or if the same persons participate directly or indirectly in the management, control or capital of both enterprises.

5. Profits derived by an enterprise of a Contracting State from the transportation of personnel or supplies by ships or aircraft to or within an area as referred to in paragraphs 2(a) and (b), in the other Contracting State in which business activities are carried on in connection with surveying and exploration for or exploitation of hydrocarbons, or from the operation of tugboats, supply ships or other auxiliary vessels in connection with such activity, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

6. The provisions of paragraph 4 of Article 13 and paragraph 3 of Article 23 shall apply, respectively, to gains from the alienation of ships, boats and aircraft referred to in paragraph 5, and to capital consisting of such ships, boats and aircraft.

7. Notwithstanding any other provision of this Convention, the following provisions shall apply as regards the taxation of wages and other similar remuneration derived by a resident of a Contracting State in respect of work performed in another Contracting State for an employer carrying on activities as referred to in paragraphs 1 and 2:

(a) subject to the provisions of sub-paragraphs (b) to (d), such remuneration may be taxed in that other State, but only if the work is performed in that State for a period or periods exceeding in the aggregate 30 days in any period of 12 months.
(b) such remuneration shall be taxable only in the first-mentioned Contracting State, where:
(1) the work is connected with the exploitation of hydrocarbon deposits situated on the dividing line between Contracting States or between a Contracting State and a third State;
(2) these States have entered into an agreement relating to the joint exploitation of the deposits; and
(3) the exploitation is undertaken on both sides of the dividing line simultaneously.

The provisions of this sub-paragraph shall apply only by agreement between the competent authorities of the Contracting States.

(c) if the work is performed aboard a boat or ship as referred to in paragraph 5, such remuneration shall be taxed in accordance with the provisions of paragraph 3(a) of Article 15.
(d) if the work is performed aboard an aircraft as referred to in paragraph 5, such remuneration shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

8. A resident of a Contracting State who carries on activities offshore in another Contracting State shall be exempt from tax in that other State in respect of gains which that person shall be deemed to have derived from the transfer of floating drilling rigs or hotel platforms to an area outside that other State. For the purpose of this paragraph, the term "gains" means the amount by which the market value at the moment of transfer exceeds the residual value at that moment, as increased by any depreciation taken.

9. Gains derived by a resident of a Contracting State from the alienation of:

(a) the right to surveying and exploration for or exploitation of hydrocarbon deposits in another Contracting State, including a right to a share in or profits from such deposits, or
(b) shares or other corporate rights, the value of which is wholly or substantially, directly or indirectly, attributable to such right,

may be taxed in that other State.

Article 22
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 if the recipient is a resident of a Contracting State and has a permanent establishment or a fixed base in another Contracting State and the right or property in respect of which the income arises is effectively connected with the business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be. In such cases, the provisions of Article 7 or Article 14, respectively, shall apply. However, where immovable property, as referred to in paragraph 2 of Article 6, belongs to a permanent establishment or a fixed base, the income from such property shall be taxed in accordance with the provisions of paragraphs 1, 3 and 5 of Article 6.

Article 23
Capital

1. Immovable property as referred to in paragraph 2 of Article 6, owned by a resident of a Contracting State and situated in another Contracting State, may be taxed in that other State.

2. Capital represented by shares and other corporate rights in a company as referred to in paragraph 4 of Article 6, owned by a resident of a Contracting State, may be taxed in the Contracting State where the immovable property is situated.

3. Capital represented by ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Capital represented by containers (including trailers and other equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated, unless the containers are used solely between places in another Contracting State.

5. All other elements of capital, wherever situated, owned by a resident of a Contracting State shall be taxable only in that State.

6. Notwithstanding the provisions of paragraph 5, movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in another Contracting State, or movable property pertaining to a fixed base which a resident of a Contracting State has in another Contracting State with a view to the performing of independent personal services, shall be taxable in that other State.

7. The provisions of paragraphs 1 to 6 shall be applied in a Contracting State only in relation to another Contracting State which levies a general tax on capital.

Article 24
Estates of deceased persons

Income or capital taxed in the hands of an estate of a deceased person which is a resident of a Contracting State may not be taxed in the hands of persons entitled to a share in the estate who are residents of another Contracting State.

Article 25
Elimination of double taxation

1. Denmark
(a) where a resident of Denmark derives

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income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Denmark shall, subject to the provisions of paragraph 8, second sentence, of Article 10 and paragraphs (b) and (c) below, allow:

(1) as a deduction from the Danish tax on the income of that resident, an amount equal to the income tax paid in that other State;

(2) as a deduction from the Danish tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the Danish income tax or capital tax, as computed before the deduction is given, which is attributable to the income or capital which may be taxed in that other State.

(b) where a resident of Denmark derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Denmark may include such income or capital in the tax base, but shall allow as a deduction from the Danish tax on income or capital that part of the income tax or capital tax, as the case may be, which is attributable to the income derived from that other State, or the capital owned in that other State.

(c) where a resident of Denmark derives income referred to in Article 15 or in paragraph 7 of Article 21, Denmark may include such income in the tax base, but shall allow as a deduction from the Danish tax on income that part of the income tax which is attributable to the income derived from that other State.

2. The Faroe Islands

(a) where a resident of the Faroe Islands derives income which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, the Faroe Islands shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraphs (b) and (c) below, allow as a deduction from the Faroese tax on the income of that resident an amount equal to the income tax paid in that other State.
Such deduction shall not, however, exceed that part of the Faroese income tax, as computed before the deduction is given, which is attributable to the income which may be taxed in that other State.

(b) where a resident of the Faroe Islands derives income which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, the Faroe Islands may include such income in the tax base, but shall allow as a deduction from the Faroese tax on income that part of the income tax which is attributable to the income derived from that other State.

(c) where a resident of the Faroe Islands derives from another Contracting State income from dependent personal services referred to in Article 15 or in paragraph 7 of Article 21 which, in accordance with these Articles, may be taxed in that other Contracting State, the Faroe Islands may include such income in the tax base, but shall allow as a deduction from the Faroese tax on income that part of the income tax which is attributable to the income derived from that other State.

3. Finland

(a) where a resident of Finland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Finland shall, subject to the provisions of paragraph 8, third sentence, of Article 10 and paragraphs (b) and (c) below, allow:

(1) as a deduction from the Finnish tax on the income of that resident, an amount equal to the income tax paid in that other State;

(2) as a deduction from the Finnish tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the Finnish income tax or capital tax, as computed before the deduction is given, which is attributable to the income or capital which may be taxed in that other State.

(b) where a resident of Finland derives from another Contracting State income from dependent personal services referred to in Article 15 or in paragraph 7 of Article 21 which, in accordance with these provisions, may be taxed in that other Contracting State, such income shall be exempt from Finnish tax.

(c) where a resident of Finland derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, or derives income which, in accordance with paragraph (b), above, shall be exempt from Finnish tax, Finland may include such income or capital in the tax base, but shall allow as a deduction from the Finnish tax on income or capital that part of the income tax or capital tax, as the case may be, which is attributable to the income derived from that other State, or the capital owned in that other State.

4. Iceland

(a) where a resident of Iceland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Iceland shall, subject to the provisions of paragraphs (b) and (c) below, exempt such income or capital from tax.

(b) where a resident of Iceland derives income which, in accordance with the provisions of Article 10, paragraph 7 of Article 13, Article 16 or paragraphs 1 to 6, 8 and 9 of Article 21, may be taxed in another Contracting State, Iceland shall, subject to the provisions of paragraph 8, first sentence, of Article 10 allow as a deduction from the Icelandic income tax an amount equal to the income tax paid in that other Contracting State. Such deduction shall not, however, exceed that part of the Icelandic tax, as computed before the deduction is given, which is attributable to the income which may be taxed in that other State.

(c) where in accordance with any provision of the Convention income derived or capital owned by a resident of Iceland is exempt from tax in that State, Iceland may nevertheless, in calculating the Icelandic tax on the remaining income or capital of such resident, take into account the exempted income or capital.

5. Norway

(a) where a resident of Norway derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Norway shall, subject to the provisions of paragraphs (b) and (c) below, exempt such income or capital from tax.

(b) where a resident of Norway derives income which, in accordance with the provisions of Article 10, paragraph 7 of Article 13, Article 16 or paragraphs 1 to 6, 8 and 9 of Article 21, may be taxed in another Contracting State, Norway shall, subject to the provisions of paragraph 8, first sentence, of Article 10 allow as a deduction from the Norwegian income tax of that resident an amount equal to the income tax paid in that other Contracting State. Such deduction shall not, however, exceed that part of the Norwegian tax, as computed before the deduction is given, which is attributable to the income which may be taxed in that other State.

(c) where in accordance with any provision of the Convention income derived or capital owned by a resident of Norway is exempt from tax in that State, Norway may nevertheless, in calculating the Norwegian tax on the remaining income or capital of such resident, take into account the exempted income or capital.

6. Sweden

(a) where a resident of Sweden derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Sweden shall, subject to the provisions of paragraph 8, fourth sentence, of Article 10 and paragraphs (b), (c) and (d) below, allow:

(1) – with due regard to the provisions of Swedish law (also in a wording resulting from any future amendments which, however, shall not affect the general principles thereof) – as a deduction from the

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tax on income, an amount equal to the income tax paid in that other State;

(2) as a deduction from the Swedish tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction shall not, however, exceed that part of the Swedish capital tax, as computed before the deduction is given, which is attributable to the capital which may be taxed in that other State.

(b) as regards the application of sub-paragraph (a) above, where under special legislation relief from Finnish income tax or capital tax is given in respect of a permanent establishment which a Swedish enterprise has in Finland, such amount of income tax or capital tax, as the case may be, shall be deducted from the Swedish tax on the income or capital of the enterprise as would have been payable in Finland if no such relief had been given.

(c) where a resident of Sweden derives from another Contracting State business profits referred to in Article 7, income from independent personal services referred to in Article 14, income from dependent personal services referred to in Article 15 or in paragraph 7 of Article 21 or gains referred to in paragraph 3 of Article 13, and the income or gains may, in accordance with these provisions, be taxed in that other Contracting State, such income or gains shall, notwithstanding the provisions of sub-paragraph (a) above, be exempt from Swedish tax. However, with respect to Articles 7, 13 and 14 this provision shall apply only if the major part of the income or gains is derived from personal, trading or industrial activities carried on in the other Contracting State which do not consist of the administration of securities or other similar movable property.

(d) where a resident of Sweden derives income or gains or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, or derives income or gains which, in accordance with sub-paragraph (c) above, shall be exempt from Swedish tax, Sweden may, in determining the tax rates of the Swedish progressive tax on the other income, gains or capital, take into account the income, gains or capital which shall be taxable only in the other Contracting State and the income or gains which are exempt from Swedish tax.

7. Common provisions

(a) the term "paid in the other State" in this Article shall be deemed to include tax on income paid in Denmark, the Faroe Islands, Finland, Iceland, Norway and Sweden, respectively, which shall be transferred to the other State mentioned in order to be credited in that State to the person concerned as a tax on the same income.

(b) where a resident of a Contracting State (the residence State) derives from another Contracting State (the employment State) income from dependent personal services which, in accordance with paragraph 1 of Article 15 or paragraph 7 of Article 21, may be taxed in the employment State, the residence State shall, notwithstanding the provisions of paragraphs 1(c), 2(c), 3(b), 4(a), 5(a) or 6(c) of this Article, eliminate double taxation through a deduction equal to the tax paid in the other State, in accordance with the provisions of paragraphs 1(a), 2(a), 3(a), 4(b), 5(b) or 6(b) where the resident concerned derives the income from an enterprise or permanent establishment in the employment State and he is, or was immediately prior to his employment in the employment State, employed:

(1) by any enterprise of the residence State which is associated with the enterprise of the employment State; or

(2) by an enterprise of the residence State to which the permanent establishment belongs.

(c) notwithstanding the provisions of the preceding paragraph, the provisions of paragraphs 1(c), 2(c), 3(b), 4(a), 5(a) or 6(c) of this Article shall apply if the resident concerned is able to prove that:

(1) he was present in the employment State during and for the purpose of his work for a continuous period exceeding 3 months in the tax year concerned; or

(2) the work in the employment State was carried out for, or its cost was rightfully borne by, an enterprise of that State or a permanent establishment situated in that State.

Article 26
General rules of taxation

1. Income derived by a resident of a Contracting State or capital owned by such resident may not be taxed in another Contracting State, unless taxation is explicitly allowed under this Convention.

2. If the right to tax any income or property is attributed, in accordance with the Convention, to another State than the State of which the person deriving the income or owning the property is a resident, and that other State is unable, under its law, to include such income or property in tax liability in its entirety, or takes the income or property into account for the purpose of computing the progression or for some other tax computation only, the income or property shall be taxable only in the Contracting State of which the person concerned is a resident.

3. If, in accordance with paragraph 1 of Article 14 and paragraphs 2 and 3(b) and (c) of Article 15, the right to tax income derived by a resident of a Contracting State is attributed, in accordance with the Convention, exclusively to that State the income may be taxed in another Contracting State, if the income cannot be taxed in the first-mentioned State pursuant to the law of that State.

Article 27
Non-discrimination

1. Nationals of a Contracting State shall not be subjected in another 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, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or more of the Contracting States.

2. The taxation on a permanent establishment or a fixed base which an enterprise or resident of one of the Contracting States has in another Contracting State shall not be less favourably levied in that other State than the taxation on enterprises or residents 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 another 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. Neither does the provision grant any right to obtain in a Contracting State a deduction or exemption for taxation purposes in respect of dividends and other distributions to a company resident in another Contracting State.

The provisions of the first sentence also shall not prevent a Contracting State from taxing income derived by a permanent establishment in accordance with the provisions of its own laws, if that permanent establishment is owned by a company limited by shares or a comparable company in another Contracting State. However, the taxation shall be equal to the taxation levied on companies limited by shares and comparable companies which are residents of the first-mentioned Contracting State, in respect of their income as computed without any deduction being given for distributed profits.

3. Except where the provisions of paragraph 1 of Article 9, paragraph 4 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of another Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of another Contracting State shall, for the purpose of determining the taxable capital

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of such enterprise, be deductible under the same conditions as debts to a resident of the first-mentioned State.

4. 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 one or more of the other Contracting States, 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.

5. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 28
Mutual agreement procedure

1. Where a person considers that the actions of one or more 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, if his case comes under paragraph 1 of Article 27, to that of the Contracting State of which he is a national.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State involved in the issue, with a view to the avoidance of taxation which is not in accordance with the Convention. If the State, to the competent authority of which the person in question has presented his case, is not itself involved in the issue, that competent authority shall hand over the case to the competent authority of any of the States which is or are involved in the issue.

3. Where any difficulties or doubts arise between Contracting States as to the interpretation or application of the Convention, the competent authorities of these States shall consult together in order to try and resolve the issue by special agreement. In addition, the competent authorities of the Contracting States may consult together for the elimination of double taxation in cases not provided for in this Convention or in order to resolve, by special agreement, any issues which – without being provided for by the Convention – may arise in respect of the taxes referred to in Article 2, as a result of disparities between the principles governing the computation of tax in the States concerned, or any other reason.

Before a decision on any issue, as referred to in the first sub-paragraph, is taken, the outcome of the consultations referred to shall be communicated to the competent authorities of the other Contracting States as soon as possible. If the competent authority of a Contracting State considers that consultations should take place between the competent authorities of all Contracting States, such consultations shall take place without delay at the request of the competent authority of the first-mentioned Contracting State.

Article 29
Members of diplomatic missions and consular posts

The provisions of this Convention shall not affect the fiscal privileges of members of a diplomatic mission or consular post under the general rules of international law or under the provisions of special agreements.

Article 30
Territorial extension

1. This Convention may be extended, either in its entirety or with any necessary modifications, to the territories which under paragraph 1(a) of Article 3 are excluded from the application of the Convention, on the condition that in those territories taxes are imposed which are substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including provisions as to termination, as may be specifically agreed between the Contracting States in notes to be exchanged through diplomatic channels.

2. Where the Convention is terminated in accordance with Article 32, the Convention shall, unless otherwise agreed by the Contracting States, also be terminated in respect of the territories to which it has been extended under this Article.

Article 31
Entry into force

1. This Convention shall enter into force on the thirtieth day after the date on which all Contracting States have informed the Finnish Ministry of Foreign Affairs that the Convention has been approved. The Finnish Ministry of Foreign Affairs shall notify the other Contracting States of the receipt of such information and of the date of the entry into force of the Convention.

2. Upon the entry into force of the Convention, its provisions shall have effect:
(a) in respect of taxes withheld at source, for income derived on or after the first of January in the calendar year immediately following the year in which the Convention entered into force;
(b) in respect of other taxes on income, for taxes determined for tax years beginning on or after the first of January in the calendar year immediately following the year in which the Convention entered into force;
(c) in respect of taxes on capital, for capital assessed to tax for the second calendar year following the year in which the Convention entered into force and subsequent years.

3. The Convention of 18 February 1987 between Denmark, Finland, Iceland, Norway and Sweden for the avoidance of double taxation with respect to taxes on income and on capital shall cease to have effect in respect of income and capital for which the present Convention has effect in accordance with paragraph 2. The first-mentioned Convention shall be terminated on the last date the present Convention shall take effect in accordance with the preceding provisions of the said paragraph.

4. The Convention of 12 August 1986 between the Government of Denmark and the Local Government of the Faroe Islands for the avoidance of double taxation, etc. shall cease to have effect in respect of income for which the present Convention has effect in accordance with paragraph 2. The first-mentioned Convention shall be terminated on the last date the present Convention shall take effect in accordance with the preceding provisions of the said paragraph.

Article 32
Termination

A Contracting State may, not later than 30 June of any calendar year beginning after the end of a period of five years from the date on which the Convention enters into force, terminate the Convention through a notice in writing to the Finnish Ministry of Foreign Affairs, which shall inform the other Contracting States about the receipt of such notice and its contents. If the time limit for giving such notice has been observed, the Convention shall cease to have effect in the relationship between the State which has given notice of termination and the other Contracting States:
(a) in respect of taxes withheld at source, for income derived on or after the first of January in the calendar year immediately following the year in which the Finnish Ministry of Foreign Affairs received the notice of termination;
(b) in respect of other taxes on income, for taxes determined for tax years beginning on or after the first of January of the calendar year immediately following the year in which the Finnish Ministry of Foreign Affairs received the notice of termination;
(c) in respect of taxes on capital, for capital assessed to tax for the second calendar year immediately following the year in which the Finnish Ministry of Foreign Affairs received the notice of termination and subsequent years.

The original of this Convention shall be deposited with the Finnish Ministry of Foreign Affairs, which shall transmit certified copies thereof to the other Contracting States.

In witness whereof the duly authorized representatives have signed this Convention.

Done at Helsinki, this 12th day of September 1989 , in the Danish, Faroese, Finnish, Icelandic, Norwegian and Swedish languages, there being two texts in Swedish, one for Finland and one for Sweden, all

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texts being equally authentic.

For the Government of the Kingdom of Denmark:

Mogens Rasmussen

For the Local Government of the Faroe Islands:

Petur A. Lamhauge

For the Government of the Republic of Finland:

Rainer Söderholm

For the Government of the Republic of Iceland:

Sigurbjörn Thorbjörnsson

For the Government of the Kingdom of Norway:

Per Olav Gjesti

For the Government of the Kingdom of Sweden:

Kerstin Boström

PROTOCOL

At the signing of the Convention concluded today between the Government of Denmark, in conjunction with the Local Government of the Faroe Islands, and the Governments of Finland, Iceland, Norway and Sweden for the avoidance of double taxation with respect to taxes on income and on capital, the undersigned have agreed upon the following provisions which shall form an integral part of the Convention:

I. With reference to Article 5, paragraph 3

Notwithstanding the provisions of paragraph 3 of Article 5, a building, construction, installation or assembly project, or activities consisting of planning, supervising, consulting or other auxiliary work by personnel connected with such a project shall, in the relationship between the Faroe Islands on the one hand and Denmark, Finland, Iceland, Norway and Sweden on the other hand, be deemed to constitute a permanent establishment, but only if the project or the activities last more than 6 months in a Contracting State.

II. With reference to Articles 7 and 15

1. Notwithstanding the provisions of Article 7, profits derived by an enterprise of Norway or Sweden from a business carried on in Sweden or Norway, respectively, shall be taxable only in the State of which the enterprise is a resident, if the business is concerned with the erection and maintenance of fences for reindeer along the sections of the Norwegian-Swedish frontier as determined in an agreement under paragraph 4.

2. Notwithstanding the provisions of Article 15, income derived by a resident of Norway or Sweden in respect of an employment exercised in Sweden or Norway, respectively, shall be taxable only in the State of which that person is a resident, if the employment is concerned with the erection and maintenance of fences for reindeer along the sections of the Norwegian-Swedish frontier as determined in an agreement under paragraph 4.

3. The provisions of paragraphs 1 and 2 concerning enterprises and residents, respectively, of Norway or Sweden shall equally apply in respect of enterprises and residents, respectively, of Finland or Norway.

4. The competent authorities of the Contracting States involved shall by mutual agreement determine the sections of the respective frontiers to which the provisions of paragraphs 1 to 3 shall apply.

III. With reference to Articles 7, 10 to 15, 19 and 23

1. Notwithstanding the provisions of Article 7, paragraph 2 of Article 10, paragraph 2 of Article 11 and paragraph 2 of Article 12, profits derived by an enterprise of Denmark or Sweden in respect of the construction and operation of fixed connections across the resund shall be taxable only in the State of which the enterprise is a resident.

2. Notwithstanding the provisions of paragraph 3 of Article 13, gains derived by an enterprise or resident of Denmark or Sweden from the alienation of property referred to in that paragraph, which is used for the construction and operation of fixed connections across the resund, shall be taxable only in the State of which that enterprise or person, as the case may be, is a resident.

3. Notwithstanding the provisions of paragraph 1 of Article 14, paragraph 1 of Article 15 and Article 19, income derived by a resident of Denmark or Sweden in respect of the construction and operation of fixed connections across the resund shall be taxable only in the State of which that person is a resident.

4. Notwithstanding the provisions of paragraph 6 of Article 23, property referred to in that paragraph which is owned by an enterprise or resident of Denmark or Sweden and used for the construction and operation of fixed connections across the resund shall be taxable only in the State of which that enterprise or person, as the case may be, is a resident.

IV. With reference to Articles 7, 8, 13, 15 and 23

1. The provisions of Article 7, paragraph 1 of Article 8, paragraph 4 of Article 13 and paragraph 3 of Article 23 shall apply in Denmark, Norway and Sweden to profits derived by the consortia Scandinavian Airlines System (SAS), Scanair or SAS Commuter from commercial international and inland air transport and other activities directly related thereto, to capital gains derived by the consortium concerned from the alienation of movable property used for such air transport or such other activities, and to property owned by the consortium and used for such air transport or such other activities, in the same proportion as the shares in the consortium are owned by partners who are residents of Denmark, Norway or Sweden respectively.

2. The provisions of paragraph 3(b) of Article 15 shall also apply to remuneration derived in respect of work performed aboard aircraft operated in inland traffic by the consortia SAS, Scanair or SAS Commuter.

3. Subject to agreements between the competent authorities of Denmark, Norway and Sweden, the provisions of paragraphs 1 and 2 shall also apply to any other consortium or similar entity for the carrying on of air transport or other activities directly related thereto, the shares in which are owned, directly or indirectly, solely by partners of SAS and which is basically organized according to the same principles as SAS.

V. With reference to Articles 8, 13 and 23

A share in the profits of a business, as referred to in paragraphs 1 and 3 of Article 8, a share in the gains from the alienation of items of property, as referred to in paragraphs 4 and 5 of Article 13, and a share in property, as referred to in paragraphs 3 and 4 of Article 23, which a resident of a Contracting State derives or owns as participant in an enterprise shall be taxable only in that State if:

(a) the participants are residents of different Contracting States;
(b) the enterprise is carried on by a company or other entity having participants who are jointly and severally liable, at least one of them also having unlimited liability; and
(c) it is not evident that the enterprise has

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its place of effective management in one Contracting State only.

The competent authorities of the Contracting States may conclude an agreement concerning the application of the taxation principles laid down in the first sub-paragraph also to cases where the conditions set out in that sub-paragraph are not satisfied.

VI. With reference to Article 13

he provisions of paragraphs 6 and 7 of Article 13 shall not affect the right of Denmark to tax, in accordance with its own law, gains with respect to shares which a person who moves out of Denmark is deemed to derive in connection with his departure.

VII. With reference to Article 15

1. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15, income derived by a resident of a municipalitiy in Finland, Norway or Sweden which borders upon the land frontier between Finland and Sweden, or Finland and Norway, as the case may be, in respect of work performed in such a municipality situated in another of these States, shall be taxable only in the State of which the person in question is a resident, provided that such person is regularly present at his permanent address in that State.

2. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15, income derived by a resident of Sweden in respect of continuous personal services performed in Denmark shall be taxable only in Sweden, provided that such person is regularly present at his permanent address in Sweden.

3. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15, income derived by a resident of Denmark in respect of continuous personal services performed in Sweden shall be taxable only in Denmark, provided that such person is regularly present at his permanent address in Denmark.

4. The provisions of paragraphs 2 and 3 shall apply only if the services last for a continuous period of at least 6 months.

5. The expression "continuous personal services" refers to an employment situation which is entered into with the intention of its being the taxpayer's main occupation.

6. The expression "is regularly present" means that the taxpayer is normally present at least once every week at his permanent address in the Contracting State of which he is a resident. In order for the taxpayer to be deemed to be present at his permanent address, his presence in the State of which he is a resident must comprise at least 2 days. In this connection, as in any other place where the term "day" is used in this Convention, "day" also means part of a day.

7. In paragraph 2(d) of Article 15, employees resident in a Contracting State shall be deemed to be hired out if they are placed at another person's disposal by a person (the employment agent) to carry out work in the business of such other person (the principal), situated in another Contracting State, provided that the principal is resident or has a permanent establishment in that other State, and that the employment agent has no responsibility and does not bear any risk in respect of the result of the work.

In determining whether an employee shall be deemed to be hired out, a comprehensive review should be carried out, with particular reference to whether:

(a) the ultimate control over the work rests with the principal;
(b) the work is carried out in a place of work which is at the disposal of the principal and for which he has responsibility;
(c) the remuneration of the employment agent is computed according to the time spent or with reference to any other relationship between the remuneration and the wages received by the employee;
(d) the main tools and materials are supplied by the principal; and
(e) the employment agent does not decide unilaterally on the number of employees or their qualifications.

VIII. With reference to Articles 15 and 19

1. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15 and paragraph 1 of Article 19, income derived by a resident of a municipality in Norway or Sweden which borders upon the land frontier between these States, in respect of work performed in such a municipality situated in the other of these States, shall be taxable only in the State of which the person in question is a resident, provided that such person is regularly present at his permanent address in that State.

2. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15 and paragraph 1 of Article 19, income derived by a resident of Sweden in respect of continuous personal services performed in Denmark shall be taxable only in Sweden, provided that such person is regularly present at his permanent address in Sweden.

3. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15 and paragraph 1 of Article 19, income derived by a resident of Denmark in respect of continuous personal services performed in Sweden shall be taxable only in Denmark, provided that such person is regularly present at his permanent address in Denmark.

4. The provisions of paragraphs 2 and 3 shall apply only if the services last for a continuous period of at least 6 months.

5. The expression "continuous personal services" refers to an employment situation which is entered into with the intention of its being the taxpayer's main occupation.

6. The expression "is regularly present" means that the taxpayer is normally present at least once every week at his permanent address in the Contracting State of which he is a resident. In order for the taxpayer to be deemed to be present at his permanent address, his presence in the State of which he is a resident must comprise at least 2 days. In this connection, as in any other place where the term "day" is used in this Convention, "day" also means part of a day.

IX. With reference to Article 18

Notwithstanding the provisions of Article 18, the following shall apply in the relationship between Denmark and the Faroe Islands:

Pensions, annuities, social security benefits, maintenance payments and similar payments, derived from a part of the Kingdom and paid to a resident of the other part of the Kingdom, shall be taxable only in that other part of the Kingdom.

X. With reference to Article 19

1. Notwithstanding the provisions of Article 19, the following shall apply in the relationship between Denmark and the Faroe Islands:

(a) remuneration (excluding pensions) paid by a part of the Kingdom, a political subdivision or a local authority thereof to an individual in respect of services rendered to that part of the Kingdom, political subdivision or local authority shall be taxable only in the part of the Kingdom in which the services are rendered.
(b) notwithstanding the provisions of subparagraph (a), remuneration derived by a resident of a part of the Kingdom in respect of personal services rendered as an employee in another part of the Kingdom shall be taxable only in the first-mentioned part of the Kingdom if:
  (1) the recipient is present in that other part of the Kingdom for a continuous period not exceeding 60 days; and
  (2) the remuneration is paid by his normal salary administration.
(c) the provisions of Articles 15 and 16 and of Article IX of the Protocol above shall apply to remuneration derived in respect of services rendered in connection with a business carried on by a part of the Kingdom, a political subdivision or a local authority thereof.

2. Notwithstanding the provisions of paragraph 1 above, the following shall apply in the relationship between Denmark and the Faroe Islands:

(a) disbursements determined by public authorities solely to cover expenses incurred in connection with governmental or other dependent personal services, which include no element of remuneration, and which are paid by the State of Denmark or a political subdivision or a local authority thereof to a

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person who works in the Faroe Islands, shall be taxable only in Denmark.

(b) disbursements determined by public authorities solely to cover expenses incurred in connection with governmental or other dependent personal services, which include no element of remuneration, and which are paid by the Local Government of the Faroe Islands or a political subdivision or a local authority thereof to a person who works in Denmark, shall be taxable only in the Faroe Islands.

The provisions of subparagraphs 2(a) and (b) above shall apply for the first 5 years during which the person concerned receives such disbursements.

XI. With reference to Article 20

1. A person who is present in a Contracting State other than the Faroe Islands and a person who is present in a Contracting State other than Iceland solely for the purpose of:

(a) study at a university or other educational institution in that Contracting State; or

(b) business, fishery, industrial, agricultural or forestry training in that Contracting State,

and who is, or immediately before his stay was, a resident of the Faroe Islands or Iceland shall, in respect of income from employment in the first-mentioned Contracting State, be taxed only for such part of that income as exceeds 20,000 Swedish crowns in a calendar year, or its equivalent in Danish, Finnish, Icelandic or Norwegian currency. The amount stated above shall, during stays in Finland, Norway or Sweden, include the personal allowance for the calendar year in question.

2. The exemption referred to in paragraph 1 shall be allowed only for a period of time which reasonably or normally is needed for the study or training, subject to a maximum of 6 consecutive calendar years.

3. Notwithstanding the provisions of paragraphs 1 and 2 above, the following shall apply in the relationship between Denmark and the Faroe Islands:

A student, apprentice or similar person who is, or immediately before his stay in a part of the Kingdom was, a resident of the other part of the Kingdom and who is temporarily present in the first-mentioned part of the Kingdom solely for the purpose of education or training shall not be taxed in that part of the Kingdom in respect of payments received from the other part of the Kingdom or from any other State for the purpose of his maintenance, education or training. Neither shall he be taxed in respect of amounts paid as remuneration for work performed, provided that such work is necessary for his maintenance.

A student, apprentice or similar person who immediately before his stay in Denmark was a resident of the Faroe Islands shall not be taxed in the Faroe Islands in respect of remuneration for work performed in Denmark.

Persons who, after having finished a study, commence a specialist study or a study in another field shall not be considered as students.

A stay shall be considered temporary if it does not exceed the standard study period, increased by 2 years.

A stay shall not be considered as being "solely for the purpose of education or training" if it has lasted more than 6 months before the commencement of the education.

Any period of time, not exceeding one year, spent in connection with a preparatory course which, according to the educational institution, is a condition in order to be able to commence the education in question, shall not be taken into account for the above 6-month period.

If two spouses request to be admitted to an educational institution and only one of them is admitted, the 6-month rule is extended with respect to the other spouse, subject to a maximum period of 2 years.

The provisions of this paragraph shall apply to income derived on or after 1 January 1989. However, the "Faroe deduction" shall be included in the remuneration for work performed as of 1 January 1988, irrespective of whether such remuneration was derived from Denmark or from any other State.

4. Notwithstanding the provisions of paragraph 1 above, a student, apprentice or similar person who is, or immediately before his stay in Denmark was, a resident of Iceland and who is temporarily present in Denmark solely for the purpose of education or training shall not be taxed in respect of amounts paid as remuneration for work performed, provided that such work is necessary for his maintenance.

5. A person who is studying at a university or other educational institution in a Contracting State other than Finland and who, during a temporary stay in Finland is employed in Finland during not more than 100 days in any one calendar year in order to gain practical experience in connection with his study, shall be taxable in Finland only for that part of the income from such employment which exceeds an average monthly income of 2,400 Finnish marks. However, the exemption from tax under this paragraph shall not exceed in the aggregate 8,000 Finnish marks in a calendar year.

6. Students at a university or other educational institution in a Contracting State other than Sweden who during a temporary stay in Sweden are employed in that State in connection with their study or education, shall be taxable in Sweden only for that part of the income from such employment which exceeds 10,000 Swedish crowns in a calendar year.

7. A person who is a resident of a Contracting State other than Denmark and who during a temporary study in Denmark is employed in Denmark during not more than 100 days in any one calendar year shall be taxable in Denmark only in respect of the part of the income exceeding the amount which in accordance with existing provisions is necessary for his maintenance, provided that the work is performed within the framework of the Nordic programme for the exchange of training and holiday work and that the work has been arranged by Nordjobb.

The amount which is considered necessary for the maintenance of the person concerned shall be determined on a yearly basis and shall be reduced according to the length of the stay in Denmark in relation to the calendar year.

The provisions of this paragraph shall apply as of 1 January 1989.

8. The competent authorities of the Contracting States may conclude agreements as regards the application of the provisions of paragraphs 1 to 7. The competent authorities may also conclude agreements on such changes in the amounts mentioned in those paragraphs as may be reasonable with regard to changes in the value of money, amended legislation in any of the Contracting States or any other similar circumstance.

XII. With reference to Article 25

1. At the request of the Faroe Islands, the provisions of paragraph 2 of Article 25 may be changed and replaced by the following text:

"(a) where a resident of the Faroe Islands derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, the Faroe Islands shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraphs (b) and (c) below, allow as a deduction from the Faroese income tax or capital tax of that resident, an amount equal to the income tax or capital tax paid in that other State.
Such deduction in either case shall not, however, exceed that part of the Faroese income or capital tax, as computed before the deduction is given, which is attributable to the income or capital which may be taxed in that other State.

(b) where a resident of the Faroe Islands derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, the Faroe Islands may include such income or capital in the tax base, but shall allow as a deduction from the Faroese tax on income or capital that part of the income tax or capital tax which is attributable to the income or capital which may be taxed in that other State.

(c) where a resident of the Faroe Islands derives from another Contracting State income from dependent personal services referred to in Article 15 or in paragraph 7 of Article 21 which, in accordance with these provisions, may

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be taxed in that other Contracting State, the Faroe Islands may include such income in the tax base, but shall allow as a deduction from the Faroese tax on income that part of the income tax which is attributable to the income derived from that other State".

The request for such change shall be made through diplomatic channels, by giving notice to each of the other Contracting States. The change shall enter into force on the thirtieth day after the date on which all other Contracting States have received such notice and its provisions shall thereupon have effect in respect of taxes on capital, for capital assessed to tax for the second calendar year following the year in which the change entered into force and subsequent years.

2. At the request of Iceland, the provisions of paragraph 4 of Article 25 may be changed and replaced by the following text:
"(a) where a resident of Iceland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Iceland shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraph (b) below, allow:
(1) as a deduction from the Icelandic tax on the income of that resident, an amount equal to the income tax paid in that other State;
(2) as a deduction from the Icelandic tax on the capital of that resident, an amount equal to the capital tax paid in that other State.
Such deduction in either case shall not, however, exceed that part of the Icelandic income tax or capital tax, as computed before the deduction is given, which is attributable to the income or capital which may be taxed in that other State.
(b) where a resident of Iceland derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Iceland may include such income or capital in the tax base, but shall allow as a deduction from the Icelandic tax on income or capital that part of the income tax or capital tax, as the case may be, which is attributable to the income derived from that other State, or the capital owned in that other State."

The request for such change shall be made through diplomatic channels, by giving notice to each of the other Contracting States. The change shall enter into force on the thirtieth day after the date on which all other Contracting States have received such notice, and its provisions shall thereupon have effect:
(a) in respect of taxes withheld at source, for income derived on or after the first of January in the calendar year immediately following the year in which the change entered into force;
(b) in respect of other taxes on income, for taxes determined for tax years beginning on or after the first of January in the calendar year immediately following the year in which the change entered into force;
(c) in respect of taxes on capital, for capital assessed to tax for the second calendar year following the year in which the change entered into force and subsequent years.

3. At the request of Norway, the provisions of paragraph 5 of Article 25 may be changed and replaced by the following text:
"(a) where a resident of Norway derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Norway shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraph (b) below, allow:
(1) as a deduction from the Norwegian tax on the income of that resident, an amount equal to the income tax paid in that other State;
(2) as a deduction from the Norwegian tax on the capital of that resident, an amount equal to the capital tax paid in that other State.
Such deduction in either case shall not, however, exceed that part of the Norwegian income tax or capital tax, as computed before the deduction is given, which is attributable to the income or capital which may be taxed in that other State.
(b) where a resident of Norway derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Norway may include such income or capital in the tax base, but shall allow as a deduction from the Norwegian tax on income or capital that part of the income tax or capital tax, as the case may be, which is attributable to the income derived from that other State, or the capital owned in that other State."

The request for such change shall be made through diplomatic channels, by giving notice to each of the other Contracting States. The change shall enter into force on the thirtieth day after the date on which all other Contracting States have received such notice, and its provisions shall thereupon have effect:
(a) in respect of taxes withheld at source, for income derived on or after the first of January in the calendar year immediately following the year in which the change entered into force;
(b) in respect of other taxes on income, for taxes determined for tax years beginning on or after the first of January in the calendar year immediately following the year in which the change entered into force;
(c) in respect of taxes on capital, for capital assessed to tax for the second calendar year following the year in which the change entered into force and subsequent years.

4. At the request of Sweden, the provisions of paragraph 6 of Article 25 may be changed and replaced by the following text:
"(a) where a resident of Sweden derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Sweden shall, subject to the provisions of paragraph 8, fourth sentence, of Article 10 and paragraphs (b) and (c) below, allow:
(1) – with due regard to the provisions of Swedish law (also in a wording resulting from any future amendments which, however, shall not affect the general principles thereof) – as a deduction from the tax on income an amount equal to the income tax paid in that other State;
(2) as a deduction from the Swedish capital tax of that resident, an amount equal to the capital tax paid in that other State. Such deduction shall not, however, exceed that part of the Swedish capital tax, as computed before the deduction is given, which is attributable to the capital which may be taxed in that other State.
(b) as regards the application of sub-paragraph (a) above, where under special legislation relief from Finnish income tax or capital tax is given in respect of a permanent establishment which a Swedish enterprise has in Finland, such amount of income tax or capital tax, as the case may be, shall be deducted from the Swedish tax on the income or capital of the enterprise as would have been payable in Finland if no such relief had been given.
(c) where a resident of Sweden derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Sweden may, in determining the tax rates of the Swedish progressive tax on the other income or capital, take into account the income or capital which shall be taxable only in that other Contracting State."

The request for such change shall be made through diplomatic channels, by giving notice to each of the other Contracting States. The change shall enter into force on the thirtieth day after the date on which all other Contracting States have received such notice and its provisions shall thereupon have effect:
(a) in respect of taxes withheld at source, for income derived on or after the first of January in the calendar year immediately following the year in which the change entered into force;
(b) in respect of other taxes on income, for taxes determined for tax years beginning on or after the first of January in the calendar year immediately following the year in which the change entered into force;
(c) in respect of taxes on capital for capital assessed to tax for the second calendar

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year following the year in which the change entered into force and subsequent years.

XIII. With reference to Article 26

1. Where a person referred to in paragraph 3(a) of Article 15 may, pursuant to the provisions of paragraph 2 of Article 26, be taxed in Iceland or Norway, he shall be entitled in the State concerned to the same deductions as would be allowed if he had been employed aboard a ship in international traffic registered in that State.

2. The provisions of paragraph 3 of Article 26 shall apply correspondingly in cases referred to in sub-paragraphs 3 and 4 of paragraph III of the Protocol.

XIV. With reference to Article 31

1. The exemptions granted in Finland and Sweden to associations of raftsmen established for the purpose of carrying on rafting on the rafting routes in the border rivers Torne and Muonio shall be governed by a special agreement.

2. The basis for the apportionment between Norway and Sweden of taxing rights concerning the income of Luossavaara-Kiirunavaara A.B. shall be determined by a special agreement.

The original of this Protocol shall be deposited with the Finnish Ministry of Foreign Affairs, which shall transmit certified copies thereof to the other Contracting States.

In witness whereof the duly authorized representatives have signed this Protocol.

Done at Helsinki, this 12th day of September 1989, in the Danish, Faroese, Finnish, Icelandic, Norwegian and Swedish languages, there being two texts in Swedish, one for Finland and one for Sweden, all texts being equally authentic.

For the Government of the Kingdom of Denmark:

Mogens Rasmussen

For the Local Government of the Faroe Islands:

Petur A. Lamhauge

For the Government of the Republic of Finland:

Rainer Söderholm

For the Government of the Republic of Iceland:

Sigurbjörn Thorbjörnsson

For the Government of the Kingdom of Norway:

Per Olav Gjesti

For the Government of the Kingdom of Sweden:

Kerstin Boström

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INTERNATIONAL:

INCOME TAX REFORMS IN OECD MEMBER COUNTRIES

Sijbren Cnossen and Ken Messere

Sijbren Cnossen is Professor in the Economics Faculty of Erasmus University Rotterdam. **Ken Messere** is Head of the Fiscal Affairs Division of the Organisation for Economic Co-operation and Development (OECD).

This article is based on a paper presented at the conference of the International Seminar in Public Economics held at Erasmus University Rotterdam in January 1989. The proceedings of the conference have been published in Sijbren Cnossen and Richard M. Bird (eds.), *The Personal Income Tax: Phoenix from the Ashes?* (Amsterdam: North-Holland Publishing Company, 1990).

The authors are grateful to Richard Goode, John Nørregard, Jeffrey Owens and Eugene Steuerle for their perceptive comments on an earlier draft. As a staff member of the OECD, Ken Messere is obliged to make it clear that nothing in this article commits the OECD or its member countries to agreement with anything that is said.

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I. INTRODUCTION AND CONCLUSIONS

Since 1986 nearly all OECD countries have reformed their personal income tax systems. The gist of the reforms has been to lower and flatten the rates and to broaden the base. Tax base issues concern the definition of income: what should be regarded as income (e.g. fringe benefits, imputed rents, capital gains) and which deductions should be allowed in ascertaining net income (e.g. pension and life insurance contributions, mortgage interest). These issues may be said to be related to horizontal equity and efficiency. On the other hand, rate issues (thresholds, top and bottom rates, number of brackets) bring into play vertical equity and efficiency criteria. In addition, there are a number of problems concerning both horizontal and vertical equity as well as efficiency, which refer to both the tax base and the tax rates (e.g. standard tax reliefs, tax unit, indexation).

Possible adverse effects of high tax rates on work effort as well as their inducement to participation in the underground economy are among the reasons behind reforms to lower rates of income tax. Other reasons are that high rates exacerbate tax-induced distortions of investment decisions and that they accentuate the injustice as between those who can avoid payment of tax and those who cannot. Widening the tax base, necessary anyway to recoup the revenue losses from rate lowering, is aimed at reducing the difference between those taxpayers who can and those who cannot take advantage of gaps in the tax base and opportunities to reduce gross income through deductions. Generally preceding these tax base and tax rate reforms have been modifications of the tax unit and the standard tax reliefs reflecting a greater emphasis on the individual and an increase in the participation of women in the paid work force.

As regards tax base issues, the survey indicates that most countries regard second-best, not too radical solutions an improvement over a no-change policy. Fringe benefits are taxed more widely than before and provisions on costs incurred in earning income have been tightened. Generally, pension contributions and life insurance premiums remain deductible, but excesses have been curtailed through the imposition of ceilings and other restrictions. Imputed rental income of owner-occupied dwellings is taxed somewhat more widely than before or mortgage interest deductions have been made less generous. There is also less reluctance to tax capital gains. Overall, the tax base changes have improved the equal treatment of various sources of income and reduced the extent to which the neutrality criterion was violated.

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Tax neutrality has also been improved through the lowering and flattening of the rates and through changes in the definition of the tax unit (the individual, a married couple, a family or a household). The effect of the recent reforms on income tax yields remains unclear. In addition to the reduction in the top mariginal rates, the base-widening measures have been accompanied by revenue-reducing measures such as raising tax thresholds and personal allowances, increasing tax reliefs and adding new ones.

It is of interest to note that fiscal illusions continue to play a role in the income tax policy debate. To take three examples discussed more fully below: bracket reduction is presented as simplifying the income tax schedule, but apart from easing the calculation that hardly anyone makes in any event, it simplifies nothing; second, indexation is supposed to reduce fiscal drag but as countries with indexation modify it from time to time and make ad hoc adjustments, and countries without indexation also make adjustments to offset fiscal drag, this can be done equally well under indexed and non-indexed systems; third, the choice of the tax unit has certain normative and administrative implications, but little influence on the issue it is primarily intended to address, i.e. the relative treatment of different tax units (single, one-earner and two-earner married couples) with differing aggregate incomes and in differing family circumstances, since the rate schedule and the size, conditions and types of tax reliefs are far more important determinants.

The survey suggests that though much has changed, much has remained the same. The scope of the rate reductions and the changes in the tax base, influenced to a large extent by the income tax reform in the United States, are unprecedented. They reflect the growing internationalization of the tax policy debate. That much has remained the same reflects the fact that tax systems of democratic countries have a quasi-constitutional character. In other words, a high degree of stability and certainty is desirable. Whilst there may remain some scope for further base broadening in some countries, attempts to move closer to the theoretical concept of income are likely to pose political and technical problems. Moreover, the personal income tax is only one stone in the tax and expenditure structure. Conflicting principles, practices and perceptions must be balanced. As Aaron, Galper and Pechman (1988, p. 13) note: ". . . recommendations for perfecting pure forms of taxation may well be inferior advice for improving a hybrid tax system. Of equal importance, they may be politically irrelevant".

II. REVENUE DEVELOPMENTS

The primary function of the income tax, like nearly all taxes, is to raise revenue. This section reviews tax revenue trends in OECD member countries, with emphasis on the income tax. Revenue statistics include receipts from central, provincial and local governments. The term 'tax ratio' refers

Table 1

OECD: Tax Revenue Trends, 1965-87
(Unweighted Averages)

	1965	1970	1975	1980	1985	1987	1987 minus 1965
			A. Tax Revenue as Percentage of GDP				
Taxes on Income	*14.6*	*17.4*	*20.8*	*22.9*	*23.8*	*24.5*	*9.9*
Personal income tax	7.3	8.9	10.7	11.6	11.6	12.0	4.7
Corporation income tax	2.4	2.6	2.4	2.7	3.0	3.0	0.6
Social security contributions	4.9	5.9	7.7	8.6	9.2	9.5	4.6
Taxes on Consumption	*9.7*	*10.4*	*9.8*	*10.3*	*11.2*	*11.8*	*2.1*
Taxes on Property	*2.0*	*2.0*	*1.9*	*1.7*	*1.8*	*2.1*	*0.1*
Other Taxes	*0.3*	*0.4*	*0.4*	*0.5*	*0.5*	*0.4*	*0.1*
Total Tax of which:	*26.6*	*30.0*	*32.8*	*35.2*	*37.3*	*38.8*	*12.2*
United States	25.9	29.2	29.0	29.5	29.2	30.0	4.1
Japan	18.3	19.7	20.9	25.5	28.0	30.2	11.9
European Community	27.2	30.8	33.4	36.4	39.4	40.6	13.4
			B. Percentage Composition of Total Tax Revenue				
Taxes on Income	*53.7*	*57.0*	*62.8*	*64.6*	*63.7*	*62.9*	*9.2*
Personal income tax	26.3	28.2	31.4	32.7	31.1	30.7	4.4
Corporation income tax	9.2	9.0	7.7	7.7	8.1	7.9	–1.3
Social security contributions	18.2	19.8	23.7	24.2	24.5	24.3	6.1
Taxes on Consumption	*37.1*	*34.8*	*30.1*	*29.1*	*29.8*	*30.3*	*–6.8*
Taxes on Property	*8.0*	*7.1*	*6.1*	*5.2*	*5.0*	*5.5*	*–2.5*
Other Taxes	*1.1*	*1.2*	*1.3*	*1.2*	*1.1*	*1.0*	*–0.1*
Total Tax	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*0.0*

Source: OECD, 1989, Tables 3, 10-15, 20-25.
Note: Totals may not add because of rounding.

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to tax revenues as a percentage of gross domestic product (GDP). The expression 'tax share' is defined as the percentage contribution of a particular tax to total tax revenue.

A. Main categories of tax

Table 1 shows that the total tax ratio in the OECD area rose on average from 27 percent to 39 percent (approximately 0.6 percentage point per annum) from 1965 to 1987, a time span of some 20 years. The growth of the total tax ratio was evenly spread between the two decades under review, though both the amount and the timing of this growth varied widely from country to country.

Of the major sources of government tax revenue, the most significant increase occurred in the personal income tax ratio, which rose from 7.3 percent in 1965, when the income tax ranked second to consumption taxes in terms of revenue, to 12 percent in 1987, when it had moved to first place. More than 90 percent of the increase in the income tax ratio occurred between 1965 and 1975, due mainly to uncorrected fiscal drag resulting from economic growth and particularly inflation. Between 1975 and 1980, fiscal drag was largely offset in most OECD countries (OECD, 1986) and income tax revenue trends during the 1980s suggest that offsetting has continued in most, if not all, countries.

Table 1 also indicates that since 1965 around 85 percent of overall tax revenues in the OECD have been derived from three sources of revenue: personal income taxes, social security contributions and consumption taxes. Whereas the shares of the three sources were in 1965 26 percent, 18 percent and 37 percent, respectively, by 1975 they had become 31 percent, 24 percent and 30 percent. Since 1975 the shares have not changed much for these three sources of revenue. These unweighted averages conceal substantial country differences. Since 1975 the personal income tax share has increased by at least five percentage points and sometimes much more in Canada, Ireland, Italy, Spain and the United States, and decreased by corresponding amounts in Denmark, the Netherlands, Norway, Sweden, Turkey and the United Kingdom.

The marked increase in the income tax share between 1965 and 1975 was due not only to the increase in its ratio referred to above but also to the developments in respect of the other two major sources of revenue, social security contributions and consumption taxes. The increase in the social security contributions share (and ratio) was due largely to discretionary rate increases to finance increases in coverage and real benefits, although improved (withholding) collection techniques may also have contributed. The drastic decline in the share of consumption taxes over that period was due to the effect of negative fiscal drag on excises on drinking, smoking and motoring, which until quite recently were the most important consumption taxes in nearly all OECD countries. The stability of the share of consumption taxes since 1975 is due to the adoption or extension of value added taxes, together with increases of rates of excises, especially on gasoline.

B. The personal income tax

Personal income taxes are defined as including 'all taxes levied on the income of individuals and of unincorporated enterprises (e.g. the self-employed, small businesses, farmers and the liberal professions), as well as income taxes earmarked for social security expenditures and, when integrated with the income tax, capital gains taxes' (OECD, 1986, p. 8). The inclusion in the tax base of the profits of unincorporated enterprises indicates that the income tax interacts with the corporation tax. If the corporate form of doing business is widely used in a country (as in Japan, for example), what would be shown as personal income tax receipts in other countries is shown as corporate tax receipts. Similarly, the borderline between personal income taxes and employees' social security contributions is not too clear when, for example, a certain proportion of income tax receipts is earmarked for social security expenditures or, to put it differently, social security contributions are levied on the basis of net income (involving the application of tax thresholds and family allowances) rather than gross income.

Table 2 shows that country variations in the income tax ratio are enormous. In 1987 the income tax ratio ranged from 4.6 percent in Greece to 25.6 percent in Denmark which collects most of its social security financing requirements through the income tax. Similarly, the income tax share ranged from 12 percent in Greece and France to 50 percent in New Zealand which, like Denmark, does not levy separate social security contributions (OECD, 1989, Table 11). In Denmark, the income tax ratio rose by more than 10 percentage points in the period under review. In Denmark, as well as in Belgium, Canada, Greece, Ireland, Italy and Spain, the 1987 income tax ratio was more than double the 1965 ratio. In most countries, this was due to fiscal drag (at least initially), changes in collection methods, such as the introduction of PAYE (pay-as-you-earn) and increases in taxpayer coverage.

Apart from future government legislative decisions on rates and the tax base, too many factors come into play to forecast the future of the income tax ratio and share with any confidence. Among them are relative future government and taxpayer preferences between income taxes and other sources of revenue, possibly greater integration of income taxes and social security contributions, macroeconomic factors such as rates of growth and inflation, and improvement in collection techniques, which tend especially to increase income tax yields. However, with the growing perception that income taxes are more harmful to economic performance than consumption taxes and the greater resentment of taxpayers against income taxes than against value added taxes or social security contributions, it seems unlikely that the income tax ratio or its share will increase over the coming years in most OECD countries.

III. TAX BASE ISSUES

Arguing that a broader, more inclusive, definition of income would result in a fairer, more neutral and simpler tax, in recent years most OECD member countries have taken or announced measures to withdraw the favorable treatment of various forms or sources of income. Generally, these measures focus on five areas, although the attention that each of them receives varies widely from country to country.

(1) The favourable tax treatment of fringe benefits, i.e. various forms of income-in-kind from employment, has resulted in a proliferation of this form of wage and salary payment. Before the 1986 tax reform in the United States, for example, it was not uncommon to have remuneration packages where more than one third of the total remuneration was made available in the form of fringe benefits (OECD, 1986, p. 47). Such treatment erodes the tax base, distorts employment and consumption decisions and undermines the fairness of the tax.
(2) The deductibility of premiums for retirement and insurance schemes has involved a massive conversion of current income into future income. This has distortionary

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effects on savings (and investment) decisions, is often regarded as unfair by those deriving income from self-employment and involves administrative complications if measures are taken to prevent undue proliferation of the schemes or to extend similar benefits to other taxpayers.

(3) Allegedly, the favourable treatment of the imputed income from owner-occupied property (generally by exempting the gross income of the asset, while permitting the deduction of mortgage interest from other income) discriminates against renters of dwelling space and leads to more investment in housing than is commensurate with an optimal allocation of resources.

(4) The exemption or inadequate taxation of capital gains is regarded as unfair vis-à-vis taxpayers who enjoy only labour income. The costs of arbitrage are also high in this field as complex schemes are devised to convert taxable capital income into untaxable capital gains.

(5) As the total level of welfare benefits, e.g. for unemployment and sickness, has increased in the past years, their exemption from tax in some countries has increasingly been questioned on incentive grounds. Moreover, it has been considered that the general acceptability of these benefit schemes would be promoted if the beneficiaries would also pay their share through the income tax.

A. Fringe benefits

Employment income is generally taxed comprehensively in OECD countries. Problems are encountered with the proper valuation of fringe benefits, defined as 'all advantages, other than monetary salary and wages, in consequence of services rendered or to be rendered by an employee' (OECD, 1988a, p. 8). Such advantages include the below-cost or below-market value provision of food, transportation, shelter and other amenities. Another issue concerns the proper treatment of costs incurred in earning income. While there is no doubt that expenses for the acquisition of professional tools and literature should be deductible from gross receipts, problems arise with so-called mixed expenses which, although related to the employment, also have an element of personal consumption. Examples are entertainment, travel, lodging and commuting expenses.

Table 2

OECD: Taxes on Personal Income in 1965, 1975 and 1987
(As Percentage of GDP)

Higher than 20 percent	Between 15 and 20 percent	Between 10 and 15 percent	Between 5 and 10 percent	Lower than 5 percent
		1965		
None	Sweden (17.3)	Finland (10.6) Denmark (12.4) Norway (13.2)	Canada (5.9) Belgium (6.3) Switzerland (6.5) Austria (6.9) Luxembourg (7.6) United States (7.9) Australia (8.0) Germany (8.2) United Kingdom (9.1) Netherlands (9.2) New Zealand (9.7)	Greece (1.5) Spain (2.1) Italy (2.8) France (3.7) Turkey (3.7) Japan (4.0) Ireland (4.3)
		1975		
Sweden (20.2) Denmark (23.1)	Finland (17.0) New Zealand (17.0)	Canada (10.6) Switzerland (10.7) Germany (10.8) Luxembourg (10.9) Netherlands (11.8) Australia (12.1) Belgium (13.1) United Kingdom (13.5) Norway (14.1)	Japan (5.0) Turkey (6.8) Ireland (7.9) Austria (8.4) United States (9.5)	Greece (2.3) Spain (2.8) Italy (4.0) France (4.5)
		1987		
Sweden (21.1) Denmark (25.6)	Belgium (15.1) Finland (16.4) New Zealand (19.2)	United Kingdom (10.0) Germany (10.9) Switzerland (10.9) United States (10.9) Luxembourg (11.1) Norway (12.8) Canada (13.4) Ireland (13.8) Australia (14.2)	France (5.7) Turkey (6.0) Spain (7.0) Japan (7.3) Italy (9.5) Netherlands (9.5) Austria (9.6)	Greece (4.6)

Source: OECD, 1989, Table 10.
Note: Figures for Iceland and Portugal are not available.

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Ignoring compensating wage movements, a generous attitude by the tax authorities in respect of the valuation of fringe benefits and the deductibility of mixed expenses means that the income tax discriminates in favour of people who enjoy a higher-than-average amount of fringe benefits or who can deduct a higher-than-average amount of mixed expenses (or who can obtain a higher-than-average non-taxable reimbursement of mixed expenses). Favourable treatment of fringe benefits and mixed expenses will induce people to look for employment whereby, given the same gross wage, a larger portion of the income is received in the form of fringe benefits or a larger portion of the receipts are deductible as costs of earning income. Similarly, such treatment will induce firms to provide as large a portion of the remuneration in the form of fringe benefits or expense reimbursements as possible. This will distort the optimal allocation of labour, particularly since the income tax rates will have to be higher to ensure the same yield.

In recent years many countries, including Australia, Ireland, New Zealand and the United States, have re-examined the tax treatment of fringe benefits. Other countries have also expressed concern about the revenue loss of favourable tax treatment and its distributional implications since the monetary value of fringe benefits tends to increase as income rises.

1. Forms of fringe benefits

The most widely used fringe benefits in OECD countries are food, discounts, transportation, leisure facilities, accommodation, medical and dental insurance, financial assistance and education expenses (OECD, 1988a). Nearly all countries treat fringe benefits under their income tax legislation. Exceptionally, Australia and New Zealand impose a separate fringe benefits tax on business firms and other employers. Nearly all countries tax the benefit of employer-provided motor vehicles and accommodation, but the tax treatment of other fringe benefits differs widely.

Of other individual fringe benefits, canteen facilities tend to be exempted if provided on a non-discriminatory basis. Even countries that tax such facilities in principle tend to exempt basic meals. On the other hand, meal vouchers which enable employees to eat outside business premises are usually taxed. The treatment of staff discounts varies widely, but generally an exemption applies if there is no cost to the employer or if the discount is reasonable and does not exceed what is customary in the trade. Most countries tax the value of gifts, except if largely gratuitous or related to employee-specific events (e.g. anniversaries, retirement or similar occasions). Typically, the approach in respect of all these forms of fringe benefits is to tax them in principle, but to exempt reasonable and customary benefits on practical grounds. In other words, the taxing rule largely acts as an anti-avoidance measure.

OECD countries are evenly distributed as regards the tax treatment of commuting expenses. However, nearly all countries (Greece being the only exception) tax the benefit of employer-provided motor vehicles. Many do so by reference to standard values computed by the tax department. Some countries attempt to tax actual costs and use, but even then standard rates are used as a back-up device. In some other countries (Japan, Spain, the United States), the taxable benefit is set at the lease or rental charge of a similar car. Recently, Norway and Sweden have reviewed the tax treatment of employer-provided vehicles.

The tax treatment of leisure and recreational facilities is also evenly distributed between taxing and exempting countries. Again, the difference may be small if the taxing country provides an exemption for, say, reasonable sporting facilities or if the exempting country taxes the benefit of above-average facilities. The benefit of employer-provided accommodation is taxed nearly everywhere. Low interest loans for housing are generally exempted, but similar loans for other purposes are usually taxed. Of course, whether or not the difference between the market rate of interest and the actual rate should be taxed also depends on the general rule regarding interest deductibility. If interest is fully deductible, the taxation of the benefit associated with a low interest rate makes little sense because the amount so taxed would also be a tax allowance against income. The treatment of employer-paid medical and dental insurance premiums varies. Finally, education expenses for employees are generally exempt, although often subject to the condition that the education must be employment-related. Similar expenses for dependants, however, are nearly always included in income.

With minor exceptions, the cost of fringe benefits is deductible under the corporation tax in all OECD countries. Various countries stipulate that the expense must be reasonable or set other limitations. Italy disallows the cost of some fringe benefits (meal vouchers, leisure facilities, motor vehicles) or permits a deduction only if the benefit does not exceed 5 percent of the remuneration (gifts, employee education expenses). Generally, the treatment of fringe benefits in the calculation of compulsory social security contributions, if levied, is the same as under the income tax. Ireland, Spain, Turkey and the United Kingdom do not include fringe benefits in the contribution base for social security. Norway and Portugal only include some fringe benefits.

2. Rationale, valuation and other issues

Various reasons may be given for the existence of fringe benefits depending on whose views are solicited. Employees may find it convenient to eat on the employer's premises, feel gratified with receiving discounts or gifts, enjoy the added status of a company car, like to meet their colleagues at a physical work-out or appreciate the financial support provided by the employer. Presumably, employers try to encourage productivity by making their employees more content in the workplace and by making salary structures more flexible. Also, fringe benefits which receive favourable tax treatment permit them to reduce taxes in respect of gross wages and social security contributions.

On the other hand, governments may react against the erosion of the tax base and the loss of revenue that follow from the favourable treatment of fringe benefits. However, some fringe benefits, such as canteen or recreational facilities, may be so much a part of accepted working conditions that it would be considered unfair to tax them at their full value. Generally, the same reasoning applies to staff discounts and gifts. In other instances, e.g. the payment of education expenses or medical and dental insurance premiums, governments may consider that a worthwhile policy objective is being served. As the use of fringe benefits proliferates, however, governments become increasingly aware of the revenue cost as well as the distributional implications of the favourable tax treatment of fringe benefits.

One of the main issues in the taxation of fringe benefits concerns the monetary value that should be attached to the advantage enjoyed by the employee. Broadly, four methods may be followed: the value to the employee, the cost to the employer, the fair market value or the standard value established by the tax administration. Presumably, the value to the employee is the most difficult to ascertain. Gifts might

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be valued on this basis. The cost to the employer is readily ascertainable, but difficulties arise if a case can be made for taking incremental rather than total costs for valuation purposes. Airline tickets are an example. Market value would be the most satisfying criterion for the theoretically inclined mind, but its rigorous application might be regarded as inequitable or defeat the purpose of most fringe benefits. Standard values are commonly used for meals, company cars and accommodation. In practice, as this brief summary shows, different fringe benefits are valued in different ways.

One way to avoid some of the subjective and contentious aspects of the valuation of fringe benefits is to tax them at the level of the employer, either by disallowing their cost in computing taxable profits or by subjecting them to a separate tax. Since this approach obviates the need for attributing the value of fringe benefits to individual employees, significant administrative savings may be realized. Moreover, the revenue effects or distributional implications may be minimized if the top marginal income tax rate is set close to the rate of the corporation tax.

In recent years, a separate fringe benefits tax has been introduced in Australia and New Zealand. The New Zealand tax is confined to employer-provided cars, low interest loans and free or discounted goods and services. The Australian tax has a much broader coverage, including board, accommodation and air travel. The value of canteen and recreational facilities is excluded from the coverage of the tax. Employers' surveys in Australia indicate that there is expected to be a significant reduction in the provision of travel and holiday expenses. In New Zealand employers expect an increase in cash payment remuneration.

Table 3

OECD: Treatment of Pension and Life Insurance Contributions, 1989

Country	Social Security Contributions (Individual)[a]	Pension Contributions		Life Insurance Premiums		
		Employer	Individual	Employer	Individual	Capital gains
Australia	None	E	TA*	T	TC	E
Austria	TA	E[b]	T	E[b]	TA*	E
Belgium	TA	T[c]	TA	T	TA*	E
Canada	TC	E	TA*	E[d]	TA*	E
Denmark	TA[e]	E	TA*	T	TA*	E
Finland	TA	E	TA*	E	TA*	E
France	TA	T	TA*	T	TC*	E
Germany	TA*	E[f]	TA*	T[f]	TA*	E
Greece	TA	E	T	E	TA*	E
Ireland	TA*	E	TA*	T[g]	TA*	E
Italy	TA	E	TA*	E	TA*	E
Japan	TA	E[h]	TA*	T[i]	TA*	T
Luxembourg	TA	E	TA	T	TA*	E
Netherlands	T[j]	E	TA	T	TA*	E
New Zealand	None	E	TA*	T	TA*	E
Norway	T	E	TA*	T	TC*	T
Portugal	T	E	TA*	T	TA*	E
Spain	TA	E	TA*[k]	T	TC*[k]	T
Sweden	T	E	TA*	E	T	T
Switzerland	TA	E	TA*	E	TA*	E
Turkey	TA	E	TA	E[l]	TA*	E
United Kingdom	T	E	TA*	T	T	E
United States	T	E	TA*	E[m]	TA*	E

Sources: OECD, 1986, Tables 1.6, 1.8; OECD, 1988a, Table 3.4; OECD, 1988b, Table A.

Key: T = Taxed, not deductible, or included in income
E = Not taxed, exempt, or not included in income
TA = Tax allowance (contribution deductible from gross income)
TC = Tax credit (contribution deductible from tax)
* = Subject to ceiling, maximum, or other conditions

Notes:
a. The tax status of employers' social security contributions is not shown; nearly all countries do not include them in income.
b. If the contribution does not exceed 4,000 AS per annum.
c. But employee entitled to a tax deduction for the same amount.
d. If coverage does not exceed CAN$ 25,000.
e. Social security contributions are integrated with the income tax; therefore, exemption or deductibility has limited significance.
f. Statutory contributions or equivalent. Contributions to private pension and life insurance schemes are only tax-free up to 312 DM and for the equivalent of compulsory contributions if employee not subject to the compulsory schemes.
g. But employee entitled to tax relief on payment.
h. Assessable benefit if employer pays employee's contributions of more than ¥ 300 per month.
i. If paid to director.
j. The general social security premiums have been integrated with the income tax as of 1990; employees' social security premiums are still levied separately.
k. Fifteen percent of pension contributions and life insurance premiums, subject to a ceiling (above the ceiling a tax credit is allowed).
l. If it does not exceed compulsory employees' contributions.
m. Up to $ 50,000 coverage only.

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Clearly, many fringe benefits are a well-established part of employment conditions. No doubt they will continue to be exempted or taxed at less than full market value if they are reasonable and customary in the trade. Staff discounts, canteen and sporting facilities also have intangible benefits that should not be ignored. Other fringe benefits, especially company cars, will continue to be the subject of periodic scrutiny. Equity and neutrality are seriously violated when favourably taxed fringe benefits proliferate.

B. Contributions for income maintenance purposes

Most OECD countries do not include in income or provide a tax allowance for contributions which employers, employees or individuals make to social insurance schemes, pension and provident funds or life insurance and annuity schemes. These schemes have in common that they set aside current income for income-maintenance purposes at a later date, generally retirement but also unemployment, sickness or disability. The schemes differ in the extent to which they are compulsory. Whereas social security schemes are generally compulsory, participation in pension funds is usually voluntary, although it may also be compulsory or quasi-compulsory, e.g. by virtue of agreement with professional and union organizations. Contributions to life insurance and annuity schemes are generally voluntary.

The exemption or provision of a tax allowance for the contributions made to these schemes, in conjunction with the later taxation of the benefits, means that the tax on the income set aside is deferred. This implies that the income tax discriminates against individuals who pay tax on their savings out of current income as well as on the interest earned thereon. In other words, employees and others who are permitted to make tax-free contributions for income-maintenance (retirement) purposes enjoy an interest-free loan from the government equal to the amount of tax that should have been payable.

Current treatment in respect of voluntary and semi-voluntary contributions violates tax equity and neutrality criteria. The accretion concept therefore requires that entitlements to retirement and other forms of future income be taxed. The annual increase in the discounted value of the future stream of income increases (as accretion) the economic power of the beneficiary. Generally, this implies that contributions paid by the individual (employee) should not be deductible from income and that employer contributions should be taxed to the employee along with the interest, if any, accruing on his past contributions. Later pay-outs would then be debited against the capitalized value of the rights to future income; they would not be subject to tax.

1. Deductibility of contributions and premiums

Table 3 shows particulars of the tax treatment of social security contributions, pension contributions and life insurance premiums in OECD countries. Social security systems are public and contributions are compulsory. In other words, a contribution, generally determined by reference to income, is difficult to distinguish from the income tax itself. The idea that those who contribute to the system are 'insured' against income loss upon reaching a designated age is also weak because social security systems are generally not reserve-financed but operate on a pay-as-you-go basis. For these reasons, Australia and New Zealand do not have separate social security levies, but pay the benefits out of general revenue. Seven countries with separate levies do not allow the contributions as a deduction in ascertaining taxable income; accordingly, some of these countries exempt subsequent payouts. In 14 countries contributions are deductible and employer contributions are excluded from employee income. These countries appear to attach some significance to the insurance philosophy; they tax payouts. As of 1990 the Netherlands has integrated its general social security levies with the income tax, but continues to earmark them.

Employer pension contributions are rarely included in income (Belgium and France are the only exceptions) and generally a tax allowance is granted to employees paying into pension funds. Austria and Greece tax individual pension contributions and Spain permits both a tax allowance and a tax credit (which makes the absolute amount of the tax saving the same across income brackets). Nearly all countries impose a limit on the amount of the contribution for which an individual obtains a tax allowance. The exceptions are Belgium, Luxemburg, the Netherlands and Turkey. Similarly, some countries impose a limit on the amount of the employer contribution; Germany and Japan are examples.

Most countries have strict regulations on the financial and investment policies of public and private pension and superannuation funds. Approval by the tax authorities is often required. If the scheme is approved, employer contributions would generally be chargeable against profits for corporation tax or business income tax purposes. It should be noted that the difference between a strictly regulated private pension scheme and a public scheme or, indeed, a social security system may not be very great. Pension schemes are reserve-financed and there is no room for redistributive policies, but, on the other hand, contributions are often compulsory and the amount of the eventual payouts is subject to all the vagaries of future developments in financial and labour markets.

The income tax treatment of life insurance premiums differs widely from country to country. The relief for employer-paid premiums is much less generous than the relief for employer pension contributions. Fourteen countries tax employers' premiums, while nine countries exempt the premium from tax, although some of them do set limits on the size of the premium or the amount of coverage for which relief is given. In some countries these limitations are the same as those imposed on pension contributions paid by the employer. Generally, the treatment of individually paid life insurance premiums is much more generous. Presumably, the philosophy is that the self-employed cannot join pension funds. Sweden, which has a comprehensive old age social security system, does not provide any relief. The United Kingdom abolished the allowance for life insurance policies issued after 1984. To limit the tax saving of high income groups, four countries provide the relief in the form of a tax credit.

2. Evaluation

The tax reliefs for retirement benefits have changed from an incidental phenomenon in the first half of this century to become a massive tax deferment mechanism, at least in respect of private schemes. As in other cases, legislators have attempted to adjust for the tax deferral benefit that some groups of taxpayers enjoyed by extending similar tax advantages to other groups. Reliefs for life insurance premiums and government contributions to public pension funds were followed by reliefs for private pension funds, professional retirement plans, the tax-free conversion of profits upon cessation of a business into an annuity and other reliefs. The equal treatment rule readily implied that voluntary contributions to private schemes should be

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treated at par with compulsory contributions to public schemes. As a result, the income tax legislation became more complex, the corporate form of doing business was tax-preferred, tax avoidance schemes proliferated, and more generally, savings and investment decisions were distorted.

In assessing this situation, however, it seems important to make allowance for the degree to which contributions are compulsory. Social security contributions for government or trust-fund-provided retirement benefits are economically indistinguishable from the income tax. Whether or not contributions are excluded or deductible from income does not make any difference. This explains why some countries simply finance the benefits out of general revenue rather than through (regressive) payroll taxes. Additionally, this simplifies tax administration. The most rational solution would be to integrate the social security contributions with the income tax, although the transparency of the tax system and the perceived link between contributions and benefits which, however weak, is still discernible, might suffer.

Another issue is whether contributions should be deducted from the tax base. If the view is taken that employees' social

Table 4

OECD: Treatment of Income in Respect of Owner-Occupied Property, 1989

Country	Principal Residence			Secondary Residence[a]	
	Assessed rental rate (%)[b]	Deductibility of interest	Treatment of capital gains	Deductibility of interest	Treatment of capital gains
A. *Rental Value Taxed*[c]					
Belgium	4[d]	TA(L)	E	TA(L)	E
Denmark	2.5-7.5	TA	E[e]	TA	E
Finland	3	TA(L)	E	TA(L)	T
Greece	4	TA	E	N	E
Italy	. . .	TA(L)	E	TA(L)	E
Luxembourg	4-6	TA(L)	E	TA(L)	T
Netherlands	1.8	TA	E	TA	E
Norway	2.5	TA	E(L)	TA	E(L)
Portugal	. . .	TA(L)	E[g]	TA(L)	E
Spain	2	TA(L)[f]	E[g]	TA(L)	T
Sweden	2-8	TA	E(L)[g]	TA	T
Switzerland	Varies	TA	T	TA	T
B. *Rental Value Not Taxed*					
Australia	TC(L)	E	N	T	
Austria	TA(L)	E	N	E	
Canada	N	E	N	T	
France	TC[h]	E	N	T	
Germany	N[i]	E	N	E	
Ireland	TA(L)	E(L)	N	T	
Japan	N	E(L)[j]	N	T	
New Zealand	N	E	N	E	
Turkey	N	E	N	E	
United Kingdom	TA(L)	E(L)	N	T	
United States	TA(L)	E(L)[g]	TA(L)	T	

Sources: Assessed rental rates: updated from *European Taxation* (1986); deductibility of interest: updated from OECD, 1986, Tables 1.7 and 2.1; treatment of capital gains: OECD, 1988b, Table 3.4. Some information may not be complete or up-to-date.

Key: TA = Tax allowance (interest deductible from gross income)
TC = Tax credit (interest deductible from tax liability)
N = Interest not deductible
(L) = Subject to ceiling, maximum, or other conditions
E = Capital gain generally exempt from tax
T = Capital gain generally subject to tax

Notes: a. Information on assessed rental rates is not available. Presumably, these are the same as for the principal residence.
b. Personal income taxes at the sub-national level which may include imputed income from owner-occupied property are levied in Belgium, Canada, Denmark, Finland, Italy, Japan, Norway, Switzerland and the United States.
c. Rental rates are assessed on various valuation bases, such as the value under the net wealth tax (e.g. Denmark, Spain), the cadastral value (e.g. Belgium, Italy), the capital value (e.g. Sweden, Switzerland), the market value (e.g. Greece, the Netherlands, Portugal) or the assessed value (e.g. Luxembourg, Norway).
d. Generally, the imputed income is wiped out by a lump-sum deduction.
e. Normally an exemption applies on the condition of occupation during at least two years. Gains on the sale of large estates are taxed in full if sold within three years of acquisition; thereafter gains on sale are reduced by 20 percent for each additional year of ownership.
f. Subject to a ceiling of 800,000 Pts. per annum. Additionally, an annual tax credit is provided of 15 percent of the capital invested in the purchase of a principal residence.
g. Subject to repurchase of new residence and/or taxable on excess over repurchase of new residence.
h. Additionally, tax relief for house maintenance and energy insulation expenses.
i. Instead, an eight-year 'amortization allowance' applies with a maximum of 15,000 DM per annum.
j. First ¥ 30 million is exempt.

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security contributions are equivalent to a (regressive) income tax, there seems no rationale for deducting them from gross income. Such a practice renders less transparent the taxpayer's relative income tax and contributions bill. More progressivity would be achieved if the revenue gained from non-deductibility were used to reduce contributions, especially at low levels of income. If, however, the view is taken that employees' social security contributions are quasi-insurance premiums, essentially different from income tax payments, there are a number of arguments for deductibility: to tax more or less the same income twice looks like economic double taxation; employers' contributions are deductible anyway as business expenses; and tax relief is generally given for voluntary and quasi-voluntary contributions.

To some extent, these considerations also apply to quasi-voluntary employer and employee contributions which are paid into pension and superannuation funds. Tax relief for contributions and full taxation at the time of payout have the advantage that income is averaged over the lifetime of the employee. Moreover, in most cases the amount of the contribution paid out of current income would not equal the increase in the discounted value of the future benefits which ideally should be included in income under the accretion concept. In fact, that increase cannot be determined accurately. The size of the benefits is uncertain because they usually depend on the length of service, the average income during the last years of employment, the outcome of wage negotiations and other uncalculable factors. These arguments apply even more strongly in respect of employee insurance schemes that provide income support in case of disability, sickness or accident.

Of course, once relief is provided for voluntary contributions to pension and superannuation schemes, it is only a small step to argue that the equal treatment principle requires that the same relief be given to premiums paid for annuities or life insurance. However, an element of discrimination vis-à-vis the conventional saver remains to the extent that no tax is levied on the interest which accumulates on pension and life insurance reserves. Ideally, the employee or policyholder should be taxed annually on the interest. Alternatively, the pension fund or insurance company might be taxed in respect of its investment income.

On balance, it seems that (limited) relief for voluntary contributions and full taxation of benefits seems preferable to no relief at all and exclusion of future benefits. In either case it would be necessary to tax the interest on the contributions and premiums. Interestingly, under some simplified assumptions, these two approaches lead to the same after-tax income (U.S. Treasury, 1977, p. 57). Consider an employee or other individual who pays a pension or life insurance premium of $ 1,000 at the beginning of period 1. The contribution bears interest at a rate of 10 percent per annum. The employee receives the full pension at the beginning of period 2. In both periods he is subject to an income tax of 30 percent. Under the accretion concept, he would pay $ 321 tax in period 1, namely $ 300 plus 30 percent of $ 70 (10 percent of ($ 1,000-$ 300)) and no tax in period 2. If he were given relief for the contribution but were taxed on the interest and the payout, he would pay $ 30 tax in period 1 and $ 321 (30 percent of $ 1,070) in period 2. Under both approaches, therefore, he would receive $ 749 after tax.

C. Owner-occupied dwellings

In theory, the owner-occupier should be taxed on the net rental value of his dwelling, i.e. the rent his residence would fetch in the marketplace minus the costs incurred for interest on mortgage debt, depreciation, repairs and maintenance, property taxes and casualty insurance. The economic position of a homeowner does not differ from that of someone who invests his money in stocks or other income-yielding assets and who is assessed on the net income thereof, nor from that of someone who rents a house and whose rental payments are included in his income as consumption. The homeowner may be said to derive a return from his property (income) which he simultaneously offers himself as housing services (consumption).

In addition to the equity case, there are economic arguments for taxing the net rental value of owner-occupied dwellings. The exemption or less than full taxation of the gross rental value constitutes a tax saving which lowers the effective price of the housing services or, what is the same, increases the after-tax rate of return. Under some plausible assumptions, this means that more funds are invested in owner-occupied housing than in, say, business assets. In short, equity is violated and resources are misallocated. For various reasons these arguments are not accepted in the real world.

1. Tax treatment of home ownership

No OECD country lives up to the ideal of the accretion concept. Table 4 shows that 12 countries tax the imputed rental income of owner-occupied dwellings on a presumptive basis, but also that they do so at what seem to be very low rental rates. Moreover, these rates are applied to capital values which may be out of date or which are reduced before the rate is applied. Sweden appears to be an exception since the rental rate may be as high as 8 percent of the capital value of the house. However, most homeowners in Sweden still report negative incomes from their investment (Pechman, 1987c, p. 146). Japan, the United States and nine other countries do not impute any income in respect of owner-occupied housing.

Nearly all countries, whether or not they impute rental income, permit a deduction for interest on mortgage debt, generally against income from all sources. Canada, Germany and Turkey are the only exceptions. New Zealand also used to deny the relief, but in 1982 it changed to a credit system up to a ceiling. The relief in countries that tax rental values seems to be more generous than the relief in countries that do not tax such values. It appears as if the inclusion of a nominal rent in income is a pretext for providing greater relief. Sometimes the relief is confined to associated income (Belgium), or the relief is given in the form of a tax credit (Australia, France, Japan, New Zealand) which limits the benefit for higher income homeowners. Spain provides a limited tax allowance for mortgage interest, as well as a tax credit for investment in new residences.

Nearly all countries that tax rental values also provide relief for mortgage interest in respect of secondary residences, generally under the same conditions. Countries that do not tax rental values deny the relief. The United States is the only exception and its government has made it clear that it does not intend to abolish the relief for the purchase of a principal or secondary residence.

In principle, the line of reasoning that the imputed return of owner-occupied dwellings should be taxed also applies to the capital gain realized on the sale of private residences. As Table 4 indicates, however, the favourable treatment of such gains is even more widespread than the leniency shown in respect of the taxation of imputed rents. All OECD countries save Switzerland exempt the gain. Portugal, Spain, Sweden and the United States stipulate that the

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proceeds of the sale must be used for the purchase of another house. Furthermore, Sweden and the United States tax the seller on the excess of the proceeds over the purchase price of the new residence to the extent that the amount represents a capital gain. In the United States the relief is a deferment of tax, since it is deducted from the cost of the new residence for capital gains purposes.

Most countries, however, provide an unqualified exemption. Usually, the argument is that in nearly all cases the owner's house is the only major asset he possesses. If he sells the house, he is likely to reinvest the proceeds in a new dwelling and his mobility might be impaired if he were taxed on the gain. The gain represents an accretion of economic power, but if he buys a similar house he does not acquire more dwelling space. If the owner moves into a smaller abode or, instead, rents a house, this event may coincide with his retirement and he may wish to use part of the proceeds of his previous residence to supplement a possibly inadequate pension. Presumably, for this reason the U.S.'s income tax provides an outright exemption, up to $ 125,000, for any capital gain accruing to a person of 55 or older.

These arguments do not apply to gains realized on the sale of secondary residences. Table 4 shows that half of all OECD countries tax those gains. The underlying argument is that secondary residences are less of a necessity than principal residences. Extending this argument, Denmark applies the unqualified capital gains exemption only to one or two-family houses. Gains of large estates, even when used as the principal residence, are taxed in full if realized within three years of acquisition. To prevent a notching problem, thereafter gains on sale are reduced by 20 percent for each additional year of ownership. In other words, gains on the sale of large estates held for eight years or more are also fully exempted.

2. Recent developments and evaluation

The accretion principle prescribes that the favorable treatment of imputed rental income should be corrected by increasing the assessed rental rates to their fair market value. Additionally, interest on mortgage debt and other costs should be fully deductible. Apparently, this route is not being followed. Only the Netherlands has recently raised the rental rate from 1.3 percent of 60 percent of the market value of owner-occupied dwellings to 1.8 percent. The difficulty with increasing rental rates is that assessed values are difficult to establish accurately, although closer approximation of actual values should be possible. Furthermore, a problem that arises in allowing a deduction for the costs of repairs and maintenance is that such costs are often difficult to distinguish from improvements which should not be permitted as a deduction from gross income.

Most countries, therefore, have opted for second-best solutions by disallowing all costs, except mortgage interest (and property taxes). The OECD (1986, p. 55) reports that in the late 1970s and early 1980s several countries limited the deductibility of interest. Ireland restricts the relief to the principal residence. Australia and New Zealand confine the relief to the first purchase of a dwelling, and Finland and Italy impose ceilings on hitherto unlimited deductibility. Furthermore, the United Kingdom has deliberately left the ceilings on mortgage interest deductions unchanged so that their real value has eroded. Japan denies the relief to taxpayers with income over a certain amount. Finally, Australia and France have replaced tax allowances with tax credits which provide the same nominal relief to taxpayers in all income brackets. These solutions appear to improve equity, because mortgage holders (and renters) are more numerous than equity holders in dwellings. The solutions are more illusory than real to the extent that rich mortgage holders can more easily effect changes in their debt portfolio than poor mortgage holders. Whatever the equity effects, efficiency in resource allocation should improve.

The proper taxation of imputed rental income, of course, has more angles to it than the simple application of the accretion principle implies. Thus, in many countries, renters also enjoy considerable untaxed benefits in the form of rent controls and housing subsidies. Second, it is not unlikely that the tax advantage associated with low imputed rents has been capitalized in the form of higher prices that new owners have had to pay for their house. This may be deduced from the low net returns that real estate fetches. Third, the property tax, to the extent that it is borne by owners and renters, may be viewed as a substitute for the income tax that should be levied on the difference between (imputed) market rents and (imputed) actual rents. Of course, this argument only applies to the extent that property tax payments exceed the benefits derived from government services provided in the form of roads, sewage facilities and parks, for example. Fourth, the accretion principle does not (and cannot) take account of the objective of many governments that home ownership should be encouraged in view of the positive externalities that it generates.

The arguments in favour of rent imputation also apply to the benefits that other durable consumer goods confer on their user, benefits that are not taxed either. Examples of such goods are cars, yachts, paintings and antiques. On benefit, equity and externality grounds much can be said for imposing new taxes or higher taxes on yachts and cars before tackling the tax advantage of owner-occupied dwellings. In many countries the latter issue has to be solved in the context of an overhaul of the whole price-cum-subsidy system for housing. The case seems much stronger for eliminating the mortgage interest relief for secondary residences. Even though work obliges certain taxpayers (e.g. U.S. Congressmen) to have two residences, exceptions could be made for such taxpayers, rather than extending the relief to all taxpayers with secondary residences.

D. Capital gains

The proper taxation of capital gains is as contentious an issue as the taxation of imputed rental income of owner-occupied property. Tax theorists maintain that capital gains constitute an accretion of economic power that increases a taxpayer's ability to pay. Hence, they should be included in income, due allowance being made for the offset of capital losses. Students of the Schanz-Haig-Simons concept of income believe moreover that full taxation applies to unrealized as well as realized capital gains. In their view, if a gain can be realized, it is irrelevant whether or not realization actually takes place. Realization is a matter of portfolio management, not an issue which affects the income definition. Accountants and business people, on the other hand, attach great importance to the 'realization principle'. While they might include realized gains in income, they regard as heresy the idea that unrealized gains should be taxed.

Tax administrators often argue that a capital gains tax yields so little revenue that it may not be worth the cost of collection. More generally, they believe that the tax would be difficult to administer properly. In contrast, proponents of a capital gains tax point out that the tax is not levied to yield a large amount of revenue, but to increase the equity of the income tax. Taxpayers in the same economic position would be treated more equally and the progressivity of the income

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tax would improve. As regards its feasibility, they point out that many administrative problems under an income tax without a capital gains component arise because time and again a distinction has to be made between taxable capital income, on the one hand, and non-taxable capital gains, on the other hand. Taxing capital gains protects income tax yields, because tax avoidance schemes are frustrated.

1. How widely are capital gains taxed?

Table 5 shows that most OECD countries have some form of capital gains tax, although the coverage may vary from limited to extended. Five countries have adopted a schedular approach and therefore tax capital gains under a separate statute. Ten countries have integrated the taxation of capital gains with the income tax. The distinction between these two groups, however, is often a difference much more of form than of substance. By the same token, the capital gains coverage in countries (noted in the memorandum item) that have special provisions for short-term or speculative gains may not differ much from limited capital gains taxes elsewhere. This could also hold for countries without special provisions if they label a transfer giving rise to a capital gain more readily a business transaction chargeable to tax than countries that tax capital gains more explicitly. These countries may also tax capital gains more widely under their business income taxes.

Like the modern income tax, most capital gains taxes are of relatively recent origin. The Nordic countries, where tax equity seems to be taken more seriously than in most other countries, adopted capital gains taxes, separate or as part of the income tax, in the 1950s. Portugal and the United Kingdom followed suit in the 1960s. Canada and France introduced new capital gains tax legislation in the 1970s when several other countries strengthened their existing capital gains taxes. The most noteworthy examples of the latter move are Australia and the United States. Australia introduced a comprehensive capital gains tax in 1985, and since 1987 the United States taxes all capital gains as ordinary income with no distinction between long and short-term gains and no preferential tax rate. One country, the Netherlands, explicitly decided not to introduce a capital gains tax because of the attendant technical complications, additional administrative costs, and detrimental economic and financial effects.

As regards coverage, all countries exempt gains realized on the sale of private residences, although some do so on a rollover basis (for details see Section C above). Countries that have capital gains taxes with extended coverage generally exempt little else, except the proceeds of life insurance and superannuation as well as the gains on small chattels. Life insurance proceeds, however, are taxable under the extended systems of Japan, Norway, Spain and Sweden. Intermediate systems have all the exemptions of extended systems, but in addition leave gains on government securities and nearly all chattels out of the base. Ireland and the United Kingdom are examples.

Finally, systems with limited coverage, as found in Denmark, for example, also exempt gains realized on the sale of secondary residences. Noteworthy is the exemption for retirement purposes extended to business proprietors in Ireland, the United Kingdom and some other countries.

As is well known, a capital gains tax that does not cover unrealized gains (and none does) hampers capital mobility because the potential tax liability causes owners to hold on to their assets. The distortion of this lock-in effect may be reduced by deeming capital gains to be realized at death, transfer of the asset by way of gift or upon taking up residence abroad. This is the rule under the capital gains taxes of Canada and Spain. Several countries permit deferral of the potential tax liability at death by allowing the capital gain to be passed on to the heir who would subsequently be taxed upon realization. Of course, gains at death may also be exempted outright which is what most countries do. Table 5 shows that gains on gifts are taxed more often than gains at death, presumably because lifetime transfers, unlike transfers at death, are a voluntary act.

To prevent the administrative nuisance of having to tax small gains, various countries have an annual threshold below which gains are not taxable. Canada has introduced a lifetime exemption which is increased fivefold for farmers and small-business people. Many countries tax long-term gains at lower rates than short-term gains which are often viewed as ordinary income. Lower rates are justified because the gain, having accrued over several years, bunches in one year. Often such rates are also viewed as an (arbitrary) device to adjust the tax base for inflation. The lower rates (sometimes effected by taxing only a portion of the gain) should reduce the lock-in distortion. The United States taxes all capital gains at ordinary income tax rates which, it should be noted, are low by international standards. This is less of an administrative simplification, however, than appears to be the case at first sight. Since capital losses can only be offset against capital gains, the distinction between capital gains and ordinary income has to be maintained.

2. Evaluation

Nowadays capital gains are taxed more widely than used to be the case. Apparently, it is increasingly being realized that the capital maintenance criterion which was previously invoked to justify the exemption of capital gains may be relevant in respect of inflationary gains but not real gains. Moreover, the difference in function between interest, dividends and rental payments, on the one hand, and changes in the value of the underlying assets, on the other hand, has faded. It is not possible anymore to make a tax-relevant distinction between capital income and capital gains. If capital income is to be taxed under the accretion concept, so should capital gains.

To be sure, capital gains taxes have a number of adverse economic effects. There is a presumption that a capital gains tax, like other taxes on income from capital, stimulates consumption and discourages saving. In small, open economies high taxes on capital induce capital flight. In the long run, such taxes may be borne by workers because they will have less capital to work with; their productivity and income would fall accordingly. The lock-in effect of a capital gains tax that is confined to realized gains might restrain the mobility of capital and people. Furthermore, administrative problems arise upon introduction of a capital gains tax when existing assets must be appraised at their current value if retroactive taxation is to be avoided. Australia solved this problem by taxing only gains and assets acquired after the introduction of the capital gains tax. Similarly, elaborate loss offset provisions are needed to prevent people from realizing their negative gains and setting them off against ordinary income, but postponing the realization of positive gains or having them taxed abroad under a more favourable regime.

Finally, the taxation of realized gains, of course, only solves part of the problem. The incentive to convert taxable income into exempt realized gains which has thus been thwarted now becomes an incentive to convert income and

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Table 5

OECD: Treatment of Capital Gains, 1989

Country	Coverage	Threshold per annum	Rate of Tax: Long-term gains	Rate of Tax: Short-term gains	Treatment at death	Treatment of gifts
			A. Separate Tax			
Denmark	Limited	No general threshold[a]	50%	As long-term	Deferred	Taxable
Ireland	Intermediate	IR£ 2,000[b]	1-3 yrs: 50% 3-6 yrs: 35% > 6 yrs: 30%	60% (gains realized within a year)[c]	Exempt	Taxable
Portugal	Limited	—[d]	Half real gain is taxed as income (stocks: 10%)	As long-term	Exempt	Exempt
Switzerland[e]	Limited	2,000 Sfrs.	10-40%[f]	As long-term	Deferred	Deferred
United Kingdom	Intermediate	£ 5,000	As income tax	As long-term	Exempt	Taxable
			B. Integrated with Income Tax			
Australia	Extended	None	Real gain taxed as income[g]	Taxed as income	Deferred[h]	Taxable
Canada	Extended	Lifetime: C$ 100,000[i]	Three-quarters gain taxed as income	As long-term	Taxable[j]	Taxable[j]
Finland	Intermediate	Long-term gains only	40% of gain over 200,000 Fmk. taxed as income	As unearned income; reduction for immovables after 5 years	Exempt	Exempt
France	Limited	6,000 Ffrs.	Depends on nature of asset and period held	Taxed more heavily than long-term gain	Exempt	Exempt[k]
Japan	Extended	¥ 500,000 (¥ 1,000,000 for land and buildings)	Half gain is taxed as income[l]	Taxed as income if held < 5 years[l]	Deferred	Deferred
Luxembourg	Intermediate	1,250,000 Lfrs. over ten years	Half income tax rates[m]	As income tax	Deferred	Deferred
Norway	Extended	None	As income tax (land: 32%; shares exempt)	As long-term (shares: 40%)	Exempt	Exempt
Spain	Extended	None	As income tax[n]	As long-term	Taxable	Taxable
Sweden	Extended	None[o]	Proportion of gain is taxed as income	As income tax	Deferred	Deferred
United States	Extended	None	Taxed as income	As long-term	Exempt	Deferred

Memorandum Items

1. Special provisions mainly restricted to short-term or speculative gains:
   Austria, Belgium, Germany, Turkey.
2. No special provisions, i.e. income tax applies, albeit with a narrow definition of capital gains:
   Greece, Italy, the Netherlands, New Zealand.

Source: OECD, 1988b, Tables 3.1-3.4, as updated from various sources.

Notes:
a. A 6,000 Dkr. threshold applies in certain limited cases.
b. Double for married couple.
c. Ireland does not make a formal distinction between short-term and long-term gains, but instead imposes a tapering rate.
d. Agricultural land is exempt.
e. In Switzerland capital gains on private property are taxed by the cantons. The information in the table refers to Zurich. Like most cantons, Zurich taxes only capital gains realized on the sale of real property.
f. Holding less than two years: extra charge; holding five years or more: reduction of tax.
g. Subject to averaging provisions relating to a notional five-year period.
h. Except where bequests are made to tax-exempt bodies.
i. Lifetime exemption of C$ 500,000 for farmers and shareholders in small business corporations.
j. Liability is deferred for transfers between spouses or where a farm is transferred to a (grand)child.
k. If not sold by donee within five years.
l. Special rate on land and buildings; gains on certain securities taxed at 26 percent.
m. In practice, long-term tax only applies to real property, with tax after ten years confined to undeveloped land.
n. Averaging provisions relate to number of years held. Lower rate for transfers at death (8 percent if the recipient is a member of the deceased's family unit) or as gifts (20 percent).
o. Special threshold for shareholdings, depending on period held.

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realized gains into unrealized gains. To avoid capital gains tax liability, presumably the financial market is capable of developing new instruments under which potentially capital-gains-tax-liable assets are used as collateral. No doubt, tax lawyers would be able to design more intricate tax avoidance schemes. In conclusion, the inability to tax unrealized gains remains the Achilles' heel of the accretion concept.

E. Unemployment and sickness benefits

On neutrality and equity grounds, a case can be made for taxing unemployment and sickness benefits and perhaps child allowances. Unemployment benefits are taxed in 14 OECD countries for which information is available, but not in Austria, Germany, Ireland, Japan, Portugal, Spain and Turkey. The tax treatment of sickness benefits generally follows that of unemployment benefits, except that in Canada, New Zealand and the United States sickness benefits are not subject to tax and in the United Kingdom they are only partially taxed. In most of the countries that tax them, unemployment and sickness benefits have been brought into the tax net since the mid-1970s (OECD, 1986, p. 17). On the basis of the information which is available, child allowances are taxed only in Canada and Spain.

In theory, all these benefits should be taxed and policymakers should be deciding what their value should be in net terms without regard to taxation. The work-incentive argument in favour of taxing unemployment benefits is, for example, irrelevant, since any work-incentive effect can be equally obtained by reducing the gross amount of the benefit. In the real world the situation is probably less simple, since taxing and spending decisions are taken and administered by different people and emotive arguments may be advanced for and against taxation of these benefits, which may influence governments at the political level. Whilst it still seems eminently logical to tax unemployment and sickness benefits and look only at their net-of-tax level, other considerations apply to child allowances which would explain why in almost all countries they remain untaxed. Administrative expenses in some countries could be high and little revenue recouped (OECD, 1987a, p. 44, with regard to France) and in a number of countries child benefits are paid to mothers, who are frequently not in paid employment. Moreover, under individual taxation the allowance is likely to be less than the tax threshold of the mother.

IV. MIXED TAX BASE AND TAX RATE ISSUES

This section covers those areas which relate to both the tax base and the rate schedule, namely, methods of applying standard tax reliefs; the tax treatment of marriage; the tax/benefit treatment of parenthood; alternative minimum and gross income taxes; indexation of tax reliefs and tax schedules; relationship with employees' social security contributions.

A. Standard tax reliefs

The most important non-standard, expense-related tax reliefs have already been surveyed in Part III. Standard tax reliefs are given for specified characteristics of a taxpayer, e.g. family circumstances, age, health, source of income – and unlike non-standard reliefs, they do not usually depend on expenditures actually made.[1] They represent a major determinant of the relative tax bills of different categories of taxpayers, they vary greatly in size and kind as between countries and frequently change within countries. In an article of this size, country practices can be referred to only in very summary fashion (OECD, 1986, pp. 2229 elaborates), but more detail is given in the next two subsections on standard reliefs for marriage and parenthood.

Of ways of implementing standard tax reliefs, the most frequently employed are tax allowances (often called tax deductions), under which deductions are from income subject to tax, so that under progressive income tax schedules, their value increases as income increases, and tax credits, which are lump-sum deductions from tax payable, so that their absolute amount is unaffected by the taxpayer's income.[2]

The important threshold available to all taxpayers takes a variety of forms. Countries are almost equally divided between those that use fixed tax allowances, tax credits and zero-rated tax brackets. The additional basic relief for earned income may take the form of a lump-sum allowance for work-related expenses, allowances for actual costs of certain work-related expenses, tax allowances related to earned income up to a ceiling or a tax credit, and again the choice varies greatly between countries, which often change their form and amount.

Standard tax reliefs for the aged, the disabled and dependants other than children usually take the form of tax allowances, though a number of countries give tax credits for dependants other than children and a few for the aged and disabled.

The choice between tax allowances and tax credits has been much discussed (Brannon and Morss, 1973; Pogue, 1974; Gottschalk 1976; Sunley, 1977) and is considered in more detail below (see IV.C on taxation and parenthood) where cash transfers outside the tax system represent an alternative or supplementary approach. Though more or less the same progressivity can be obtained by a steeper rate schedule with tax allowances and a less steep schedule with tax credits, governments have had a number of more pressing reasons for reducing the progressivity of the rate schedule which has probably contributed to a drift away from tax allowances in respect of both standard and non-standard reliefs.

B. Taxation and marriage

As regards the choice of the most appropriate tax unit, unfortunately, lack of empirical data compels neglect of a number of important social issues: the income tax treatment of informal unions (of the same or different sexes, with or

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1. There are two exceptions: deductions for social security contributions do and work-related deductions may relate to actual expenses.
2. Other instruments include:
(a) the use of separate schedules for unmarried and married taxpayers (Norway, the United States);
(b) income-splitting, where the income of spouses is allocated equally between them, the rate schedule applied to half that total and tax due doubled (Germany, the United States);
(c) family quotient, where the total income is further reduced if there are dependent children (France, Luxemburg);
(d) zero-rated brackets. In some circumstances the effect of substituting a zero rate for a positive rate in the first bracket is to produce the same effect as giving a tax credit. But the extension of an existing zero-rate bracket produces the same result as increasing a tax allowance unless the extension is balanced by a reduction of the next higher bracket or brackets.

In a few countries and for a few kinds of reliefs, tax allowances and tax credits may be related positively or negatively to income subject to tax and/or be subject to a ceiling which would modify this picture.

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without children), of one-parent families, of alimony, etc. For similar reasons the tax treatment of unearned income of spouses is also not covered.

Even within this mainstream/majority situation, where it is assumed that couples are married, there are many conflicts about what income tax systems and related family benefits should be trying to do in differentiating between the tax bills of single persons and married persons, whether one or both of the married partners are gainfully employed. Among the questions which arise are:

- Should the income tax system encourage, discourage or remain neutral towards decisions of earners to marry?
- Should the income tax system encourage, discourage or remain neutral to influencing the decision of a second spouse to take up paid work?
- What should be the relative tax treatment of the earnings of a single person and twice that amount earned by a married couple (whether or not both are working), granted the economies of scale available to the latter?

There is overlap between these questions but the first two refer primarily to incentive effects and the last to horizontal equity.

Table 6

OECD: The Tax Unit for Earned Income and Reliefs for Marriage, 1989

Country	Changes since 1970	Kind of relief[a]
	Individual Taxation (13)	
Australia	— —	TC-R
Austria	From family in 1973	TC-R
Canada	— —	TC
Denmark	From joint in 1970	TC
Finland	From joint (separate schedules) in 1976	no relief
Greece	— —	TC
Italy	From family in 1977	TC-R
Japan	— —	TA-R
Netherlands	From joint in 1973	TA
New Zealand	— —	TC-R
Sweden	From joint in 1971	TC-R
Turkey[b]	— —	TA
United Kingdom	From optional in 1990	TA
	Joint or Family Taxation (7)	
Belgium	To individual in 1990	TC
France	— —	Income-splitting[c]
Germany	— —	Income-splitting
Ireland	— —	TA
Luxembourg	— —	Income-splitting[c]
Portugal	From optional in 1989	Income-splitting[d]
United States	— —	Income-splitting
	Optional Taxation (2)	
Norway	— —	TA
Spain	From family in 1988	TC

Source: Country legislation and reports.

Notes: a. TA = Tax allowance
TC = Tax credit
R = Reduced if second spouse earns income (exceeding a fixed amount).
b. But joint above a ceiling.
c. Income-splitting extended to dependent children.
d. Income-splitting is partial.

1. Country practices

Table 6 summarizes present country practices and changes over the last two decades. It shows that 13 countries have opted for individual taxation, seven for joint or family taxation and two for optional taxation or some kind of mixture. It shows also that, Portugal apart, there has been a one-way move towards individual taxation, but that there has been very little change in the last ten years (only Belgium, Portugal, Spain and the United Kingdom).

The last column of Table 6 lists the variety of tax reliefs received in 1989 by married couples and how they are affected when both of them are gainfully employed. Under joint taxation the amount of basic relief is invariably unaffected when a one-earner couple becomes a two-earner couple, but it is usually reduced under individual taxation – exceptions being Denmark, Greece and the Netherlands, where it remains unchanged.

2. Evaluation

Unmodified individual taxation produces a lower tax bill for two-earner couples at high income levels but (because of the usual method of tax reliefs by way of tax allowances) increases it at lower income levels relative to two-earner couples under joint taxation. An advantage of individual taxation is that it helps to protect the privacy of each spouse and may provide an inducement to the second spouse to enter the labour force. These were the main motives for the introduction of individual taxation in so many countries during the 1970s, when it was desired for both social and economic reasons to encourage female participation in the work force. A consequence of unmodified individual taxation is that the tax bill of a two-earner couple whose joint earnings equal, say, $ 10,000 per year will vary immensely according to the individual composition of their incomes (e.g. $ 8,000 and $ 2,000 versus $ 5,000 and $ 5,000), because of the interaction of different marginal rates applicable to different levels of income with the amount and nature of the marriage allowance for each couple. This problem has recently become generally less important with the flattening of rate schedules and has been resolved earlier in some countries (e.g. Denmark, the Netherlands) by the lower-earning spouse being permitted to transfer any basic tax relief and/or any additional marriage allowance to the higher-earning spouse.

The combination of the tax unit, the rate schedule and basic and married tax reliefs could equally provide the same kinds of horizontal inequity under joint taxation, e.g. between the $ 8,000/$ 2,000 couple and the $ 5,000/$ 5,000 couple, and for this reason most joint taxation countries base tax liability on the so-called income-splitting principle, i.e. $ 5,000/$ 5,000 is assumed whatever actual earnings are.

There are also other relevant arguments about the various advantages and disadvantages of individual and joint taxation. For example some social benefits (e.g. low income family benefits, child care expenses) may have to be based on the family and so (especially if the tax/benefit system becomes more integrated) there could be a mismatch between tax and benefits under individual taxation. On the other hand, for administrative simplicity, individual taxation probably has the advantage, especially if it is wished to avoid tax discrimination between married and cohabiting couples.

On balance, the tax unit debate has probably little practical significance, first because the rate schedule and the extent and nature of tax reliefs are probably more important determinants of the relative tax burdens of taxpayers in different

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family circumstances (OECD, 1977, 1978 and 1980), second because the two extreme systems have in practice been modified in the ways described above, and third because rate schedule flattening and base broadening have reduced the tax differential between the various tax units. And the fact that over the last decade there have been important changes in the tax unit in only four countries suggests that governments have come to realize that this is not a substantial issue of tax policy. .

Finally, it has been presumed that the different tax bills of unmarried, one-earner and two-earner couples at the same and at varying levels of income are settled in somewhat haphazard fashion by the interaction of tax unit, tax relief and rate schedule. This presumed 'haphazard' effect should not be construed as a criticism of government policies, because the use of income tax differentiation in the wider sense to promote greater economic efficiency, horizontal and vertical equity has more important implications than getting what happens to be considered the optimum degree of fine tuning as between the relative tax bills to be paid by different family units at similar and different income levels.

C. Taxation and parenthood

Methods of providing relief to parents through the income tax system or outside it represent one of the most discussed areas of tax policy. Government practices diverge greatly and have changed much in recent years. This area provides a concrete illustration of the choice between a tax allowance and a tax credit approach already touched upon.

1. Issues and country practices

The rationale for tax allowances as the appropriate means of aiding parents follows from what has been called the 'tax capacity approach' under which it is argued that income tax is normally charged on income in excess of subsistence income and that since costs of parents are greater than those of childless couples, the use of tax allowances for children ensures that the proportion of income needed to meet these additional costs is not subject to tax. The taxable capacity approach is concerned only with the internal logic of a progressive tax system based upon the ability-to-pay principle.

A contrasting 'social welfare approach' exemplified by tax credits and cash transfers outside the tax system concerns itself primarily with the alleviation of poverty, which tends to be positively related to the number of dependent children in a family. Such objectives would provide no justification for a tax allowance which subsidizes richer parents to a greater degree than poorer parents.

Table 7 shows that there are no tax reliefs for parents in eight countries, that there are tax allowances in nine countries, tax credits in five countries and the quotient system in two. Over recent years the general trend has been to take reliefs for parents outside tax systems, although Germany has recently increased tax allowances. These abolitions of tax reliefs occurred largely in the 1970s to the detriment of high income parents who sometimes benefited from moves from joint to individual or optional taxation (Austria, Denmark, the Netherlands, the United Kingdom, cf. Tables 6 and 7).

2. Evaluation

Supporters of the 'taxable capacity' approach point out that if the fixed amount were equal to that needed to support a child of a taxpayer in the lowest income bracket, its value (being equal to that amount multiplied by the lowest marginal rate of tax) would be insufficient to compensate a higher income parent who would require relief equal to the subsistence costs multiplied by his marginal rate of tax. Conversely, if the tax credit were sufficient to free the highest rate taxpayers from tax on the subsistence costs of their children, the reduction in tax liability would be too great for low income parents. In other words, to provide a tax credit of the lower amount would, under the taxable capacity approach, be held to penalize rich parents unduly in relation to rich childless couples, and to grant a tax credit of the higher amount would be held to favour poor parents unduly in relation to poor childless couples.

Supporters of the 'social welfare' approach also oppose tax credits as not going far enough to meet their objectives. Apart from the fact that tax credits for parents which exceed tax liabilities are wasted outside Canada, credits are re-

Table 7

OECD: Tax Reliefs[a] for Parents[b]

Country	Recent changes
	No Tax Relief (8)
Australia	Tax credit abolished in 1976
Austria	Tax credit abolished in 1978
Denmark	— —
Ireland	Tax allowance abolished in 1986
Netherlands	Tax allowance abolished in 1978
New Zealand	Tax credit abolished in 1987
Sweden	— —
United Kingdom	Tax allowance abolished in 1978-9
	Tax Allowance (9)
Canada	Fixed allowance and since 1978 non-wastable tax credit
Germany	Almost abolished in 1975, re-introduced in 1983 and considerably increased in 1986
Greece	Since 1988
Iceland	— —
Japan	— —
Portugal	TC
Switzerland	— —
Turkey	— —
United States	— —
	Tax Credit (5)
Belgium	— —
Finland	TA
Italy	— —
Norway	Recently re-introduced
Spain	— —
	Quotient System (2)
France	Ceiling imposed in 1981
Luxembourg	— —

Source: Country legislation.

Notes: a. Allowances and credits unrelated to income except in Belgium, where tax credits increase as income increases, thus having some of the characteristics of a tax allowance.
b. All OECD countries except Japan, Switzerland and the United States (both federal level) give cash transfers to parents irrespective of their income level. The United States gives cash transfers to parents at low income levels.
— — denotes no recent changes.

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ceived usually by the father and cash transfers usually by the mother who needs them most, and also cash transfers are in some countries taxable which meets progressivity objectives. Even on the 'social welfare' approach, however, subsidies through the tax system have one great advantage over (even universal) cash transfers: the take-up ratio is likely to be much greater.

There are no objective criteria to support the choice between the taxable capacity and social welfare approaches. It is a matter of value judgment and, in particular, the importance that is attached to maintaining the internal integrity of the income tax system. On a taxable capacity approach, it may be seen as perfectly normal that tax allowances exist side-by-side with cash transfers, and most governments, finding some validity in both approaches, operate aid to parents simultaneously through the two systems (Messere and Owens, 1979).

D. Alternative minimum and supplementary gross income taxes

Another recent development in income taxation is the adoption of measures in a few countries to ensure that high income taxpayers cannot escape payment of tax beyond a minimum amount by taking advantage of the non-standard reliefs available to them (especially by taking out loans for house purchase or other purposes which in some countries remain fully deductible from income subject to tax). These take the form of either an alternative minimum tax or a supplementary tax on gross income, which may be illustrated by the following examples.

In its 1986 Tax Reform Act the United States introduced an alternative minimum tax under which higher income taxpayers are obliged to pay whichever is the greater of 21 percent of their gross income or the normal rate schedule applied to their taxable income. Similar provisions exist in Canada.

Norway has recently adopted what is colloquially known as a 'top tax' (since its high threshold means that it is payable only by those with high incomes). It was levied in 1989 at 8.5 percent on gross income. 'Top tax' is payable in addition to the central and local government income taxes. Similar provisions were introduced under the 1986 tax reform in Denmark where there is a 12 percent supplementary tax on 'personal income' (which is roughly gross income minus income from capital) and where again a high threshold applies.

Alternative minimum taxes or supplementary gross income taxes may be introduced for a variety of reasons, including:

- to ensure high income groups pay a reasonable amount of tax and to counter tax avoidance (horizontal and vertical equity objectives);
- to broaden the tax base and/or to reduce high marginal rates on income from capital (horizontal equity and efficiency objectives);

Table 8

OECD: Indexation of Rate Schedules and/or Reliefs, 1978-90[a]

Country	Year of legislation	Applies to rate schedules	Applies to main reliefs	Applies to local income taxes	Other comments and subsequent developments
Australia	1976	Yes	Yes	n.a.	Not applied in 1979 Abandoned in 1982
Belgium	1987	Yes[b]	Yes[b]	n.a.	
Canada	1974	Yes	Yes	Yes	Modified in 1983 and 1986 Now equals consumer price index minus 3 percent
Denmark	1975	Yes	Yes	Yes[c]	Abandoned in 1983
France[d]	1969	Yes	No	n.a.	
Greece	1989	Yes	Yes	n.a.	From 1990
Italy	1989	Yes	Yes	n.a.	From 1990
Luxembourg	1968	Yes	No	n.a.	
Netherlands	1971	Yes	Yes	n.a.	Often only 80 percent indexation
Portugal	1989	Yes	Yes	n.a.	Abandoned in 1990
Spain	1989	Yes	Yes	n.a.	Abandoned in 1990
Sweden	1979	Yes	No	No	Abandoned in 1983
Switzerland	1985	Yes	Yes		In nearly all cantons
United Kingdom	1978	Yes[b]	Yes[b]	n.a.	Occasionally not applied
United States	1985	Yes	Yes	In some states	

Source: Country legislation.

Notes: a. During this period there was no formal indexation in Austria, Finland (except for pension income), Germany, Ireland, Japan, New Zealand, Norway, Portugal, Spain and Turkey.
b. For Belgium: rate schedules in 1987 and reliefs in 1990; for United Kingdom: rate schedules in 1981 and reliefs in 1978.
c. Reliefs only, since rates are flat.
d. Uniquely uses indexation to increase progressivity by usually indexing low income brackets, but not high income brackets.

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- to reduce the tax advantage of borrowing compared with savings (economic efficiency objective);
- to avoid having to make a distinction between deductible interest for business expenses (which applies sometimes subject to limitations in all OECD countries except Italy and Portugal) and non-deductible or limited deductible expenses for interest for house purchase or consumer credit, which the taxpayer may find it easy to camouflage as a business expense (administrative efficiency).

Such provisions do, however, complicate the tax system and it seems worth exploring further the relative advantages and disadvantages of the alternative approach of achieving similar objectives by further limiting the deductibility of interest payments from income subject to tax (e.g. in Austria interest on borrowings for business is deductible only against associated income and in the United States there is a ceiling on such deductibility). It seems that in practice there may be less political resistance to imposing such complicated schemes than to cutting back on interest deductibility.

E. Indexation of income tax reliefs and schedules

Table 8 summarizes formal indexation provisions over the last two decades. It shows that about half of OECD countries have had such provisions and many of those countries have either abandoned or modified them. At present they exist in Canada, France, Luxemburg, the Netherlands, Switzerland, the United Kingdom and the United States and have just been introduced or extended in Belgium, Greece and Italy. Governments, whether with or without formal indexation provisions, generally make annual adjustments to the tax schedule and to tax reliefs to take account, inter alia, of rates of inflation. The evidence suggests that there is not much difference in the extent to which fiscal drag has been offset as between those countries with and those without formal indexation provisions (OECD, 1986, Ch. 4). In the 1960s and early 1970s fiscal drag was rarely offset, but since the mid-1970s it has been largely offset in most if not all OECD countries.

Indexation tends to occur after rapid rises in income tax yields (Canada and Denmark early 1970s, the United Kingdom mid-1970s, Belgium, Greece and Italy in recent years) or as a political announcement of an intention to reduce income tax (United States 1985). Indexation is abandoned (Australia, Sweden) or modified (Canada) when countries get worried about their budget deficits and feel the need not to be committed to offsetting fiscal drag totally. It thus seems that the indexation issue has more to do with political attitudes and government relations with taxpayers than with the extent to which fiscal drag is offset in practice.

On a more theoretical level, proponents of indexation cite transparency, honesty and the need to limit tax increases, and opponents stress the need for flexibility and pragmatism, noting in particular that indexation poses many difficult technical problems, that negative fiscal drag with respect to excises is almost never offset (only for a few years in Canada and Denmark) and that fiscal drag provides an automatic macroeconomic stabilizer (OECD, 1986, pp. 65-7).

In more recent years with lower rates of inflation and rate-flattening, with governments making important changes to tax reliefs and the rate schedule for other reasons, formal indexation seems to have little, other than rhetorical, use. On the other hand, in the interests of transparency there is a case for arguing that when governments make their annual proposals for changes in tax reliefs and the rate schedule, they should make it known what would be the revenue gain from unadjusted fiscal drag deriving from both the erosion of the value of tax reliefs and bracket creep.

F. Employees' social security contributions[3]

In most, though not all, OECD countries, a very different base, schedule and threshold are applied to employees' contributions from those applied to the personal income tax. The contributions base is usually something approximating to gross income, no account being taken of family circumstances, etc. Rates are mostly flat and not progressive but usually become zero at a ceiling, generally somewhat higher than the earnings of an average production worker. Thresholds are either non-existent or very low and invariably much lower than income tax thresholds. All this means that employees' contributions are much less progressive than income taxes and that because countries vary greatly in relative reliance on these two levies, it would be misleading to ignore employees' contributions in any survey designed to achieve international comparability. This is confirmed by Table 9, which shows that when one of these levies is high, the other is usually low and that when one of them increases, the other usually decreases.

Table 9 suggests that countries can be divided into four categories with regard to relative payments of these two levies at the income level of an unmarried production worker at average earnings.[4]

Employees' contributions do not or hardly exist	Employees' contributions are much less important than income tax payments	The two levies are about equally important	Employees' contributions are much more important than income taxes
Australia	Belgium	Germany	Austria
Canada	Ireland	Japan	France
Denmark	Italy	Luxembourg	Greece
Finland	Spain	Switzerland	Netherlands
New Zealand	Turkey		Portugal
Norway	United Kingdom		
Sweden	United States		

Various interests on opposite sides have motives for perpetuating the myth that contributions are quasi-insurance payments rather than taxes. Those favouring high social expenditures fear that without this distinction central government will annex contributions for other expenditures, and those favouring low social expenditures consider that the insurance concept provides a market discipline. It is true also that employees' contributions have some features not generally associated with taxes: they are the only major earmarked source of government revenues, they may provide an entitlement to benefits and, unlike other taxes, are to some extent requited, and finally because of the insurance analogy they may be perceived differently from other reve-

3. A more comprehensive survey than it is possible to undertake here would also cover employers' social security contributions, which, for example, accounted in 1986 for 29 percent of total tax revenues in Spain, 27 percent in France, 25 percent in Italy and 24 percent in Sweden, though less than 20 percent elsewhere. In so far as these levies are substantially shifted into lower wages, they have to be regarded, at least in part, as a proxy for a proportional or regressive wage tax, which is perhaps one explanation of the exceptional progressivity of the income tax schedule in these four countries.

4. At lower income levels some countries would move to the right and at higher levels to the left.

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nues by governments, politicians, employers and employees. However, for international comparisons, employees' social security contributions have to be considered as taxes, since they do not exist or barely exist in some countries but represent over 13 percent of government revenues in others (Austria, France, Germany, Greece, the Netherlands) and governments are frequently changing the income tax/employees' social security contribution mix. Also in many countries both income tax and social security contributions are deducted at source from earned income, and the taxpayer may not notice the difference between these two levies.

It does seem illogical to combine in an uncoordinated way the ability to pay (progressive) approach to the income tax and the benefit (regressive) approach to contributions, since unintended results are bound to arise. Integrating the two levies does seem a promising area for future tax reform, which has been neglected by most governments which wish, for reasons just discussed, to insist that contributions are different from taxes. However, in the Netherlands, where for many years employees' contributions have been higher than in any other country, income tax and employees' (as well as employers') contributions have been integrated from 1990.

V. TAX RATE ISSUES[5]

This section discusses, in turn, top rates, reductions in brackets, first positive rates and income tax thresholds, first recording developments, and then evaluates them.

A. Developments in rate structures

Attention has generally focused on the dramatic decline in highest marginal rates in most OECD countries over the last few years, even though, except in very few OECD countries, less than 0.3 percent of taxpayers were actually paying these top rates.[6]

More important for most taxpayers in most countries has been the reduction of second, third and fourth highest rates. However, presentationally it is easier to focus on the very top rate and Table 10 does so. It shows that the top rates vary substantially between countries (from over 55 percent to under 30 percent), and that since 1986 they have declined or are about to decline in nearly all OECD countries. In some countries (Belgium, Japan, New Zealand, Norway, Sweden, the United Kingdom and the United States) this decline represents around 17 to over 25 percentage points and in most others it has been considerable. Very moderate declines (less than four percentage points) occurred only in Germany, Ireland, Luxembourg, Switzerland, where there was no change to the very low federal income tax, and Turkey, where between 1985 and 1986 the top rate was reduced from 65 to 50 percent.

5. In the text, reference is made only to federal/central government income taxes, but see footnote 3 to Table 10 for some information on levies at subordinate levels of government.
6. OECD, 1981b. There could have been changes since the late 1970s to which these data refer but there is no reason to believe that they have occurred in any systematic direction.

Table 9

OECD: Income Tax and Social Security Contributions[a]

Country[b]	Income Tax Plus Contributions		Income Tax Payments		Social Security Contributions	
	1987	1984	1987	1984	1987	1984
Denmark	46	46	44	40	2	6
Netherlands	38	39	12	12	26	27
Sweden	37	36	37	36	0	0
Germany	36	35	19	18	17	17
Ireland	36	34	28	26	8	8
Belgium	35	35	23	23	12	12
Finland	34	33	31	30	3	3
Turkey[c]	31	34	22	26	9	8
United Kingdom	29	31	20	22	9	9
Italy	28	26	19	17	9	9
United States	27	30	20	23	7	7
Luxembourg	26	29	14	17	12	12
Austria	25	26	9	10	16	16
Canada	25	23	21	19	4	4
France	24	23	7	8	17	15
New Zealand	24	27	24	27	0	0
Australia	23	22	22	21	1	1
Norway	23	23	23	23	0	0
Switzerland	21	21	11	11	10	10
Spain	20	19	14	13	6	6
Greece	17	16	4	3	13	13
Portugal	16	18	5	7	11	11
Japan	15	16	8	9	7	7

Source: OECD, 1988[c].

Notes: a. Paid by an average production worker as percentage of gross earnings (unmarried earner) to nearest percentage point. These figures do not take account of expense-related reliefs, which even at this income level vary considerably from country to country. They include tax levied at subordinate levels of government.
b. Ranking in order of highest combined percentage in 1987.
c. 1987 figure pertains to 1986.

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The middle columns of Table 10 indicate that the number of brackets has been reduced in most OECD countries since 1986 and often drastically so, but that there has been little or no change in the number of brackets in a few countries. France, Luxemburg and Spain are now the only countries with more than 10 brackets, although last year Spain moved from a record 34 to 16 brackets. At the other extreme, in 1989 Iceland became the first OECD country to have a flat-rate tax, but only two rates exist in New Zealand and the United Kingdom (the lower rate applying to around 95 percent of taxpayers) and in the United States.

Thresholds, zero rates and first positive rates should logically be discussed together, for while most countries simply have a threshold and then a first positive rate, others have a threshold and a zero rate before a positive rate is reached. Tax reforms generally involve adjustments to both thresholds and first positive rates which, in combination, will have varying effects on the relative burdens of low income taxpayers. Unfortunately data are not at present available to treat the two together on an internationally comparable basis. The last columns of Table 10 show that, like top rates, first rates vary considerably between countries (sometimes around 5 percent, sometimes around 25 percent) and that in recent tax reforms the tendency has been for them to increase considerably in most countries – especially in Canada, Finland, Greece, Iceland, New Zealand, Norway, Spain and the United States. As regards the last two countries, however, the increase in first positive rates was accompanied by a new zero rate in Spain and a large increase in the threshold in the United States. A large decline in first positive rates is to be found only in Austria. The reason for the increase in first positive rates is presumably – in at least some countries – to recoup some of the revenue lost from the reduction in higher rates and/or increases in thresholds.

There are varying philosophies about income tax thresholds. At one extreme the view is taken that under the ability-to-pay principle those around subsistence level should not be expected to pay income tax. This approach is adopted by France (where nearly half the population is below the threshold), Japan, the Netherlands and Norway. At the other extreme is the view that for reasons of accoun-

Table 10

OECD: Top Rates, Number of Brackets and First Positive Rates

Country	Latest year	Top Rates			Number of Brackets			First Positive Rate		
		Latest year	1986	Difference	Latest year	1986	Difference	Latest year	1986	Difference
Netherlands	1990	60[a]	72	–12	3	9	– 6	35[a]	14	21
France[b]	1988	57	65	– 8	13	13	0	5	5	0
Ireland	1989	56	58	– 2	3	3	0	32	35	– 3
Luxembourg[b]	1988	56	57	– 1	25	22	3	10	12	– 2
Spain[b]	1989	56	66	–10	16	34	–18	25	8	17
Belgium[b,c]	1989	55	72	–17	7	13	– 6	25	24	1
Germany	1990	53	56	– 3	n.a.[d]	n.a.[d]	– –	19	22	– 3
Austria	1989	50	62	–12	5	10	– 5	10	21	–11
Greece[b]	1989	50	63	–13	9	19	–10	19	11	8
Italy	1989	50	62	–12	7	9	– 2	10	12	– 2
Japan	1989	50	70	–20	5	15	–10	10	10	0
Turkey	1989	50	50	0	6	7	– 1	25	25	0
Australia[c]	1988	49	57	– 8	5	6	– 1	21	24	– 3
Finland[b,c]	1989	44	51	– 7	6	11	– 5	11	6	5
Sweden[b]	1989	42	50	– 8	3	5	– 2	5	4	1
Denmark[c]	1988	40	45	– 5	3	3	0	22	20	2
United Kingdom	1989	40	60	–20	2	6	– 4	25	29	– 4
New Zealand	1988	33	57	–24	2	6	– 4	24	17	7
Canada[c]	1988	29	34	– 5	3	10	– 7	17	6	11
United States[b,c]	1988	33[e]	50	–17	3	14	–11	15	11	4
Iceland	1989	28	38	–10	1	3	– 2	28	18	10
Norway[b,c]	1989	20	40	–20	7	9	– 2	10	3	7
Switzerland[b,c]	1988	13	13	0	7	7	0	1	1	0

Source: Country legislation and government proposals.

Notes: Portugal is omitted because in 1988 moved from schedular to global taxation. Rates are shown to nearest percentage point. Nearest calendar years are substituted for fiscal years. Countries are ranked in order of highest top rate in the latest year.

a. Latest year is not comparable because includes social security contributions.
b. Country with zero-rate band. In Spain only from 1988.
c. Countries with important taxes at subordinate levels of government, typical rates for 1983 being: *flat* Belgium 7, Canada 17, Denmark 27, Finland 16, Norway 23, Sweden 30; *progressive* Japan 4 to 18, Switzerland 5 to 34 (cantonal and communal), United States 2 to 14. Little change in these rates between 1983 and 1987, when, however, Canada would be 15 and Denmark 29.
d. Not applicable. The German tax schedule is a formula-based schedule.
e. Reducing to 28 after a certain income level.

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tability or solidarity nearly all citizens should be expected to pay tax, even if at the lower end of the income scale the taxpayer may be a net beneficiary of the tax transfer system (e.g. Denmark, New Zealand and Sweden). As already noted in Section IV(F) and Table 9, this picture is much modified when employees' social security contributions are taken into account.

B. Evaluation of these developments

Whether or not high marginal rates will continue to fall will depend to some extent on whether the income tax base can be broadened. For while the revenue-neutral constraint is not paramount – it can be relaxed in either direction to meet government policy choices, and also recourse may be had to other revenue sources – this constraint is evidently of relevance. In a few countries (Australia, Iceland, Italy and Spain) there is little room for base broadening, but this is not the case in most OECD countries. Provisional calculations suggest that in many OECD countries not much more than half the potential base is included in taxable income as a result of standard reliefs for work, marriage, social security contributions as well as basic threshold reliefs and expense-related allowances on mortgage and other interest payments, savings for retirement, insurance premiums, etc. Base broadening in these areas will meet with resistance from pressure groups and politicians but that is the direction the wind has been blowing and it seems quite probable that in a number of countries it will continue to do so, provided voters continue to be offered countervailing rate reductions. However, this is likely to vary from country to country according to the political climate and economic conditions currently prevailing.

The reduction of the number of brackets has an appearance of simplicity, but it is unlikely in most countries to have much effect on simplicity in practice. For example, such reduction would probably have little effect on tax administrative or taxpayers' compliance costs, and except in countries with self-assessment systems such as Canada, Japan and the United States, there are likely to be few taxpayers who calculate their liability from the legal schedule. Most will refer directly to details of liabilities at different income levels and in different family circumstances, which are made available by governments and published in newspapers.

Since data are not available on the tax threshold of the low-paid on an internationally comparable basis, it is difficult to estimate what has been the effect on the tax bills of the low-paid from the mixture of changes to thresholds and first positive rates. Empirical evidence is available only from the United States and even there it is conflicting. It does seem probable that the considerable increase in the threshold in the 1986 reform was more important than the increase in the first positive rate from 11 to 15 percent and so the income tax system became more progressive for low income groups. This was the conclusion of the 1987 Congressional Budget Office Enquiry, but some doubts have been subsequently expressed (Koppelman, 1988).

It would seem that the heavy increase in the tax threshold in the United States was not generally matched in many other countries. But perhaps the effect on lower income levels of changes in thresholds and first positive rates is not a very interesting issue, for the tax/benefit position of the lower-paid is more likely to be affected by other factors, such as changes in their social security contributions and income-related tax reliefs and welfare benefits.

As to the effect of changes on the progressivity of the income tax system as a whole, by definition raising lowest positive rates reinforces the lowering and flattening of higher rates in rendering it less progressive. But without an analysis of the kind carried out in the United States, it is impossible to say whether this loss of progressivity has been partially, fully or even more than fully offset by the accompanying selective changes in the base and increases in thresholds. This is a topic for future investigation, but it is not possible to provide any answers at present.

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PEOPLE'S REPUBLIC OF CHINA:

THE NEW AMENDMENTS TO THE CHINESE EQUITY JOINT VENTURE LAW: WILL THEY STIMULATE FOREIGN INVESTMENT?

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On 4 April 1990 the National People's Congress of the People's Republic of China (PRC) amended nine articles[1] of the Law on Joint Ventures Using Chinese and Foreign Investment[2] apparently in an effort to achieve two related objectives. First, the PRC wanted to encourage direct investment by making equity joint ventures more attractive to foreign firms. Second, the government wanted to make the Equity Joint Venture Law more consistent with several changes in the substance or administration of other laws applicable to foreign-funded enterprises in China. For example, the revisions eliminate several structural and functional differences between equity and contractual joint ventures, presaging perhaps much more uniform treatment of the two types of joint ventures in the future or possibly even consolidation of the two joint venture statutes in one comprehensive law.

Following years of stagnating GNP growth and, more recently, the loss of Western business confidence in the aftermath of Tiananmen Square, the amendments to the Equity Joint Venture Law will probably do little to stimulate the inflow of foreign investment. Further, the revisions are so inconsequential from a managerial standpoint that they will probably not significantly affect the choice of investment form made by foreign firms interested in entering the Chinese market.

LEGISLATIVE BACKGROUND

From July 1979 to April 1988 the Equity Joint Venture Law was the primary Chinese statute governing joint ventures between domestic and foreign concerns. Joint enterprises with a foreign participant could take the form of either an "equity" joint venture subject to the limitations of the Equity Joint Venture Law or a "contractual" joint venture,[3] a form of joint undertaking not covered by the Equity Joint Venture Law. Due to various problems in conforming the structure and operations of joint ventures to the requirements of the Equity Joint Venture Law,[4] many joint enterprises in China were established outside the formal regulatory scheme, yet were ultimately approved by the Chinese government.

The large number of these anomalous contractual joint ventures posed an awkward problem for Chinese authorities. How could the government purport to regulate a major class of joint ventures which, as a result of their structure or operations, lay beyond the reach of the country's only statute regulating joint ventures? After nearly a decade of foreign investment, contractual joint ventures had become, in essence, the subject of extra-statutory ad hoc government controls. Although Chinese government administrators possess more inherent authority than their Western counterparts, they apparently did not possess enough in this instance to legitimate regulation unsupported by written law. In an attempt to bring the multiplying number of these joint ventures under the government's reign, the Seventh National People's Congress, after much debate, enacted the Law on Chinese-Foreign Contractual Joint Ventures on 13 April 1988.[5]

Contractual or, as they are sometimes called, "cooperative" joint ventures are widely believed to be the most popular vehicle for direct foreign investment in China.[6] According to the most recent official government statistics, however,

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1. The amendments revised Arts. 2, 3, 6, 7, 8, 10, 11, 12 and 13 of the Equity Joint Venture Law. Amendments to the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, adopted, promulgated and effective on 4 April 1990 at the Third Session of the Seventh National People's Congress [hereinafter cited in endnotes as "Amendments"]. The amendments were published in Chinese in the "Decision on the Revision of the Chinese Equity Joint Venture Law", *People's Daily,* 5 April 1990, at 2.
2. Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, adopted 1 July 1979 at the Second Session of the Fifth National People's Congress and promulgated 8 July 1979, reproduced in Coordinating Centre for Business Cooperation of China, *Basic Provisions of the People's Republic of China on Foreign Direct Investment* (September 1988), at 1-12 [hereinafter cited as the "Equity Joint Venture Law"].
3. These "contractual" joint ventures are also frequently referred to as "cooperative" joint ventures or "cooperative arrangements". These labels both refer to joint enterprises between Chinese and foreign concerns which are not governed by Equity Joint Venture Law. Xiao-Jun Wang, "Taxation and Investment in China", 17 *International Business Lawyer* (June 1989), at 267-68.
4. Prior to the April 1990 amendments, a joint venture in China might be viewed as lying beyond the reach of the Equity Joint Venture Law if, for example, the chairman of the board of directors was not a Chinese citizen, or the joint venture failed to open an account with the Bank of China or a bank approved by the Bank of China.
5. Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures, adopted and promulgated 13 April 1988 at the First Session of the Seventh National People's Congress, reproduced in Coordinating Centre for Business Cooperation of China, *Basic Provisions of the People's Republic of China on Foreign Direct Investment* (September 1988), at 83-92 [hereinafter referred to as the "Contractual Joint Venture Law"].
6. An "Editorial Comment" on the April 1988 Contractual Joint Venture Law recently echoed this view, noting in January 1989 that prior to

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this belief is probably mistaken.[7] Between April 1979, when the Equity Joint Venture Law was enacted, and September 1989, the Chinese government approved 20,278 foreign funded enterprises reflecting a total foreign investment commitment of US$32.17 billion.[8] These enterprises included 11,286 equity joint ventures, 7,713 contractual joint ventures and 1,230 solely foreign-owned concerns.[9] In other words, about 56 percent of all foreign-funded enterprises in China since joint venture investment became possible were equity joint ventures, while only 38 percent took the form of contractual joint ventures.

Not only do the number of equity joint ventures exceed the number of contractual joint ventures, the total amount of capital actually invested in equity joint ventures exceeds the total amount invested in the contractual variety. Since 1979, equity joint ventures have accounted for an aggregate capital inflow of about US$6.5 billion, compared to US$4.5 billion for contractual joint ventures. The total amount pledged to contractual joint ventures, however, is greater than the total amount pledged to equity joint ventures. There is currently US$11.8 billion pledged to equity joint ventures, compared to US$14.7 billion pledged to the contractual variety.[10]

In light of the overlooked frequency with which foreign firms have chosen the equity joint venture as their investment vehicle in China, the April 1990 amendments to the Equity Joint Venture Law assume added importance. They are important primarily because they will apply to such a large class of foreign-funded enterprises in China, and not because they significantly "liberalize" the regulation of joint ventures or give the parties substantially greater control over the management of their joint business. In other words, the law has been changed, but has not *necessarily* been made less restrictive. The ultimate effect of the amendments will depend on how Chinese policymakers decide to implement them.

A brief survey of the changes in the Equity Joint Venture Law quickly reveals that a literal understanding of the specific language of each amendment is only the first step in a long and sometimes uncertain interpretive journey.

NO NATIONALIZATION WITHOUT APPROPRIATE COMPENSATION

The first amendment adds a new paragraph to Article 2 of the Equity Joint Venture Law in which the PRC essentially promises "not to nationalize or requisition any equity joint venture," while simultaneously reserving the right to requisition a joint venture for a "public purpose", but only in accordance with established "legal procedures" and with payment of "appropriate compensation".[11]

While the promise not to nationalize an equity joint venture may represent an important show of good faith on the part of the Chinese government, the new provision would obviously not prevent the PRC from reversing its announced policy in the future by simply repealing the statutory promise or enacting superceding legislation. In China, as in legal systems throughout the world, the statute enacted last-in-time controls. Thus, any legislative commitment not to nationalize will last precisely as long as the Chinese government wants it to last and no longer.

To a great extent, the reservation of the right to "requisition" an equity joint venture for a "public purpose" renders meaningless the government's commitment to refrain from nationalization. Obviously the reservation might easily serve as a pretext for an expropriation if the government were to decide to euphemistically characterize an effective taking as a "requisition" instead of a "nationalization". Neither would the "public purpose" requirement afford much protection from government requisitioning since there is no qualifying language in the amendment to prevent Chinese officials from finding a public purpose even in a taking motivated by considerations of pure expediency. The government expropriation of joint ventures, however, is highly unlikely simply because any such action would immediately interrupt the flow of desperately needed investment funds, now only trickling into China, and disastrously impact the country's precarious foreign exchange position.

In the event a joint venture is requisitioned for a public purpose, the amendment to Article 2 provides that "appropriate compensation" will be paid. This standard warrants special attention. Representatives of lesser developed countries often use the words "appropriate compensation" to refer to a standard of compensation that gives the government freedom to decide what amount of money is reasonably "appropriate" under the circumstances of each expropriation, regardless of whether the sum ultimately awarded is equal to the fair market value of the enterprise or satisfies the "prompt, adequate and effective" standard advocated by industrialized, capital-exporting nations. At present, it is not clear whether the choice of the term "appropriate compensation" was intended to reflect a deliberate decision by the Chinese government to adopt a non-market value compensation standard. A determination of the intended meaning must await official interpretive comment, if any, and state practice under the new amendments.

CHANGES IN THE CONTRACT APPROVAL PROCESS?

The amendment to Article 3 reflects certain changes in the contract approval process that have already occurred as government functions have become more decentralized in the decade after the Equity Joint Venture Law was enacted. The old text of Article 3 specifically identified the Foreign Investment Commission as the appropriate government agency to which contracts had to be submitted for approval. The new text simply requires that the documents be submit-

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the enactment of the Contractual Joint Venture Law, "the cooperative joint venture was the most successful and most common form of direct investment in China, outstripping equity joint ventures by far". Christian Salbaing and Owen D. Nee, Jr., "New Chinese Law on Cooperative Joint Ventures II: An Editorial Comment", 17 *International Business Lawyer* (January 1989), at 12. When the authors made this statement, they probably had in mind the period from 1980-85. During that six-year span, contractual joint ventures were more common than equity joint ventures, but since 1986 equity joint ventures have been more numerous. Jerome A. Cohen, "The Long-Awaited Cooperative Venture Law," *China Business Review* (July-August 1988), at 15 (see graph for 1980-87 comparative statistics); Ma Guoshou, ed., *Almanac of China's Foreign Economic Relations and Trade* (Hong Kong: China Resources Advertising Co., Ltd., 1989), at 609 (for 1988 statistics).

7. "Joint Venture Law Being Amended", *China Economic News* (2 February 1990), p. 2; "Shen Jueren on Improvement of Investment Environment," *China Economic News* 11 December 1989, at 4-5.

8. Although US$32.17 billion has been pledged as foreign investment, only about US$11 billion has actually been received by joint ventures in China. Id., at 5.

9. Id.

10. Id.

11. The Chinese word *liyi* has been translated in this article to mean "purpose" in the new Art. 2 phrase "public purpose," but might also be translated as "interest", as it occasionally is in other Chinese statutes. Amendments, supra note 1, Art. 3, para. 3.

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ted to the "State department concerned with foreign economic relations and trade".[12]

The seemingly innocuous, generic reference to the "State department concerned" conceals a complex history of procedural revisions. Many of these changes seem to have been made, at least from a Western legal perspective, without proper statutory authority. This intriguing history begins in September 1983 when the State Council adopted a new set of regulations implementing the Equity Joint Venture Law.[13] Those regulations expressly gave the Ministry of Foreign Economic Relations and Trade (MOFERT) the power to approve the establishment of equity joint ventures, although according to the law they were supposed to implement that power belonged to the Foreign Investment Commission.[14] In other words, the rule in the statute had been changed in the process of its "implementation". From a Western legal perspective this seemed clearly improper because implementing regulations, according to conventional rules of lexical priority, may not modify or contradict the statute they are supposed to implement and from which they derive their authority as law. In China, however, the meta-rules that determine the lexical priority of different legal pronouncements of the central government are not yet as strictly hierarchical as in the West.

The implementing regulations did not merely substitute MOFERT for the Foreign Investment Commission, they established the broad outlines of a comprehensive, multi-tiered equity joint venture approval process that is nowhere even mentioned in the Equity Joint Venture Law. Under this extra-statutory system, MOFERT was authorized by the "implementing" regulations to delegate its approval power to provincial governments, autonomous regions, municipalities and various agencies under the State Council.[15] According to the regulations, if the "total amount of investment is within the limit set by the State Council" for a particular area and there are no special circumstances warranting direct central government intervention, then a local governmental unit for that area may independently approve the equity joint venture.[16] Unfortunately the implementing regulations do not specify which local governmental units have been specifically "entrusted" with the approval power, nor do they contain the investment ceilings set by the State Council.

The State Council's investment ceilings are set forth in an "internal circular", a species of non-public administrative law supposedly promulgated for use only by government officials. In the past, such internal laws have been kept strictly confidential and not made available to the public, but the contents of this particular internal circular are now known outside the government. Essentially, this internal circular lists a number of different investment ceilings by city and Special Economic Zones.[17]

Under the implementing regulations, the local government's power of approval may not be exercised even when the total investment falls below the applicable ceiling if the contemplated joint venture will (1) require an allocation of raw materials by the state that may impair the national distribution of energy resources, (2) disrupt the domestic transportation system to any significant extent or (3) adversely affect Chinese export quotas.[18] If any of these three disabling events are likely to occur during the life of the joint venture, a local governmental unit may not approve the equity joint venture and the parties must submit their documents directly to MOFERT for approval.

In the amendment to Article 3, the Chinese government implicitly acknowledges that review by the Foreign Investment Commission has been replaced by a decentralized, multi-tiered approval process. Regrettably, however, the revision fails to describe that process in any detail or clarify the criteria for determining which level of approval, local or national, must be obtained for equity joint ventures in different industries and locations. Consequently, despite the amendment, the approval process will probably still seem confusing and unpredictable to many foreign firms.

NON-CHINESE BOARD CHAIRPERSON

The amendment to the first paragraph of Article 6 permits for the first time the foreign half of the board of directors of an equity joint venture to appoint a foreigner as chairperson, abolishing the old discriminatory rule which gave the Chinese members of the board the exclusive right to decide who would fill that office.[19] The amendment also provides, however, that the board vice-chairperson must be selected by the side that did not select the chairperson.

This amendment will probably have little practical effect on joint venture management since the office of a chairperson is largely symbolic and its occupant, whether Chinese or foreign, has essentially no power to act except as expressly authorized by both parties to the joint venture. The amendment does, however, eliminate one of the more conspicuous formal differences between the Equity Joint Venture Law and the Contractual Joint Venture Law. For as long as the Contractual Joint Venture Law has been in effect, the chairperson of a contractual joint venture could be either a Chinese or foreign party.[20]

BANK SELECTION

Under the amendment to the first paragraph of Article 8, an equity joint venture will no longer be required to open accounts with the Bank of China or a bank approved by the

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12. Amendments, supra note 1, Art. 3.
13. Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council on 20 September 1983, reproduced in Coordinating Centre for Business Cooperation of China, *Basic Provisions of the People's Republic of China on Foreign Direct Investment* (September 1988), at 36-77 [hereinafter cited as the "Equity Joint Venture Regulations"].
14. Compare Equity Joint Venture Regulations, supra note 13, Art. 8 to Equity Joint Venture Law, supra note 2, Art. 3 (prior to amendment).
15. Equity Joint Venture Regulations, supra note 13, Art. 8, para. 2.
16. Equity Joint Venture Regulations, supra note 13, Art. 8, para. 1.
17. For Beijing, Liaoning, Guangdong and Fujian, the investment ceiling is the Chinese currency equivalent of US$10 million. For Wuhan, Chongqin, Shenyang, Xi'an, Harbin and other provinces and autonomous regions, the ceiling is US$5 million. For the 14 coastal and port cities, there are different ceilings for different cities. A limit of US$30 million has been set for Tianjin and Shanghai, US$10 million for Dalian and Guangzhou and US$5 million for all other cities in that group. For heavy industries in Special Economic Zones, the ceiling is US$50 million, compared with a limit of US$30 million for light industries in Special Economic Zones. For joint venture projects requiring a total investment which exceeds these ceilings, approval from the central government must be obtained. The contents of the non-public internal circular containing these investment ceilings are summarized in Liu Xiandong, ed., *Handbook on the Use of Foreign Investment* (Beijing: World Affairs Publishing House, 1986), at 32-33 (in Chinese).
18. Equity Joint Venture Regulations, supra note 13, Art. 8, para. 2.
19. Amendments, supra note 1, Art. 6, para. 1.
20. Under Art. 12 of the Contractual Joint Venture Law, it has been possible for the chairperson of the board of directors of a contractual joint venture to be a foreign party since that law was enacted in April 1988. Contractual Joint Venture Law, supra note 5, Art. 12.

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Bank of China, but may open a foreign exchange account at any "bank or other financial institution" authorized by the "State Administration of Foreign Exchange Control" to conduct foreign exchange transactions.[21] Whether this amendment will make any practical difference remains to be seen, but it does appear to grant equity joint ventures more banking freedom than they have enjoyed in the past.

Both the amended and original texts of Article 8 effectively give a central government agency the power to control where equity joint ventures will open their foreign exchange accounts: the Bank of China, in the original, and the "State Administration of Foreign Exchange Control", in the amendment. But neither version expressly guarantees that an equity joint venture may open a foreign exchange account at the bank of its choice without any government interference.

On the other hand, the amendment does broaden the category of financial institutions at which equity joint ventures may open a foreign exchange account and may be interpreted as eliminating any need to obtain government approval prior to opening such an account.[22]

Even with a larger selection of banking institutions and elimination of the prior approval requirement, the amendment still may not make much difference to foreign investors. Uniform interbank interest rate controls and restrictive foreign exchange regulations will continue to make bank selection decisions much less important in China than in free market environments. At the very least, however, equity joint ventures will now be able to make banking decisions based on such important secondary considerations as the quality of service and business convenience.

The amendment to Article 8 also moves the regulatory treatment of equity joint ventures another step closer to that afforded the contractual variety by adopting the same banking rule found in the Contractual Joint Venture Law.[23]

TERM OF JOINT VENTURE

Although the unamended language of Article 12 did not specifically limit the contract period of a joint venture, regulations promulgated under that provision did generally restrict the maximum permissible term to 30 years, subject to numerous exceptions.[24] For example, under the pre-amendment regulations, the initial 30-year term could be extended to 50 years if the government decided that the equity joint venture would (1) result in "large amounts of investment", (2) require "long construction periods", (3) experience "low profit rates" on invested funds, (4) manufacture the "most technologically advanced products with . . . critical technology supplied by foreign participants", or (5) make products competitive in the "international market".[25]

The new wording of Article 12 is actually not very different from the language of the old text. Both essentially state that the term of the joint venture may be determined by the parties.[26] Although there is not much, if any, substantive difference between the amended and unamended text, the revision may be read by government authorities as effectively repealing all the regulations promulgated under the old Article 12 as well as all the restrictions on the maximum permissible term of an equity joint venture. This reading of the new amendment to Article 12 would certainly make the most sense. Obviously, if the amendment was not construed to repeal the old regulations, the term limitations which they contain would continue in force, defeating the apparent purpose of the amendment. As there are very few consistently followed canons of construction in China, the final effect of the amendment will probably remain unclear until the government issues new regulations under the new law.[27]

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21. Amendments, supra note 1, Art. 8, para. 1. The amendment to Art. 8 also supercedes Art. 74 of the Equity Joint Venture Regulations, supra note 13.

22. Prior to the amendment, equity joint ventures could open foreign exchange accounts only with the Bank of China or at banks approved by the Bank of China and, after August 1983, at "other banks" approved by the State Administration of Foreign Exchange Control under (1) the Rules for the Implementation of Exchange Control Relating to Enterprises with Overseas Chinese Capital, Enterprises with Foreign Capital and Chinese-Foreign Joint Ventures, adopted by the State Council of the People's Republic of China on 19 July 1983 and promulgated by the State Administration of Foreign Exchange Control on 1 August 1983, Art. 4 [hereinafter referred to as the "Joint Venture Foreign Exchange Rules"] and under (2) Interpretation of Art. 74 of the Regulations of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, issued by the Ministry of Foreign Economic Regulations and Trade on 3 May 1985, reproduced in Guangdong High People's Court, infra note 25, pp. 458-459. After the amendment to Art. 8, any bank or other financial institution already authorized to conduct foreign exchange transactions by the State Administration of Foreign Exchange Control may receive deposits from equity joint ventures. The category of eligible institutions under the amendment is larger because it includes non-bank institutions as well as those banks which were not expressly authorized to accept a foreign exchange account from an equity joint venture, but were authorized to conduct foreign exchange transactions.

23. Under Art. 16 of the Contractual Joint Venture Law, contractual joint ventures are permitted to open a foreign exchange account at any "bank or other financial institution" which is authorized by the government to conduct foreign exchange transactions. Contractual Joint Venture Law, supra note 5, Art. 16. The amendment to Art. 8 of the Equity Joint Venture Law gives equity joint ventures the same banking freedom as contractual joint ventures. Other amendments to Arts. 10 and 11 of the Equity Joint Venture Law merely excise references to the Bank of China, thereby making subsequent provisions concerning foreign exchange transactions consistent with the revision in Art. 8. Amendments, supra note 1, Arts. 8, 10, 11. The new banking option in the amendment to Art. 8 also makes the Equity Joint Venture Law more consistent with Art. 4 of the subsequently enacted Joint Venture Foreign Exchange Rules, supra note 22, which also identify the State Administration of Foreign Exchange Control as possessing the power to authorize banks to conduct foreign exchange transactions.

24. Equity Joint Venture Regulations, supra note 14, Art. 100, Amendment to Art. 100 of Regulations for the Implementation of the Law of the People's Republic of China in Joint Ventures Using Chinese and Foreign Investment, enacted by the State Council on 15 January 1986 [hereinafter cited as the "Amendment to Art. 100"].

25. Id. The Amendment to Art. 100 was one of two legal measures promulgated by the state Council on 15 January 1986. The other was an unpublished internal circular that specifically limited the terms of equity joint ventures by industry. This internal circular prescribed a maximum equity joint venture term of (1) 25-50 years for the transportation, energy, mining and capital construction industries; (2) 15-40 years for harbour engineering design and construction projects; (3) 10-14 for the agricultural, fishery, forestry and livestock husbandry industries; (4) 10-20 years for the tourist industry; and (5) 15-30 years for general industrial enterprises, except those exporting at least 80 percent of their output or using advanced technology, which could qualify for a term extension of up to 50 years. Internal Circular on the Balance of Foreign Exchange Receipts and Payments of Chinese-Foreign Equity Joint Ventures and the Amendment to Art. 100 of the Regulations on the Implementation of the Law on Chinese-Foreign Equity Joint Ventures, issued by the State Council on 15 January 1986, reproduced in Guangdong High People's Court, *Collection of Documents for Trial of Economic Cases* (June 1986), at 447-50 (original in Chinese).

26. Where the old text provided that the "contract period" of a joint venture could be determined by the parties, the amendment substitutes the term "operation period", but otherwise retains substantially the same language in the first sentence. Compare Equity Joint Venture Law, supra note 1, Art. 12 to Amendments, supra note 1, Art. 12. The amendment then adds what seems to be a redundant second sentence which essentially restates the contents of the first sentence, as if to suggest that this time the government truly means what it says in the first sentence.

27. "Joint Venture Law Being Amended", supra note 7.

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HOUSEKEEPING AMENDMENTS

Finally, the government has made a number of housekeeping amendments to the Equity Joint Venture Law that simply reflect changes in the substance or administration of other laws applicable to equity joint ventures. For example, the amendment to the second paragraph of Article 7 replaces language making equity joint ventures using "up-to-date technology" eligible for certain tax benefits with new language permitting an equity joint venture to enjoy whatever benefits it may qualify for under applicable tax laws. Similarly, the amendment to Article 13 simply deletes an outdated reference to the "Foreign Investment Commission" with no change in substance.[28]

CONCLUSION: TOO LITTLE TOO LATE?

The new amendments to the Equity Joint Venture Law are not likely to stimulate foreign investment in China. Nor do they make equity joint ventures appreciably more attractive to foreign investors since much of the new language simply reflects changes that are already well established in practice.

The violent suppression of the pro-democracy demonstration in June 1989 has significantly depressed foreign investment in China. According to one Chinese observer, since violence erupted in Tiananmen Square, China's "[f]oreign exchange earnings have fallen, new foreign investment projects have been suspended and some specific sectors have been severely affected", especially hotel joint ventures and tourist related enterprises.[29] Obviously, in such an adverse environment, management decisions about direct investment in China will be based on more fundamental concerns than the technical wording of a joint venture law.

Even if the incident at Tiananmen Square had never occurred, however, it is unlikely that the amendments would have done much to encourage foreign investment. Long before the onset of political strife, joint ventures in the PRC were struggling to survive. Joint ventures of every description suffered from acute shortages of foreign exchange, raw materials and energy, labour problems, inflation, tight credit and arbitrary price controls. Before foreign enthousiasm for investment in China can be rekindled, the government may have to implement many more far-reaching economic reforms than those modest changes embodied in the recent amendments to the Equity Joint Venture Law.

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28. Amendments, supra note 1, Arts. 7, 13.
29. Laetitia Tjoa, "China: What is the Future for Foreign Business," 9 *International Financial Law Review* (November 1989), at 17. See also, Denis F. Simon, "Beyond Tiananmen: Is There a Future for Foreign Business in China?" 4 *Journal of East Asian Affairs* (Winter-Spring 1990), at 153-83; Richard Pomfret, "Ten Years of Direct Foreign Investment in China," 13 *Asian Perspective* (Fall-Winter 1989), at 35-53; Canice Chew-Ming Chan, "In the Aftermath of Tiananmen Square," 8 *International Financial Law Review* (August 1989), at 13-15; Paul M. Lowrey, "Assessing the Damage," *MOR China Letter,* July 1989, at 3.

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CANADA:

GOODS AND SERVICES TAX

Ingrid Sapona*

I. INTRODUCTION

The first formal steps towards one of the most dramatic changes in Canadian taxation occurred with the tabling of Bill C-62, the goods and services tax (GST) legislation, in the House of Commons on 24 January 1990. The GST is the culmination of the federal government's attempts at reforming Canada's federal sales tax (FST). For the past 25 years various ministers of finance have looked at the need to reform Canada's federal sales tax system and have considered various proposals.

In his April 1989 federal budget Finance Minister Michael H. Wilson announced the government's decision to implement the GST by 1 January 1991. In keeping with its planned timetable, in late 1989 the government tabled a Technical Paper, followed by draft legislation, and then the Notice of Ways and Means Motion and Technical Paper on 19 December 1989. In late January 1990 Bill C-62 was introduced in the House of Commons.

Numerous technical changes were made to Bill C-62 ("the Bill") in the House of Commons, with the Commons' amended version of the Bill passed on 10 April 1990. It is expected that additional minor changes will be made as the Bill makes its way through the remaining parliamentary steps on its way to receiving Royal Assent. If the Bill does not pass in Parliament by early autumn, it is unlikely that it will receive Royal Assent in time for the government's desired 1 January 1991 starting date. As a result there is some talk about postponing the starting date.

This article is based on the information set forth in the Bill as passed by the House of Commons on 10 April 1990, the Explanatory Notes to the Bill, which were released on 15 May 1990 (the Explanatory Notes) and various press releases issued by the Department of Finance through 1 August 1990.

This article is intended as a general outline of the mechanics of the system for practitioners who must advise businesses on the potential impact of this new Canadian tax. It is intended to raise issues that are likely to affect most suppliers of goods and services. Certain topics, such as the impact of the GST on the real estate sector, are of considerable importance but are not dealt with in great detail here. Some of the issues raised may require further study and consideration that is beyond the scope of this article.

II. GENERAL OVERVIEW OF THE GST SYSTEM

The GST is essentially a value added tax. The proposed rate of tax is 7 percent, down from the 9 percent that was originally proposed in the April 1989 federal budget. The GST is levied on the provision (technically referred to in the Bill as the "supply") of most goods and services and is collected by suppliers of goods and services. The GST's input tax credit system allows registered suppliers to claim a refund for taxes they have paid on goods and services they have acquired for use in a commercial activity (hereinafter referred to as inputs).[1] The net result is that, though the tax is applied at every level of production and distribution, the tax burden falls only on the final consumer.

III. THE REGISTRATION MECHANISM

The GST is collected by persons engaged in providing goods and services, i.e. so-called suppliers. Registration by suppliers both insures the collection of the tax at each level of supply and permits the registrant to claim the input tax credit. If a supply is made by a non-registrant, the purchaser of that supply cannot claim an input tax credit with respect to that good or service. Because non-registrants may not claim an input tax credit, goods and services supplied by non-registrants may be relatively more expensive than those supplied by registrants. Therefore, a supplier that is otherwise not required to register may choose to register because being able to take advantage of the input tax credit may mean that the supplier will not have to raise prices to maintain profit margins.

Generally, persons[2] engaged in a commercial activity in Canada are required to register[3] on a prescribed form.[4] Exceptions from the registration requirement exist for three types of suppliers: 1) small suppliers,[5] i.e. those having taxable sales of less than $ 30,000 per year;[6] 2) suppliers who supply real property by way of sale other than in the course of a business;[7] and 3) non-residents who do not carry on any business in Canada.[8] Suppliers required to register must apply to the Minister of National Revenue within thirty days of making their first taxable supply in Canada.[9]

In certain circumstances, non-resident suppliers who solicit orders in Canada for the supply of tangible personal property or a service made in Canada may be deemed to make a taxable supply in Canada and therefore must register.[10] Non-resident performers entering Canada for the purpose of making a taxable supply of services, such as a performance, conducting a seminar, or other event where admis-

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* Price Waterhouse, Toronto. The author wishes to thank Jonathan Spencer of Price Waterhouse, Toronto, for his input and thoughtful comments on this paper.

1. Bill C-62, subsec. 169(1), as passed by the House of Commons on 10 April 1990 [hereinafter referred to as Bill C-62].
2. For GST purposes a person is defined to include an individual, partnership, corporation, trust or estate, society, association, commission or other organization of any kind. See Bill C-62, Sec. 123(1), definition of person.
3. Bill C-62, Sec. 240(1).
4. Id. at subsec. 240(5).
5. Id. at para. 240(1)(a).
6. Id. at Sec. 148.
7. Id. at para. 240(1)(b).
8. Id. at para. 240(1)(c).
9. Id. at subsec. 240(1).
10. Id. at subsec. 240(4) and Sec. 143. Also, the Explanatory Notes to subsec. 143(2) give non-resident magazine, book and periodical publishers' subscription sales as an example of non-residents that are deemed to make a taxable supply in Canada and who therefore must register.

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sion is charged, must register before making any such supply.[11]

As mentioned, persons who are engaged in a commercial activity but are not required by the Bill to register may choose to register so that their supplies are on equal footing with those supplied by registrants and so that they can take advantage of the input tax credit system.[12] Non-resident persons who, in the ordinary course of carrying on business outside Canada, regularly solicit orders for the supply of tangible personal property for delivery in Canada may register even though their activities may not technically constitute a commercial activity in Canada. Listed financial institutions resident in Canada may also apply to the Minister to be registered.[13]

IV. THE SUPPLY CONCEPT

One of the central concepts under the GST is the concept of "supply", which is often mistakenly thought of as simply the provision of a service, or the sale of a good. The definition of "supply", however, is much broader and includes many activities that might easily be overlooked or not thought of as the provision of a good or service.[14] The term is formally defined as "the provision of property or a service in any manner, including sale, transfer, barter, exchange, licence, rental, lease, gift or disposition".[15] The definition of supply makes it clear that such things as taxable benefits received in the course of employment, e.g. automobile standby charges,[16] are therefore subject to the GST.

Basically all supplies are considered taxable if they are provided in the course of a commercial activity in Canada. Commercial activity is defined fairly broadly and includes any business carried on by a person, any adventure or concern in the nature of trade,[17] the performance of any duty or activity in relation to an office or employment,[18] and any activity engaged in that involves the supply of real property or a right or interest in real property.[19] Specifically excluded from the definition of commercial activity is the making of an exempt supply (see below) and an activity engaged in by an individual without a reasonable expectation of profit.[20]

V. TAX-EXEMPT SUPPLIES AND ZERO-RATED SUPPLIES

Two important categories of supplies are not subject to the GST: tax-exempt supplies and zero-rated supplies. Tax-exempt supplies (described more fully below) are goods and services the government has decided are not subject to the GST. Zero-rated supplies (described more fully below) are subject to GST at a rate of zero, rather than the normal 7 percent. Though in both situations registrants supplying tax-exempt supplies and zero-rated supplies collect no tax, there is an important difference between making a zero-rated supply and making a tax-exempt supply. Registrants making zero-rated supplies collect no tax but can claim an input tax credit for GST paid on goods and services related to the provision of zero-rated supplies.

Registrants making tax-exempt supplies cannot claim an input tax credit for GST paid on purchases related to those tax-exempt supplies.

VI. INPUT TAX CREDIT MECHANISM

The Federal Sales Tax (FST) is imposed on the sale price of manufactured goods and on the duty-paid value of imported goods. FST paid by manufacturers on their inputs is included in the manufacturer's selling price thus causing tax cascading. One of the effects of this cascading is the erosion of the tax base by businesses that are able to shift production costs beyond the tax point so as to reduce the price on which the tax is charged. The GST's input tax credit mechanism solves the problem of tax cascading by insuring that no tax is incorporated into the cost of inputs used by a supplier in the course of a commercial activity that gives rise to a taxable (including zero-rated) supply.[21]

The amount of input tax credit available to a registered supplier in a period depends upon the degree to which the registrant uses the input in a commercial activity.[22] If a registrant uses an input "exclusively", i.e. 90 percent or more[23] in a commercial activity, the GST paid on that input is fully creditable. In other words, to the extent a registrant supplies only taxable supplies (including zero-rated), the registrant can claim an input tax credit for all the GST paid or payable on all inputs consumed by that registrant in the course of its commercial activities. Conversely, no input tax credit may be claimed on any supplies of tax-exempt goods or services because the supply of tax-exempt goods or services is not, by definition, a commercial activity. If, however, a registrant supplies a combination of taxable supplies (including zero-rated supplies) and tax-exempt supplies, the registrant is entitled to credits for the GST paid on inputs used in its commercial activities, i.e. activities yielding a taxable (including zero-rated) supply.

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11. Bill C-62, subsec. 240(2).
12. Id. at subsec. 240(3).
13. Id. at subsec. 240(3).
14. Bill C-62, subsec. 162(1) contains an exception to the definition of supply. Under subsec. 162(1), the provision of any right to explore for or exploit natural resources is deemed not to be a supply for purposes of the GST. This exception from the definition of supply, however, does not extend to the supply of such rights to consumers or non-registered persons who acquire and subsequently sell the goods obtained by exercising those rights.
15. Bill C-62, subsec. 123(1).
16. Employees whose employer provides them with an automobile are deemed to have a taxable benefit that arises because of their access to the automobile. The auto standby charge is calculated by formula and is based on a percentage of the cost of the vehicle and the number of days the vehicle is available to the employee.
17. The concept of an adventure or concern in the nature of trade comes from the definition of "business" in subsec. 248(1) of the Income Tax Act. An adventure or concern in the nature of trade is generally an activity that a taxpayer undertakes, perhaps on a one-time basis, that is different from his or her normal business activities, but which, nonetheless, is undertaken as a business activity as opposed to as an investment activity. Common examples of this arise with respect to commodities trading. See, e.g. *MNR v. Taylor*, [1956] CTC 189, 56 DTC 1125 (Exchequer Court).
18. Bill C-62, subsec. 123(1) definition of commercial activity.
19. Id.
20. The issue of whether an individual is engaging in an activity with a reasonable expectation of profit often comes up, for example, in cases where an individual is a hobby farmer. The amount of expenses that are deductible by such a farmer often hinge on whether the individual had a reasonable expectation of profit from his or her farming activities.
21. See the Explanatory Notes to Bill C-62 issued 15 May 1990, regarding Sec. 169 [hereinafter referred to as the Explanatory Notes]. Though the GST eliminates the problem of cascading at the federal level, the problem is not completely eliminated since most of the provinces have indicated that they will levy their provincial sales taxes on prices that include GST. This topic is discussed in the article under Part XI, Sec. D Provincial Sales Tax.
22. Bill C-62, subsec. 169(2).
23. See the Explanatory Notes regarding subsec. 169(2). Though the definition of "exclusive" in subsec. 123(1) of Bill C-62 does not explicitly state 90 percent, the Explanatory Notes indicate that the term has the same meaning as the phrase "all or substantially all", which is generally accepted to mean 90 percent or more.

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A. Apportioning the GST paid on inputs

To the extent an input purchased by a registrant is not used in a registrant's commercial activity, the amount of GST paid cannot be reclaimed. Where inputs are used partly in the registrant's commercial activities and partly in its non-commercial activities, the GST paid must be apportioned between the two activities to determine the relevant input tax credit.[24] As noted, however, apportionment is only required for inputs where the input is used by the registrant for less than 90 percent in a commercial activity.

The GST legislation does not prescribe an apportionment method to use. Instead, registrants may choose any method that is reasonable in the circumstances. For example, a registrant could choose to apportion GST paid on real property based on the square footage of the property used in the registrant's commercial activity. Or, if a piece of office equipment is used in both the manufacture of a taxable good and also in the provision of a tax-exempt supply, the GST could be apportioned based on hours spent on each activity. Care must be taken in determining a reasonable method of apportioning because once a method is chosen, that method must be consistently applied.

There are restrictions on input tax credits for expenditures that have a significant personal consumption element.[25] For example, registrants may not claim any input tax credits on the following expenditures, even if the expenditures are incurred in the course of a commercial activity: (a) membership fees for a club the main purpose of which is to provide dining, recreational or sporting facilities;[26] (b) the purchase of goods or services by a registrant for the exclusive use of an officer, employer or related individual unless the property or service was subsequently sold to the individual at fair market value or, if the individual did not pay for it, if no amount were included as a taxable benefit for income tax purposes;[27] (c) essentially only 80 percent of the GST paid on meals and entertainment is eligible for an input tax credit;[28] (d) a restriction is placed on the input tax credit that can be claimed on passenger vehicles.[29]

There is an overriding restriction that denies an input credit if the good or service acquired is not a reasonable expenditure, considering the activities of the registrant or if the consideration paid is not reasonable in the circumstances.[30] There are special rules for real property inputs used by public sector bodies, but these rules are beyond the scope of this article.[31]

B. Apportioning credits for capital inputs

There are special rules for apportioning input tax credits for expenditures on capital goods. Furthermore, there are different rules regarding capital real property. The following sections outline the special rules.

1. Capital personal property

Generally, a non-financial institution registrant may claim a full input tax credit for expenditures on capital personal property if the capital property is used "primarily", i.e. greater than 50 percent,[32] in a commercial activity.[33] If capital personal property is not being used primarily to make taxable supplies, no input tax credit can be claimed with respect to tax paid on that input. Because there is no need to allocate the exact amount of input tax credit based on, for example, the percentage of commercial use to which the capital personal property is being put, this provision greatly simplifies the record-keeping with regard to capital personal property.

For GST purposes, capital property is defined as property, other than real property, that would be capitalized for income tax purposes, with the exception of property in Class 12 (100 percent depreciable) and Class 14 (intangibles such as patents and franchises) of the Income Tax Act.[34] Apportionment by financial institutions of input tax credits regarding capital personal property are dealt with below under the heading: "VII. Financial services and financial institutions".

Because a registrant can claim an input tax credit equal to 100 percent of the GST paid on capital personal property used primarily for a commercial activity, throughout the time such property is held by the registrant it must continue to be used primarily for a commercial activity. If the use of such property changes or falls below the 50 percent threshold, the property is deemed to have been disposed of at fair market value at the time it is no longer primarily used for a commercial activity and GST must be paid on the deemed disposition.[35] Conversely, if capital personal property that was not primarily used for a commercial activity at the time of acquisition (and so no input tax credit was claimed) later becomes primarily used for a commercial activity, the registrant may then claim a full input tax credit based on the lesser of the GST paid on acquisition of the property and the GST exigible on the fair market value at the time of the change in use.[36]

2. Capital real property

A full input tax credit may be claimed on capital real property that is used exclusively (i.e. greater than 90 percent) in a commercial activity. If the use of the capital real property in a commercial activity falls below 90 percent, the input tax credit must be apportioned based on the percentage of use the real property input is in the registrant's commercial activities. In other words, the "primarily test" is not applicable to capital real property. For example, if a registrant uses a real property input of 35 percent in its commercial activity, it can claim an input tax credit equal to 35 percent of the tax it paid on that real property. However, where a registrant that is an individual acquires real property for use in a commercial activity, but that property is used primarily, i.e. greater than 50 percent, for the personal use or enjoyment of the registrant,[37] no input tax credit can be claimed.[38]

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24. Bill C-62, subsec. 169(2).
25. See the Explanatory notes regarding subsec. 169(2).
26. Bill C-62, para. 170(1)(a).
27. Id. at para. 170(1)(b).
28. This is similar to the rules limiting meal and entertainment expense under Sec. 67(1) of the Income Tax Act. Under Bill C-62, Sec. 236, registrants are allowed to claim 100 percent of the GST paid on meals and entertainment as such expenses are incurred, but they are then required to report and repay 20 percent of this amount in their GST return for the first reporting period in the next fiscal year.
29. According to Sec. 201 of Bill C-62, an input tax credit can be claimed on the portion of the capital cost of the vehicle that is potentially deductible for income tax purposes. Currently, the maximum capital cost of a passenger vehicle for income tax purposes is $ 24,000.
30. Bill C-62, subsec. 170(2).
31. See, e.g. Bill C-62 Secs. 209, 210 and 211.
32. "Primarily" is not defined in Bill C-62, but it is generally accepted to mean 50 percent or more. See also the Explanatory Notes relating to subsec. 199(2) wherein it is stated that primarily means more than 50 percent.
33. Bill C-62, subsec. 199(2).
34. Id. at subsec. 123(1), definition of capital property.
35. Id. at subsecs. 199(3) and 200(2).
36. Id. at subsec. 199(3).
37. A home purchased for use as both a business office and personal residence is an example of real property so acquired.
38. See Bill C-62, Sec. 208.

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Increase/decrease in use of capital real property

Because real property has a long life, unlike capital personal property which is deemed to be disposed of when there is a change in use (with GST coming due on the deemed disposition), the government has seen fit to provide a special change-in-use rule.

If there is a significant, i.e. greater than 10 percent,[39] change in use of the capital real property by a registrant (other than a registrant that is an individual), an adjustment must be made regarding the input tax credit that can be claimed. A significant increase in the use of capital real property for commercial activities will result in an input tax credit equal to the percentage increase times the lesser of the GST that would be payable on the fair market value of the property at that time and the GST that would have been paid at the time of acquisition of the property.[40] Where there has been a significant decrease in the commercial use of the capital real property, the registrant is treated as if it sold part of the property and is required to remit GST equal to the percentage decrease in the use of the property times the lesser of the GST that would be payable on the fair market value at that time of the portion of the property no longer used and the input tax credit originally claimed on the acquisition of the property.[41]

An individual who was prohibited from claiming a credit on a real property input because it was used "primarily" for personal use can take advantage of a similar change-in-use rule if the property eventually becomes primarily used for a commercial activity.[42]

Special rules apply in cases where registrants completely stop using capital real property in a commercial activity.[43]

C. Timing of input tax credits

Input tax credits are generally claimable in the period the good or service was paid for (or became payable) by the registrant.[44] In the case of an invoiced supply, the tax is considered to have become payable as of the date of the invoice for the supply.[45] For imported goods where the GST is not collected by the supplier, the input tax credit is claimable when the GST became payable or was paid, which is when the goods are cleared through customs.

It is important to recognize that the input tax credit is claimable for the *reporting period* the goods were paid for or payable, which could have cash flow implications. For example, if an item is ordered in December and received on 28 December, for accounting purposes it would be treated as a December liability. For GST purposes, if the invoice is dated in December, the purchaser would claim an input tax credit for its December reporting period, which would be filed by 31 January. If, however, the invoice was not dated until January, the input tax credit would be claimed with respect to the January return, which would not be filed until the end of February.[46]

VII. FINANCIAL SERVICES AND FINANCIAL INSTITUTIONS

In a perfect consumption tax system the supply of financial services would be taxable just like any other supply. Realistically, applying such a tax to financial services is nearly impossible due to the fact that the price for many such services is not directly ascertainable, as it is inherent in the spread between the interest rates charged to borrowers and the interest rates paid to depositors.[47] As a result, like other countries that levy a value added tax, Canada has decided to make most financial services tax-exempt.[48] Financial services supplied to non-residents are zero-rated.[49] The domestic supply of most traditional financial services is tax-exempt, which means that suppliers of such financial services are not entitled to an input tax credit regarding those supplies. Traditional financial services, such as the exchange of currency; lending, advancing, borrowing and depositing of money; and the sale, underwriting, purchase, receipt, payment and transfer of ownership of financial instruments are tax-exempt.[50] Services provided by insurance agents, mortgage brokers and investment dealers are also tax-exempt.[51]

Some services that might normally be associated with financial transactions, such as management services to investment plans and the services of appraisers, are excluded from the definition of a financial service and therefore are fully taxable.[52] Other services provided by financial institutions, such as the sale of cheque books,[53] the rental of safe deposit boxes and fees for data processing services, are also taxable. More details concerning the types of financial services that are tax-exempt are set forth below under the heading "VIII. Specific Tax-Exempt and Zero-Rated Supplies".

Turning to the definition of financial instruments, the Bill's broad definition includes items normally thought of as financial instruments (such as debt and equity securities) as well as things not normally considered financial instruments, e.g. insurance policies, partnership interests, precious metals and futures options.[54]

Obviously, financial institutions will often supply a mix of taxable and tax-exempt goods and services. And, because of the broad definitions of financial instruments and financial services, determining whether a service provided by a financial institution is taxable (including zero-rated) or tax-exempt requires careful consideration.

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39. For the determination of whether the change has been greater than ten percent, insignificant changes are accumulated.
40. Bill C-62, subsec. 206(3).
41. Id. at subsec. 206(3).
42. Id. at subsec. 208(3).
43. Id. at subsec. 206(4).
44. Id. at subsec. 169(1). Of course, an exception to this general rule exists in the case of input tax credits that may come into existence, for example, due to a change in use of real property or a capital property.
45. Bill C-62, subsec. 169(3).
46. This is the general rule. However, there may be circumstances when a purchaser may claim an input tax credit earlier than the date of actual invoice. For example, there may be cases where a purchaser has not been invoiced but does have sufficient other documentation to support a claim for an input tax credit under subsec. 169(4).
47. See "Goods and Services Tax", a paper tabled by the Minister of Finance in the House of Commons on 19 December 1989.
48. It is interesting to note that in the 1987 White Paper on Tax Reform the government proposed the imposition of a value added tax on banks, trust companies, insurance companies and other financial institutions based on a "subtraction method" whereby the spread was taxed. After much public debate and industry consultation this was rejected because of the great difficulty in accurately calculating the spread.
49. Bill C-62, Sched. VI, Part IX.
50. See Bill C-62, subsec. 123(1), definition of financial services. See also Sched. V, Part VII.
51. See the Explanatory Notes regarding subsec. 123(1), the definition of financial services.
52. Id.
53. The sale of cheque books is taxable if a separate fee is charged for the cheques. If, for example, the cost of the cheques is subsumed in a single chequing account fee that normally is tax-exempt, then the cost of the cheques is tax-exempt as well.
54. See Bill C-62, subsec. 123(1), definition of financial instrument.

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A. Definition of financial institution

The supply of financial services is not limited to traditional financial institutions such as banks, insurance companies, stock brokers, etc.[55] Under the Bill's definition of a financial institution, in addition to traditional financial institutions (so-called listed financial institutions) other persons may be considered financial institutions and therefore could be denied input tax credits on a portion of their inputs.[56] A non-financial institution will be considered to be a financial institution under the GST if it provided a significant amount of financial services in the previous year. A de minimis test is provided to determine whether a significant amount of financial services was provided.[57]

Under the de minimis test, if more than 10 percent of a person's total income is interest, dividend or fee income (or any combination thereof) or if the person has interest, dividend or fee income (or any combination thereof) exceeding $ 10 million, the person is considered to be a financial institution for GST purposes.[58] For purposes of the test, interest and dividend income from related companies is not included in a person's income from financial services, but such income is included in determining the person's total income.[59] Though at first blush the de minimis test excludes many companies, careful consideration must be made in determining whether a registrant does indeed fall within the Bill's definition of financial institution. For example, any company that has portfolio interest or dividend income from stocks or bonds of non-related companies is considered a financial institution if that income exceeds 10 percent of the company's total income.

B. Apportionment of input credits by financial institutions

Because input tax credits can only be claimed on purchases used in making taxable (including zero-rated) supplies, to the extent a financial institution supplies a mix of goods and services that are taxable and tax-exempt it must apportion its input tax credits.

Like other registrants, GST paid on non-capital inputs used by financial institutions "exclusively" (greater than 90 percent) in a commercial activity is 100 percent creditable. But, unlike other registrants who may claim a 100 percent credit for GST paid on capital personal inputs used "primarily" for a commercial activity, financial institutions can only claim an input credit for GST paid on capital personal property to the extent that the property is actually used in the institution's commercial activities.[60] Though this provision requires financial institutions to carefully track their use of capital personal property, it also provides some relief to financial institutions that would not be entitled to claim any input credits if they had to meet the "primarily" test. Also, to the extent that a financial institution shifts the use of a capital personal property from a commercial activity to a non-commercial activity, or vice versa, no adjustment must be made unless the purchase price of the property exceeded $ 50,000 and the cumulative change in use exceeded 10 percent.

The rules regarding the apportionment of input tax credits on capital real property are the same for financial institutions as for non-financial institutions and are set forth above under the heading: "B. Apportioning credits for capital inputs: 1. Capital real property".

Practitioners are well advised to pay particular attention to the rules regarding financial institutions as they are quite detailed and are likely to affect many persons not traditionally thought of as financial institutions.

VIII. SPECIFIC TAX-EXEMPT AND ZERO-RATED SUPPLIES

As explained earlier, there are two categories of supplies that are not subject to the GST at the normal 7 percent rate: tax-exempt supplies and zero-rated supplies. The following sets forth the specific supplies that qualify as tax-exempt and zero-rated.

A. Tax-exempt supplies

Tax-exempt supplies include rentals of residential premises, sale of used housing, provision of health care services, educational services, child care services, legal aid, goods and services provided by public sector bodies and financial services.[61]

1. Real property

Residential rent paid for leasing a residential unit is exempt if the rental period is at least one month.[62] Long-term stay at hotels and motels do not qualify as tax-exempt residential rent if the hotel rents its units for periods of less than sixty days. However, short-term stays costing less than $ 20 per night or $ 140 per week are tax-exempt.[63]

The supply of used housing, which includes attached, detached, semi-detached, residential condominiums, apartment buildings and mobile homes,[64] is generally tax-exempt unless the seller has otherwise recovered the GST previously paid as an input tax credit.[65] (For example, a seller could have recovered an input tax credit on the property if the seller used it in commercial activities.) Also tax-exempt is the supply of real property by an individual or trust (all the beneficiaries of which are individuals) so long as the property was not used primarily in the course of business or sold in the course of business.[66] And finally, condominium fees are tax-exempt as well.[67]

2. Health care services

Health care services provided by hospitals, nursing homes, doctors, dentists, etc. are tax-exempt. Included in this category are leases of medical equipment by a health care facility to a patient[68] and the provision of ambulance services.[69] Services provided for cosmetic purposes are not tax-exempt.[70]

Nursing services, including private-duty nursing services,

55. Id. at para 149(1)(a).
56. Id. at para. 149(1)(b).
57. Id. at para. 149(1)(b).
58. Id.
59. Id. at subsec. 149(4).
60. Id. at Sec. 204.
61. Id. at subsec. 123(1) and Sched. V.
62. Id. at Sched. V, Part I, subsec. 6(a).
63. Id. at subsec. 6(b).
64. Id. at subsec. 123(1), definition of residential unit.
65. Id. at Sched. V, Part I, subsec. 2(a).
66. Id. at Sched. V, Part I, Sec. 9.
67. Id. at Sched. V, Part I, Sec. 13.
68. Id. at Sched. V, Part II, Sec. 3.
69. Id. at Sched. V, Part II, Sec. 4.
70. Id. at Sched. V, Part II, Sec. 5. The term "cosmetic purposes" is not defined, but it is stated to be a service performed not for medical or reconstruction purposes.

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are tax-exempt, regardless of whether they are provided in a health care facility or in an individual's home.[71] In addition, the supply of food and beverages to a health care facility under a contract to provide meals for patients is tax-exempt.[72]

3. Educational services

Educational services provided by schools, universities, colleges, etc. that generally lead to a degree, diploma or trade certificate are tax-exempt. Included in this category are charges for tuition and fees paid,[73] as well as most charges for food and beverages provided primarily to students by the educational institution.[74] Charges by elementary and secondary schools for school bus services are also tax-exempt.[75]

4. Child care services

Charges for day care services, including day camps, primarily provided to children 14 years old and younger are tax-exempt.[76] In addition, payments made by social service agencies to other organizations that operate group homes for children are exempt.[77]

5. Legal aid

The supply of legal aid services is tax-exempt.[78] However, private lawyers who provide legal services to a legal aid plan must charge GST. In those cases where services are provided by private lawyers, the legal aid plan can claim a full input tax credit for the tax paid.

6. Supplies by public sector bodies

Certain goods and services provided by public sector bodies, i.e. federal and provincial governments and their agents, municipalities, charities, non-profit organizations, etc.[79] are tax-exempt. Municipal services provided to property owners, such as road building and snow removal, are exempt so long as the service is not one in which the municipality would be in competition with the private sector. For example, if the municipality provided driveway paving services, i.e. services normally provided by a private contractor, such services would not be exempt.[80] Public sector bodies must register (unless they are exempt as a small trader) and must collect tax on taxable supplies made in the course of their commercial activities.[81]

7. Financial services

The supply of most domestic financial services is tax-exempt.[82] Financial services are defined as activities involving financial instruments, which include debt securities, equity securities, insurance policies, interests in a partnership or trust, precious metals and options or contracts traded on a recognized commodities exchange.[83] Financial services include the exchange, payment or transfer of money; the operation or maintenance of a savings, checking or deposit account; the lending or borrowing of a financial instrument; the provision, variation, release or receipt of a guarantee, acceptance or indemnity in respect of a financial instrument; the payment or receipt of dividends, interest, principal or any other amount in respect of a financial instrument; the underwriting of a financial instrument; etc.[84]

B. Zero-rated supplies

Zero-rated supplies, sometimes referred to as "tax-free" supplies,[85] include prescription drugs, medical devices, basic groceries, agricultural and fishing products, exports, travel services, transportation services, supplies to international organizations and officials and certain financial services (including insurance) provided to non-residents.[86]

1. Prescription drugs

Prescription drugs, which are essentially federally controlled drugs dispensed under the prescription of a doctor or dentist, are zero-rated.[87] In addition to the actual drugs, the dispensing fee charged by most pharmacists is zero- rated.[88]

2. Medical devices

The supply of medical devices is zero-rated and includes such items as canes, crutches, wheelchairs, prosthetic devices, hearing aids, dentures, eye-glasses, etc.[89] Also included in this category are such items as communication devices for use with a telephone by a hearing or speech impaired individual as well as seeing-eye dogs.[90] Services relating to the installation, maintenance, repair or modification of such devices are also zero-rated.[91]

The supply of cosmetics and toiletries is not zero-rated.[92]

3. Basic groceries

Foodstuffs and beverages are not taxed under the current federal sales tax. Similarly, the GST provides for zero-rating of basic grocery products. Unlike other sections of the Bill wherein items that are tax-exempt or zero-rated are enumerated, Part III of Schedule VI sets out the types of food that are *not* zero-rated.[93] Therefore, to the extent that a foodstuff does not fall into one of the categories listed in Part III of Schedule VI, it is zero-rated.

Among the items *not* zero-rated, i.e. fully subject to the GST, are alcoholic beverages, soft drinks, candies and snack foods. Sweetened baked goods and similar products are fully taxable unless they are sold in quantities (separately or

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71. Bill C-62, Sched. V, Part II, Sec. 6.
72. Id. at Sched. V, Part II, Sec. 11.
73. Id. at Sched. V, Part III, Secs. 2, 6, 7 and 8.
74. Id. at Sched. V, Part III, Secs. 3, 12, 13 and 14.
75. Id. at Sched. V, Part III, Sec. 5.
76. Id. at Sched. V, Part IV, Sec. 1.
77. Id. at Sched. V, Part IV, Sec. 2.
78. Id. at Sched. V, Part V and subsec. 258(2).
79. Id. at subsec. 123(1).
80. Id. at Sched. V, Part VI, Secs. 20-23.
81. Sec. 146 of Bill C-62 defines certain supplies made by public sector bodies that are considered supplied in the course of a commercial activity. Included in the list are such things as a supply of hunting and fishing licenses, the supply of rights to consumers to remove minerals, forestry products, water, etc.
82. Bill C-62, Sched. 5, Part VII.
83. Id. at subsec. 123(1), definition of financial instruments.
84. Id. at subsec. 123(1), definition of financial services.
85. The term "tax-free" is a misnomer because it is easily confused with tax-exempt and the two concepts are quite distinct, with different ramifications for suppliers. The Explanatory Notes relating to Schedule VI often refer to goods or services being tax-free. But, because of the potential confusion, the term "tax-free" should not be used and will not be used in this article.
86. Bill C-62, subsec. 123(1), definition of zero-rated supply and Sched. VI.
87. Id. at Sched. VI, Part I, Sec. 2.
88. Id. at Sched VI, Part I, Sec. 4.
89. Id. at Sched. VI, Part II.
90. Id. at Sched. VI, Part II, paras. 2, 7 and 33.
91. Id. at Sched. VI, Part II, Sec. 34.
92. Id. at Sched. VI, Part II, para. 1.
93. Id. at Sched. VI, Part III, subsecs. 1(a)-1(q).

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pre-packaged) of six or more.[94] Presumably the rationale behind this rule is that in small quantities such items are more likely a snack food than a basic grocery. Similarly, single servings of yoghurt, pudding and beverages are fully taxable when sold separately but are zero-rated when sold in packages of two or more (e.g. packages of three juice cartons).[95]

Prepared foods and beverages suitable for immediate consumption (either on-premises, as for example in restaurants, or for take-out) are fully taxable.[96] Also fully taxable are foodstuffs sold through vending machines and prepared catered food.[97]

The rules regarding immediate consumption are not particularly straightforward, however, and care must be used in determining whether a food item is fully taxable or zero-rated. For example, the Explanatory Notes specifically state that "the determination of whether a food or beverage is in a form suitable for immediate consumption takes into consideration not only the nature of the product . . . but also the amount of the food or beverage . . . sold".[98] As an example the Explanatory Notes state that a two-litre container of ice cream is zero-rated (it is obviously *not* a single serving) as is a whole cake sold by a restaurant for take-out (zero-rated most likely because it is analogous to the package of six or more servings of cake).[99]

4. Agricultural and fishing goods

Certain agriculture and fishing goods are zero-rated under the GST. Some of the products sold by the agriculture and fishing sectors are zero-rated as basic groceries, e.g. fruits, vegetables, milk, fish and seafood. In addition to the foodstuff items that would otherwise be zero-rated, farm livestock as well as grains, seeds and crops used to produce food or feed livestock are zero-rated.[100]

Bulk fertilizer and major capital items purchased exclusively by farmers and fishermen, e.g. combines, large tractors, commercial fishing nets, etc. are also zero-rated.[101] If it were not for the zero-rating of big-ticket items like combines and fishing nets, farmers and fishermen might find themselves in a net tax refund position, which might adversely impact on their cash flow.[102] Preferential treatment of the farming and fishing sectors is because of the significant role these sectors play in the Canadian economy, particularly in the prairie provinces and the maritimes.

It should be noted that the zero-rating of agriculture and fishing products relates only to the supply of such goods. Services relating to the agriculture and fishing sectors, such as harvesting services provided to farmers, stud services, etc. are fully subject to the GST.

5. Exports

So-called exports are zero-rated. The term "export", however, requires clarification. Exports can be thought of as goods or services consumed outside Canada. To the extent that a good or service is consumed outside Canada, no GST is applicable to it.[103] The relevant question with respect to an export is whether it is being supplied directly to a purchaser outside Canada or whether it is being supplied within Canada for export by the purchaser thereof. If the supply is provided outside Canada it is not subject to GST. If the supply is provided to a purchaser in Canada it can be zero-rated if the supply is not used by the purchaser, is not further processed in Canada, and is subsequently exported by the purchaser.[104]

Also zero-rated under the category of exports are certain supplies of goods and services to non-registered carriers[105] and the supply of excisable goods (e.g. spirits, beer and tobacco) where the recipient exports the goods in bond.[106] Purchasing and selling agents' services provided to non-residents in conjunction with the supply of a zero-rated export are also zero-rated.[107]

The exportation of services, other than advisory, consulting or professional services to non-residents, is zero-rated if the recipient of the service is a non-resident. (The supply of services to non-resident individuals will only be zero-rated if the individual is outside Canada throughout the time the service is performed.) The following services, regardless of whether they are supplied to a non-resident, are excluded from zero-rating: (i) services primarily for consumption, use or enjoyment in Canada; (ii) a service of acting as an agent of the non-resident; (iii) a service in respect of real property located in Canada;[108] (iv) a service in respect of tangible personal property that is ordinarily situated in Canada or to be delivered in Canada;[109] and (v) a transportation service.[110] The rationale for excluding these five types of services is that the benefits of such services are essentially realized (i.e. consumed) in Canada.[111]

According to the Explanatory Notes, advisory services, including consulting or professional services, supplied to non-resident businesses, are zero-rated regardless of where the benefit is realized, with the exception of services relating to real property located in Canada or relating to goods ordinarily situated in Canada or to be delivered in Canada.[112] For example, a Canadian computer consultant's supply of services to a German resident company is zero-rated, regardless of whether that German company uses the consultant's services to streamline its world-wide accounting system. The supply of an architectural service related to a building in Canada, however, is not zero-rated, even if the service is provided to a non-resident.[113] The Bill specifically provides for the zero-rating of supplies of advisory, consulting and research services provided to non-residents to assist them in taking up residence or establishing a business venture in Canada.[114]

And finally, goods sold to individuals are normally taxable if they are made available in Canada, even if the individual plans to immediately export the goods. If, however, the supplier mails or has the goods delivered to the individual via a common carrier to an address outside Canada, the goods are zero-rated.[115]

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94. Id. at Sched. VI, Part III, subsec. 1(m). 95. Id. at Sched. VI, Part III, subsec. 1(n).
96. Id. at Sched. VI, Part III, subsec. 1(o).
97. Id. at Sched. VI, Part III subsec. 1(p).
98. See the Explanatory Notes, Sched. VI, Part III.
99. Id.
100. Bill C-62, Sched. VI, Part IV, subsecs. 1 and 2.
101. See the Explanatory Notes, Sched. VI, Part IV, subsec. 10. See, also, Bill C-62, Sched. VI, Part IV, subsec. 5.
102. See the Explanatory Notes, Sched. VI, Part IV, subsec. 10.
103. The GST is only applicable to supplies made in Canada, see Bill C-62, subsec. 165(1).
104. Bill C-62, Sched. VI, Part V, Sec. 1.
105. Id. at Sched. VI, Part V, Sec. 2.
106. Id. at Sched. VI, Part V, Sec. 3.
107. Id. at Sched. VI, Part V, Sec. 5.
108. Id. at Sched. VI, Part V, Sec. 7.
109. Id.
110. Id.
111. See the Explanatory Notes regarding Sched. VI, Part V, Sec. 7.
112. Id.
113. Id.
114. Bill C-62, Sched. VI, Part V, Sec. 9.
115. Id. at Sched. VI, Part V, Sec. 12.

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6. Travel and freight services

Generally, international freight and passenger transportation services are zero-rated.[116] The provisions regarding international freight and passenger transportation are complex, the details of which are beyond the scope of this article. However, some general comments are in order.

Passenger transportation, undertaken by an individual or group of individuals, is zero-rated if it is an international trip, i.e. a trip that begins, ends or otherwise involves a stopover outside the so-called taxation area. The taxation area is defined as Canada, the United States (except Hawaii) and the islands of St. Pierre and Miquelon.[117] If a continuous journey involving air travel originates outside Canada and the airline ticket is purchased outside Canada for air travel between Canada and the United States, the purchase is zero-rated.[118] International travel by means other than air requires that the passenger be outside Canada for more than 24 hours to be zero-rated.[119]

Both inbound and outbound international freight is generally zero-rated. Any domestic legs of the shipment may also be zero-rated if they are part of a continuous inbound or outbound freight movement.[120] There is a de minimis rule for outbound freight: the value of the shipping services must be at least $ 5 in order to qualify for zero-rating.[121] Payments made by one carrier to another carrier with respect to one continuous freight movement are zero-rated.[122] As a result, according to the Explanatory Notes, only the carrier that settles a domestic bill directly with the shipper is required to collect GST,[123] if applicable.

7. Financial services provided to non-residents

The last category of zero-rated supplies relates to the supply of financial services made by a financial institution to a non-resident person. Once again, rather than enumerate all the types of financial services to non-residents that are zero-rated, Schedule VI, Part IX, Section 1 lists those financial services that are *not* zero-rated. For example, financial services relating to a debt arising from a loan, the funds of which are for use primarily in Canada, are not zero-rated,[124] nor are financial services relating to a debt arising from the purchase of real property in Canada or personal property used primarily in Canada.[125] All of these non-zero-rated financial services are treated like any other financial service, i.e. they are tax-exempt and therefore providers thereof are not entitled to an input tax credit.

Exports of insurance services are zero-rated to the extent they relate to the provision of life, accident or sickness insurance provided to a non-resident (other than a group policy), as well as other types of policies that relate to risks ordinarily situated outside Canada.[126]

IX. FISCAL PERIODS AND REPORTING PERIODS

A. Registrants

Registrants must calculate the GST they are to remit as well as the input tax credit they may claim on a periodic basis (the so-called reporting period).

Registrants (other than listed financial institutions) must report either monthly, quarterly or annually. Registrants who make annual taxable supplies of $ 6 million or more must report monthly.[127] Registrants with taxable supplies of less than $ 6 million must report quarterly at least, though they may elect to file on a monthly basis.[128] Registrants with taxable supplies of less than $ 500,000 may elect to file annually,[129] but they still have to make quarterly instalments. Threshold amounts are determined with respect to the previous year's activities[130] and are determined on an aggregated basis among associated persons.[131]

The reporting period for registered listed financial institutions is not based on any threshold amount of services. Instead, the reporting period is the fiscal year of the financial institution, unless it elects to report monthly or quarterly.[132] The rationale for this exception for listed financial institutions is to ease the record keeping burden on institutions that supply both taxable and tax-exempt goods and services. Despite being required to file only annually, financial institutions must still remit quarterly.[133]

B. Non-registrants

The reporting period for non-registrants is a calendar month.[134] For listed financial institutions that are not registrants, the reporting period is the fiscal year of the institution, unless it elects to report more frequently.[135] The reporting period of a non-registrant is significant only on the occasions when a non-registrant makes a taxable supply.

Anyone may elect to file on a monthly basis.[136]

X. FILING RETURNS

Registrants must file a prescribed return[137] with the Minister of National Revenue for each reporting period of the registrant.[138] Registrants reporting annually must file within three months after the end of the fiscal year, while those filing more frequently must file one month after the end of their reporting period.[139]

Non-registrants that make a taxable supply in Canada in the course of a commercial activity are also required to file a return. Non-registrants must file a return within one month after the end of any month in which a taxable supply was made.[140] Non-registered, non-resident performers that supply taxable admissions to a performance, exhibit, seminar or similar event must make a return and remit the tax to be paid by that person within one month after the end of the month in which the taxable supply was made.[141]

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116. Id. at Sched. VI, Part VII.
117. Id. at Sched. VI, Part VII, Sec. 1.
118. Id. at Sched. VI, Part VII, subsec. 3(c).
119. Id. at Sched. VI, Part VII, Sec. 2.
120. Id. at Sched. VI, Part VII, Secs. 7 and 10.
121. Id. at Sched. VI, Part VII, Sec. 6.
122. Id. at Sched. VI, Part VII, Sec. 11.
123. Id. See, also, the Explanatory Notes regarding Sched. VI, Part VII, Sec. 11.
124. Bill C-62, Sched. VI, Part IX, Sec. 1.
125. Id.
126. Id. at Sched. VI, Part IX, Sec. 2.
127. Id. at subsec. 245(2).
128. Id. at paras. 245(2)(d) and 246(1).
129. Id. at Sec. 248.
130. Id. at Sec. 249.
131. Id. at para. 249(2)(b).
132. Id. at para. 245(2)(c).
133. See the Explanatory Notes concerning Sec. 245. See also Bill C-62, Sec. 237.
134. Bill C-62, at para. 245(1)(a).
135. Id. at para. 245(1)(b).
136. Id. at subsec. 246(1).
137. Id. at subsec. 238(4).
138. Id. at subsec. 238(1).
139. Id. at paras. 238(1)(a) and 238(1)(b).
140. Id. at subsecs. 238(2) and 245(1).
141. Id. at subsec. 238(3).

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Registrants must file one GST return for each reporting period. If, however, a registrant can demonstrate that it has separate divisions or branches that have separately identifiable activities or locations, as well as separate accounting systems, upon application of the registrant, the Minister of National Revenue can grant permission to file separate returns.[142]

XI. REMITTANCE OF THE TAX

"Net tax" is essentially the difference between the tax collected by the registrant and the input tax credits claimed in that reporting period.[143] The net tax can be a positive or a negative amount. Positive amounts of net tax must be remitted to the Receiver General on or before the return for that period is due.[144] Returns indicating a negative net tax serve as an automatic application to the Minister of National Revenue for a refund for that period.[145]

As noted earlier, normally suppliers of taxable goods and services are responsible for collecting and remitting the tax. There is an important exception to this rule, however, for the supply of real property by non-residents, as well as the sale of real property (both residential and non-residential) to persons (other than individuals) registered for GST purposes.[146] In such cases, the purchaser is required to remit the tax payable.[147] One reason for this rule is that it is more difficult for Revenue Canada to collect from non-resident vendors than from registered, resident purchasers.[148] In addition, the government wanted to ease financing problems of registered purchasers who sought short-term financing to pay the GST at the time of purchase, knowing that within 60 days they would claim the input tax credit on the purchase.

Registrants electing to file annually must still remit quarterly instalments equal to one fourth of their instalment base.[149] The instalment base is essentially the lesser of the estimated tax for the year and the net tax for the preceding tax year. There are special rules for calculating the instalment base for transitional years.[150] If the instalment base is less than $ 1,000, no instalments need be made.[151]

A. Streamlined accounting for small businesses

To insure that compliance with the GST system is fairly straightforward for small businesses making both taxable and zero-rated supplies, a prescribed retail establishment may use one of three streamlined methods of accounting to calculate its net tax.[152] Under the streamlined methods of accounting, a qualifying retailer need not distinguish between sales of taxable goods and zero-rated goods at the time of sale. Instead, the retailer remits a fixed percentage of total sales (taxable, zero-rated and tax-exempt), varying from one to five percent, depending on the sector.

To use a streamlined method the registrant must have annual sales of taxable and zero-rated goods of less than $ 2 million. In addition, registrants must formally elect to apply a streamlined method of accounting.[153]

B. Penalties

The penalty for failure to timely remit any net tax is six percent of the tax owing plus interest at the prescribed rate.[154] The interest, which is compounded daily, applies from the time the tax was required to be remitted until the day it was remitted. The same penalty and interest are levied on late instalments.[155]

XII. SPECIAL ISSUES

A. Transitional period planning

Despite initial mixed public and political reaction, the GST will most likely be passed by Parliament and implemented as planned on 1 January 1991 (or shortly thereafter). During the transitional period before implementation, businesses should consider how the GST will impact on them and whether any particular action should be taken. For example, businesses should determine whether they must register; whether to voluntarily register even if not required to (so as to take advantage of input tax credits); whether they are eligible for one of the streamlined accounting methods, etc.

Prior to implementation of the GST persons should consider whether it is advantageous to accelerate or postpone certain purchases. The current FST is levied generally at 13.5 percent. Businesses contemplating major non-FST-exempt capital purchases in the coming few months should determine whether current prices with FST are higher than they will be under the GST, as well as considering the impact of the input tax credit that might be available to them under the GST. As well, businesses should consider renegotiating supply contracts that are based on prices that have an FST content.

Businesses that make both taxable (including zero-rated) and tax-exempt supplies should begin developing a reasonable method for apportioning input tax credits between their commercial activities that produce taxable supplies and those that produce tax-exempt supplies.

Businesses should also consider whether to invest in new point-of-sale equipment, the cost of which is eligible for immediate deduction if put in place before 1993.

All persons should review the significance of their investment revenue and financial service revenue to determine whether they will be deemed to be a financial institution for GST purposes.

B. FST rebates

To minimize double taxation on implementation of the

142. Id. at Sec. 239.
143. Id. at subsec. 225(1). While certain other amounts may be deducted (e.g. deductions for bad debts), a more detailed discussion of the net tax calculation is beyond the scope of this article.
144. Id. at subsec. 228(2).
145. Id. at subsec. 228(3).
146. Id. at subsec. 221(2).
147. Id. at subsec. 221(2).
148. This rule is similar to the Income Tax Act's Sec. 116(5) requirement that on disposition of certain types of taxable Canadian properties by a non-resident, in lieu of a certificate issued by the Minister of National Revenue indicating that the vendor has prepaid the tax, the purchaser is required to pay a portion of the tax otherwise owed on the closing.
149. Bill C-62, Sec. 237.
150. Id. at. subsec. 237(5).
151. Id. at subsec. 237(3).
152. Two of the proposed streamlined accounting methods were described in the 8 August 1989 Technical Paper issued by the Minister of Finance. The third method was set forth in a Department of Finance release (No. 90-23) dated 31 May 1990. Further changes to these methods may be made before they become final prescribed methods.
153. Bill C-62, Sec. 227.
154. Id. at subsec. 280(1). The prescribed rate of interest is set by Revenue Canada quarterly. The prescribed rate for the third quarter of 1990 was 16 percent.
155. Bill C-62, subsec. 280(2).

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GST, businesses with new FST-paid goods in inventory on 1 January 1991 qualify for rebates of the FST.[156] To qualify as FST-paid goods the inventory must have been acquired before 1 January 1991 and such goods must be inventory held for sale or lease, or building material held for use by persons in the construction business.[157] Rebates are only available for registrants and application for the rebate must be made before 1992.

The calculation of FST rebates is based on prescribed percentages, so that the actual FST content of the goods is irrelevant. On 1 June 1990 the Department of Finance announced the planned rebate rates.[158] The general rebate rate applying to most goods is 8.1 percent. The Department of Finance has also proposed the following rebate factors for specific goods: 5.6 percent for building materials; 2.8 percent for mobile homes and modular building units; 1.4 percent for propane; 11.1 percent for motor vehicles; and a per litre rebate (yet to be determined) for gasoline and diesel fuel. In addition, a special rebate factor is available to small grocery and convenience stores. Such stores may use the specific rebate factors or may use an average rebate factor of 2.5 percent applied to the total cost of both FST-paid and FST-exempt inventory, thereby eliminating the need to distinguish between tax-paid and tax-exempt inventories. To qualify for use of the special rebate factor, the value of the applicant's inventory cannot exceed $ 70,000.

FST-paid used goods in inventory on 1 January 1991 do not qualify for an FST rebate. Instead registrants can claim an input tax credit equal to approximately 3.3 percent of the value of the inventory of used goods held on that date.[159] As with other input tax credits, registrants can claim this credit on their regular GST return.

C. Invoicing for GST

One of the basic issues faced by most businesses is how to show the tax on their invoices. The legislation requires vendors to provide the purchaser with sufficient information to enable the purchaser to substantiate his claim for an input tax credit.[160] Vendors must either show the GST separately on the invoice or receipt or indicate on the receipt that the amount paid includes the GST. The ultimate decision as to how GST will be shown on the business' invoices will most likely be dictated by the requirements of the business' customers.

D. Provincial sales tax

When the decision regarding how to invoice for the GST is being made, consideration should also be given to how the provincial sales tax is to be calculated. With the exception of British Columbia and Manitoba, it appears that most provinces will levy their provincial sales tax on prices that include the GST.[161] So, for example, in Ontario, where the provincial sales tax is 8 percent, a chair costing $ 100 will suffer GST of $ 7 and Ontario sales tax of $ 8.56, for a total cost to the ultimate consumer of $ 15.56.

E. GST and professionals

Professionals have never had to worry about FST. Under the GST, however, many of the services provided by professionals are taxable.[162] Like other suppliers, professionals providing taxable supplies must collect GST on their billings for services, goods and most out-of-pocket expenses. Therefore, steps should be taken to review current client billing practices to minimize cash flow problems.

XIII. CONCLUSION

Canada's federal sales tax was introduced in 1924. While sales taxes are regressive in nature, the FST has been particularly unfair. Over the years the FST tax base has been eroded due to tax cascading, and the FST has made the cost of Canadian exports higher relative to imports because manufacturers have had to charge FST on their sales prices including such costs as marketing and distribution, which are incurred by importers after the FST has been levied on the import. The GST, though not a panacea, solves many of the problems associated with the FST and should prove to be a much-needed revenue raising tool.

156. Id. Sec. 120.
157. Id.
158. See the Department of Finance's release (No. 90-074) dated 1 June 1990.
159. Bill C-62, subsec. 120(3). See also the Explanatory Notes to subsec. 123(3).
160. Bill C-62, Sec. 223.
161. New Brunswick, Newfoundland, Nova Scotia, Ontario, Prince Edward Island and Quebec have all indicated that they will levy their provincial sales tax on GST-inclusive prices. At the time of writing, Saskatchewan is the only province that has not yet announced its decision. (The only province that does not levy a provincial sales tax is Alberta.)
162. Of course, most medical and dental services are tax-exempt.

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BARBADOS:

International Financial Sector Developments

Bruce Zagaris

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In recent months several developments have benefited the Barbados international tax and services sector. These developments include a proposed revision to the International Business Companies Act, expansion of the tax treaty network, solidification of the Barbados branch of the International Fiscal Association (IFA), reduction of import duties on computer equipment and software, and planned additions to the staff and resources of the Barbados Government in the area of international tax matters. Many of these matters were outlined in the budget speech of the Prime Minister while others were contained in speeches by Dr. Kurleigh King, Governor of the Central Bank of Barbados, and Mr. Winston Cox, Director of Finance and Planning, at a meeting of the International Fiscal Association Barbados branch.

I. BUDGET SPEECH

During his presentation of budgetary proposals to Parliament on 2 May 1990 the Honourable Mr. Erskine Sandiford, Minister of Finance of Barbados, underscored several developments and proposals concerning the Barbadian international financial sector.[1]

Mr. Sandiford explained that, as Barbados looks for new opportunities to develop foreign investment and international services work for Barbados persons, the Inland Revenue Department of Barbados was currently in the process of negotiating additional double taxation treaties.

According to Mr. Sandiford, as Barbados continues its growth as an international financial centre, businesses are increasingly becoming more sophisticated and expanding the services of accounting firms and legal advisers in their tax matters. Hence, the Barbados Government needs to also increase its own resources. In this regard, Mr. Sandiford explained that the Inland Revenue Department is planning to add professionals to evaluate tax proposals and deal with white collar crime. As a first step, it will add four posts of professional accountants to be recruited in the very near future.

With regard to training, Inland Revenue and Ministry officers will be participating in five-month training courses in tax administration with assistance from the Caribbean Organisation of Tax Administrators (COTA) and the Commonwealth Fund for Technical Cooperation (CFTC). Thereafter, the recipients of the training will conduct training courses for the junior staff.

Last year a local consultant began reviewing and is still improving the Inland Revenue Department's computer system. Similarly, a Chief Accountant has been attached to the Department for the purpose of revising and improving the accounting systems.

Finally, the Government plans to formalize and begin publishing the existing system of revenue rulings and the decisions of the Tax Appeal Board. This new administrative measure will assist taxpayers and foreign investors in their interpretation of tax laws as well as improve clarity and reduce administrative costs.

Mr. Sandiford also stated that the International Business Companies (IBC) Act will be revised to further facilitate the use of the IBC to enhance Barbados' international financial sector.

Mr. Sandiford also announced that computer equipment and software will, in future, be exempt from customs duty and consumption tax on importation. As a result, consumers should be able to buy such equipment and software at a cost that is reduced by 30% to 40%. The reduced import duties will also encourage the use of computers in all aspects of business, increase information technology services in Barbados, and enable persons in the international services sector to be more competitive.

The budget statement and proposals show the continued growth of the international services and financial sector in Barbados and the continued commitment of the Government to developing the sector.

II. INTERNATIONAL FISCAL ASSOCIATION, BARBADOS BRANCH

The Barbados branch of the International Fiscal Association, which was established last year, has begun holding regular meetings. At its 21 March lunch meeting, the guest speakers included Kurleigh King, Governor of the Central Bank of Barbados, Winston Cox, Director of Finance and Planning, and Yolande Bannister, Legal Counsel to the Central Bank.[2] Mr. Cox stated that the Central Bank has now established an ad hoc International Business Advisory Committee to review the IBC Act. Dr. King stated that the international business and financial sector has the potential to generate foreign exchange to compensate the high level of imports in Barbados.

At a meeting of the Executive Committee of the Barbados IFA branch of 18 May, a seminar on the Caribbean Common Market and Community Tax Treaty was tentatively scheduled for 26 and 27 October 1990 in Barbados. Participants will include Caribbean government officials and tax experts from within and outside the region.[3]

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1. The Rt. Hon. L. Erskine Sandiford, Prime Minister and Minister of Finance and Economic Affairs, Financial Statement Budgetary Proposals (2 May 1990).
2. Minutes of the International Fiscal Association (Barbados Chapter), 21 March 1990.
3. Minutes of a Meeting of the Executive Committee of the Barbados Branch of the International Fiscal Association, 18 May 1990. For the

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III. PROPOSED INTERNATIONAL BUSINESS COMPANIES ACT (IBC) AMENDMENTS

The proposed revisions to the IBC Act will significantly enhance the use and benefits for shareholders and the Barbados economy generally.[4]

A. Scope of activities

The new Act will grant IBC status to companies that either are carrying on the business of international manufacturing or international trade and commerce. All existing IBC activities will qualify, except for those for which special legislation exists (i.e. offshore banking, exempt insurance, foreign sales corporations). The new Act will allow IBCs to provide services to other IBCs and other specially designated offshore entities whereas currently an IBC cannot trade or provide services to another IBC. An IBC will be able to carry on any business provided it does not engage in the buying or selling of goods to be used or consumed in Barbados other than for the purposes of its own operations in Barbados; the provision of services for persons resident within CARICOM;[5] and the making, processing, preparing, assembling or packaging within Barbados of any product which will be exported to the CARICOM region.

B. Manufacturing

The existing Act does not enable manufacturing enterprises to obtain eligibility for IBC benefits since they may be eligible for tax concessions under the Fiscal Incentives Act. The new IBC Act confers IBC status and benefits on companies who engage in the business of "making, processing, preparing, assembling or packaging within Barbados any product which is exclusively for export to countries outside of the CARICOM region". The IBC enterprise will be able to choose benefits either under the IBC Act or the Fiscal Incentives Act. Companies that are eligible for and elect approved status under the Fiscal Incentives Act will be eligible for IBC status after the expiry of the tax holiday.[6]

No proposed limit will be imposed on the types of products that can be manufactured. However, the goods must be exclusively for export outside of the member countries of CARICOM. Several benefits accrue to persons who qualify for IBC status. Many products, including those that are not eligible for Fiscal Incentives Act benefits, will now be eligible for IBC status. The IBC Act provides for full duty-free exemptions on imports of plant, machinery, equipment and raw materials and components for use in the manufacturing process. IBC enterprises are exempt from exchange controls unlike companies qualifying under the Fiscal Incentives Act..

C. Qualifying and licensing

The new Act will grant a licence on application and payment of the prescribed fee (which is creditable against any taxes payable), when the Minister verifies that a "qualifying" company is carrying on or intending to carry on, from within Barbados, the business of international manufacturing or international trade and commerce. Regardless of its place of incorporation, a company qualifies to carry on business as an IBC, provided it meets the clear legislative standards.[7]

D. Residence

The new Act deems that a company will be resident in Barbados if it is either incorporated in Barbados, or, if incorporated outside of Barbados, holds a valid licence issued under the Act. The change will facilitate the establishment of branches of foreign corporations and does not require an extent of activity that must be conducted in Barbados.

E. Further income and withholding tax benefits

Two new benefits are contained under the revised Act. All IBCs will pay tax at the graduated rates of tax from 1 percent to 2.5 percent on profits. Currently, only IBCs engaged exclusively in investment activities qualify for the lower rates. The new Act will exempt from tax altogether an IBC whose shares form part of the assets of an offshore trust under the management of a licensed Barbadian offshore bank. As a result of the latter benefit, Barbados may be more competitive as a jurisdiction for establishing foreign trusts. The new Act will also specifically exempt the IBC from any taxes under the Income Tax Act or from any other direct tax on its profits or gains under any other enactment.

The IBC will be exempt under the new Act from tax under the Income Tax Act, all rents (except for property in Barbados), dividends, royalties, interest, fees, management fees, salaries, emoluments or other monies paid or deemed to be paid by an IBC to a company carrying on international business or to a person resident outside CARICOM. At present fees and salaries paid to non-resident service providers or employees are taxable as income derived from Barbados.

While retaining the existing exemptions from withholding taxes on dividends, royalties, interest, rent and management fees, the new Act expands the existing law to exempt all fees, salaries, emoluments and other monies paid to non-residents of Barbados from any withholding tax.

F. Exchange control exemption and foreign currency accounting

The new Act will continue the current Act's allowance to specifically allow IBCs to apply for exemption from exchange control. Whereas at present IBCs currently must apply for exemption from exchange control, the new Act will grant IBCs automatic exemption from exchange control in respect of their international trade and commerce and international manufacturing.

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information on the Barbados IFA chapter, the author is grateful to Colin T.O. Brewer, the Treasurer of the Barbados chapter and a member of Price Waterhouse (Barbados).

4. Ernst & Young, Synopsis of Major Changes Contained in the proposed New International Business Companies Act 1989 of Barbados. The section on the proposed revisions to the IBC Act relies heavily on the Ernst & Young memo for which the author is grateful to Peter N. Boos, FCA, Ernst & Young.

5. For this purpose a company, 90 percent of whose issued shares of all classes are owned by non-residents of CARICOM, will be deemed not to be resident in CARICOM.

6. IBC incentives endure potential in perpetuity whereas the tax holidays under the Fiscal Incentives Act last for up to a maximum of 10 years.

7. Under the new Act an individual who is a shareholder of the IBC will not be deemed to be a resident of Barbados if he is ordinarily resident in Barbados by reason of an employer/employee relationship with the IBC. This change is designed to encourage owner-managed companies to establish their operations in Barbados.

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G. Exemptions from other legislation

IBCs will be exempt under the new Act from the Rate of Interest Act, the requirement to file financial statements with the Registrar of Companies and the disclosure of information other than such information as forms part of the public record in the possession of the Registrar of Companies.

H. Audit requirements

All IBCs must have a local audit except those owned by an offshore trust under the management of a Barbadian licensed offshore bank or ones whose assets do not exceed U.S.$ 500,000.

IV. SUMMARY AND CONCLUSION

The conjunction of the budget proposals, the proposed IBC Act revisions and the IFA chapter discussions reflect a maturation of the Barbados international financial sector.[8] The holding of the CARICOM tax treaty seminar shows a consideration of the interaction of the sector with the economic integration of the region and the need to begin devising future directions. The attention to lowering import duties on computer equipment and software and the statements in the budget reflect increased attention to an integrated services sector approach to economic development and diversification in Barbados.

8. For additional information on the international financial sector in Barbados, see Zagaris, B., "Barbados" in Spitz, *Tax Havens Encyclopedia, Doing Business in Barbados,* Price Waterhouse (1990).

Conference Diary

SEPTEMBER 1990

ATI/PSU U.S. Tax Course Program: Fundamental Elements of U.S. Federal Taxation (24-26 September), Introduction to U.S./International Taxation (24-26 September) and U.S./International Reorganizations (27-28 September), Paris (English):
The American Tax Institute in Europe, 9, avenue Matignon, 75008 Paris, France.

M & A Transactions in France, Italy, Germany, Holland & Belgium. London, 25 September (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

7th European Congress of Tax Consultants. Cannes (France), Lectures 27 September, working group 28 September (multilingual):
C.F.E. General Secretariat, Dechenstrasse 14, Postfach 1340, D-5300 Bonn 1 (G.F.R.).

OCTOBER 1990

Taxation of Unit Trusts – the New Rules. London, 3 October (English):
Oracle Business Information, 8 Bartok House, 30 Lansdowne Walk, London W11 3LT, United Kingdom.

Holdingstructuren. Amsterdam, 5 October (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Unit Trust Management. London, 8-9 October (English):
Oracle Business Information, 8 Bartok House, 30 Lansdowne Walk, London W11 3LT, United Kingdom.

U.S. Expatriate Taxation: Estate & Gift, Benefits/Retirement Plans & Financial Planning. London, 8-12 October (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

The Second World Offshore Convention. London 9-10 October (English):
Offshore Investment, Conference Division, P.O. Box 66, Douglas, Isle of Man, British Isles.

International Tax Management of Expatriates, Offshore Payments. London, 10 October (English):
The Overseas Taxation Company Ltd., 14 West Smithfield, London EC1A 9HY, United Kingdom.

Europees Economisch Samenwerkingsverband. Breda, 10 October (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Fiscale en Para-Fiscale Optimalisatie van Grensoverschrijdende Tewerkstelling. Gent, 11 October (Dutch):
Uitgeverij Biblo, Studiedag 11 Oktober 1990, Brasschaatsteenweg 200, 2180 Kalmthout, Belgium.

EG – Steuerharmonisierung; DBA Deutschland/Italien. München, 12 October (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postfach, CH-8022 Zürich, z.Hd. Frau Schüpbach, Switzerland.

Les paradis fiscaux – Mythes ou Réalité? Monte Carlo, 15-16 October (French):
Janine de la Begassière, Forum du Droit et des Affaires, 19, avenue de Messine, 75008 Paris, France.

Taxation, Trade and Investment in the European Communities. New York, 15-17 October (English):
ALI – ABA, 4025 Chestnut Street, Philadelphia, Pennsylvania 19104, U.S.A.

Fachkongress der Steuerberater. Köln (Gürzenich), 16-17 October (German):
Fachinstitut der Steuerberater e.V., Bahnstrasse 16, 4000 Düsseldorf 1, Germany.

International Conference on Computer and Law, organized by the Buenos Aires Bar Association and the French Association pour le Développement de l'Informatique juridique. Buenos Aires, 16-19 October (English, French, Spanish):
Secretaria del Congreso Internacional de Informatica y Derecho, Uruguay 485, piso 3°, 1015 Buenos Aires, Argentina.

Life Office Taxation – the New Rules – Problems and Opportunities. London, 17-18 October (English):
Oracle Business Information, 8 Bartok House, 30 Lansdowne Walk, London W11 3LT, United Kingdom.

International Taxation – Management Techniques: Transfer Pricing; Mergers and Acquisitions. Paris, 18-19 October (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Joint International Tax Planning Conference, Brighton, 18-19 October (English):
P.O. Box 433, Chartered Accounts' Hall, Moorgate Place, London EC2P 2BJ, United Kingdom.

Internationale Steuerberaterseminare Deutschland – Belgien – Niederlande – Basisseminar Deutschland. Osnabrück, 19-20 October (Deutsch):
Bundessteuerberaterkammer, Postfach 1340, D-5300 Bonn I, Federal Republic of Germany.

NOVEMBER 1990

How to do successful business in West and East Germany – Key legal, Tax, Accounting & Business Practice. London, 1-2 November (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT 14 7JL, United Kingdom.

Wat U als Financieel Manager moet weten van Vennootschapsbelasting. Zandvoort, 7-9 November (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

ITPA Maui Seminar: e.g. Private Banking in the Pacific Rim; Investment in Taiwan; New Offshore Centres, Belize, Labuan, Western Samoa, Maui, Hawaii, 15-16 November (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

International Conference on Corporate Tax Strategy and Intercompany Pricing. Brussels, 19-20 November (English, French):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

7th Asian-Pacific Conference – Practical problems of International Tax Practice. Singapore, 26-27 November (English):
APTIRC, 2 Nassim Road, Singapore 1025.

Planning and Executing Successful International Acquisitions and Alliances. Brussels, 28-30 November (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

DECEMBER 1990

Taxation of Branches and Subsidiaries, Brussels, 13-14 December (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

De Praktijk van fusies en overname. Rotterdam, 18-19 December (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

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ZAMBIA: Tax Treatment of the Family

Dr. Robert Ngosa Simbyakula

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For any country, appropriate tax treatment of the family constitutes a cardinal issue for policy consideration in the design and implementation of its scheme of individual income taxation. If the tax system decides to treat the family as the taxpaying unit, the first consideration is to determine the extent of the family, i.e. whether or not minors and other dependants should be considered as part of the family, or whether the unit should consist of only a husband and wife. The second issue is whether the income of the family should be aggregated or split among the family members. Depending on how the taxpaying unit is defined, resulting tax liabilities are bound to differ greatly, especially with a single progressive rate structure.

There are basically two competing principles with respect to tax treatment of the family. The first is that couples with identical incomes should pay equal taxes. The second is the "marriage neutrality principle", which implies that there should be no tax penalty for being married and none for being single. That is, each person should be taxed on the basis of his or her own income so that the total tax liability of two individuals should not change when they marry.

The principle of equal taxation of couples with identical incomes is based on the premise that since spending decisions are made jointly by husband and wife, taxpaying capacity should be measured by considering the family as one economic unit and their incomes aggregated. For example, couple A, in which one spouse earns 5,000 K and the other 20,000 K, should pay the same tax as couple B, in which only one spouse earns the full 25,000 K. Aggregation of incomes may indeed ensure equality in the tax liability of couples with identical incomes. However, with a single progressive rate structure, pooling incomes may significantly increase the tax liability of a two-earner couple for the simple reason that their combined income takes them into higher marginal rates than would be the case if each spouse was taxed on his individual earnings. If, for example, the rates are 5 percent on the first 10,000 K and 10 percent on the next 20,000 K, the total tax liability for both couples in this example (i.e. on 25,000 K) would be 2,000 K. However, if the couples are taxed separately, tax liability for the one-earner couple B remains the same at 2,000 K, while that for the two-earner couple B is reduced to 1,750 K (i.e. 250 K on 5,000 K and 1,500 K on 20,000 K).

The difference in tax liability before and after marriage – which in this case amounts to 250 K – constitutes the so-called "marriage tax" and violates the marriage neutrality principle. Nonetheless, although separate assessment accords best with the principle of marriage neutrality, it in turn fails to satisfy the principle of equal taxation of couples with identical incomes.

A technique that attempts to combine both precepts to some extent is splitting the aggregated income of the couple equally between the spouses and applying the tax rate to the distributed income. This method ensures that couples with equal total income (whether one-earner or two-earner) pay equal taxes. Furthermore, this approach removes the marriage penalty. For instance, the combined income of 25,000 K in the preceding example is split equally so that each spouse is taxed on 12,500 K. Each spouse would thus pay 625 K, amounting to a total tax liability of 1,250 K for the couple.

With a single progressive rate structure, income splitting may even provide a significant tax benefit for marriage. The benefit is much more pronounced in the case of one-earner couples. For example, the total tax liability on 25,000 K for the earning spouse in couple A reduces significantly from 2,000 K prior to marriage to 1,250 K after marriage (a net gain of 750 K). Similarly, a wealthy family can divide assets among various relatives and children and file separate tax returns in order to split their income into lower marginal tax brackets for tax purposes, even though the family is, in fact, one spending and earning unit.

These inequities are the inevitable consequence of a single progressive rate schedule. For this reason, jurisdictions that decide to tax on the basis of joint income attempt to ameliorate the resulting inequities by maintaining different rate schedules for married couples, single individuals and single heads of households (i.e. unmarried individuals with children). Those that tax under a single progressive rate schedule use either a scheme of personal allowances to take account of marital status or simply consider the individual as the taxpaying unit.

A subsidiary issue pertains to the treatment of families that have substantial investment or services income received by minor children. If such children are considered as part of the family, the same principles discussed above apply, i.e. pooling incomes, separate assessment or income splitting. However, the same inequities are bound to occur. Many jurisdictions treat children who earn substantial income as single taxpayers. Under the French quotient system, income is split not only among spouses but also with unmarried children who are under the age of 18.[1] That is, the total family income is divided by the number of family members so that low tax rates are applied and then the tax of each family member is added up.

TREATMENT OF THE FAMILY IN ZAMBIA

The tax treatment of the family in Zambia has basically gone through two phases: the pre-1970 system which taxed according to aggregated incomes, and the post-1970 system of separate assessment. However, during both phases, both single and married individuals have been taxed under a single progressive rate schedule. To ameliorate the resulting inequities caused by the application of a single rate schedule, a scheme of personal allowances has been used to take account of marital status and family size. These allowances consisted of a:
(a) *married allowance* granted to a husband where the taxpayer's wife was living with him during the tax year;
(b) *single allowance* granted to an unmarried individual, or

1. Lienard, J.L., Messere, K.C. and Owens, J. "France", in Pechman, J.A. (ed)., *Comparative Tax Systems: Europe, Canada and Japan* (Tax Analysts, Arlington, Virginia, 1987), at 157.

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a person whose wife was not living with him. A minor with income in his own right (e.g. salary or investment allowance not deemed to be his parents') was entitled to this allowance;
(c) *child allowance* granted to a taxpayer who maintained unmarried minors under the age of 18, up to a maximum of six minors. The allowance could also be claimed in respect of older children (by natural parents only) if the children were either undergoing full-time education at a recognized educational institution or so incapacitated as to be incapable of taking care of themselves. Except for an allowance in respect of older children, a claimant did not have to be a parent. Any person who was a guardian and maintained the child was entitled to the allowance. This reflects the extended family system in Zambia. Where two or more individuals claimed and were entitled to child allowance in respect of the same child (e.g. divorced parents), the allowance could be apportioned among the claimants in the proportions that their respective contributions bore to the sum of the contributions;
(d) *family allowance* granted to a taxpayer who was not entitled to married allowance but maintained a child for which he or she was entitled to the child allowance. This allowance was in addition to the single and child allowances. Thus, a single person who maintained one child, for example, was entitled to a total allowance of 1,080 K (i.e. 450 + 450 + 180). The family allowance was later abolished in 1970.

Although not expressly stated in the statute, a minor who earns his own income is treated as a single person and taxed accordingly. This creates opportunities for income fragmentation. For example, a family business can reduce its tax liability by splitting assets among family members to take advantage of lower marginal rates.

Until the 1982 amendment to the Income Tax Act, the scheme of allowances, insofar as the married couple was concerned, was clearly biased against women in that both the married and child allowances were only available to the working husband. The history of the tax treatment of the family in Zambia thus contains a series of attempts to correct the inequities between the spouses.

On 1 April 1989 a new system of complete separate taxation of individuals was introduced. Under this scheme the single, married and child allowances were abolished and replaced by one general exemption known as the primary allowance. The following section presents a chronological review of the different phases in the tax treatment of the family in Zambia from the inception of the Income Tax Act in 1966. This is followed by a discussion of the present system of complete separate taxation introduced in April 1989.

Pre-1970: aggregation of incomes

Prior to 1 April 1970 the general characteristic had been to consider the family as one taxable unit. The unit envisaged under the Act consisted of a husband and a wife. Following the old British Victorian conception of regarding the husband as the sole bread-winner, the income accruing to the wife was deemed to be that of the husband and added to his income for the purpose of determining the tax payable. As a result of pooling, the couple's income was subject to tax at a higher rate. While the principle of equal taxation of couples with identical incomes may have been achieved, the system clearly violated the principle of marriage neutrality. Taxed separately, two unmarried individuals were bound to pay less tax. Furthermore, this scheme meant that the income of the secondary worker was taxed at a much higher rate and was likely to render a disincentive for the wife to enter the cash economy.

However, the couple's tax liability was reduced by allowing a married allowance to the husband which was almost three times the single allowance (Table 1). The allowance was granted even if the wife was not in receipt of any income as she was deemed to have imputed income. Because the allowance was so high, it constituted a significant tax subsidy for marriage where the wife was unemployed but it imposed a tax penalty for being single.

Table 1

Personal allowances 1969-1990 (kwacha, p.a.)

Year	Married	Single	Child	Insurance	Handicapped	Primary	Family
1969	1,300	450	180	300	—	—	450
1972	1,000	500	180	300	400	—	
1984	1,700	650	325	400	600	—	
1986	2,100	900	330	400	600	—	
1987	4,600	1,800	330	800	600	—	
1988	4,600	1,800	330	800	600	—	
1989	—	—	—	800	600	6,000	
1990	—	—	—	800	600	12,000	

Source: Income Tax Act
1989 Budget Address
1990 Amendment Act

Greater inequity arose in cases where the husband was unemployed. Whereas an unemployed wife was deemed to have imputed income which enabled the husband to claim the married allowance, the husband was not deemed to have imputed income. Consequently, the married allowance was not transferable to the wife. She was taxed as an unmarried individual and entitled to only the single allowance. However, if she maintained any children, she could, in addition to the single allowance, claim the child allowance and the family allowance. Even so, the combined total of these three allowances was less than the married allowance. In such instances, the principle of equal taxation of couples with identical incomes was blatantly violated because a family in which the wife was the single source of income paid more tax than one in which a man was the sole source of an equal amount of income.

Post-1970: separate taxation

(i) 1970-1981

The shift towards separate taxation was instituted by an amendment to the Income Tax Act on 1 April 1970 which abolished aggregation of incomes. This move was precipitated by the social changes in Zambia during the late sixties which saw the expanded labour force participation of married women and hence an increase in two-earner families, especially among the middle and upper income classes.

Although incomes accruing to a wife and a husband were to be taxed separately (under the same rate schedule), the perception that a husband was the sole bread-winner persisted. The married and child allowances were granted only to married men and were not transferable to wives. For that reason the bias against married women remained. Whereas a married man could claim both the married and child allowances, a wife was taxed without the benefit of any of these allowances, including the single allowance. As a result, while a man received a substantial "marriage subsidy" upon entering into matrimony, a woman became subject to a

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marriage penalty because she was stripped of even the single allowance and taxed on her gross income. That is, once a woman ceased to be a *femme sole,* her tax liability increased thereby violating the marriage neutrality principle. This loss in income, however, was mitigated by the higher married allowance given to her husband which was more than twice the single allowance (Table 1).

Although the legislative intent for granting the married and child allowances to the husband was aimed at increasing the family's disposable income, the provision was apt to render hardship for the working married woman in instances where the husband abdicated his responsibilities to the family or in the case of a separation without a judicial decree. Under Section 3 of the Act, a woman was treated as living with her husband unless separated under a court order or by a deed of separation. Thus a husband could continue to receive the married allowance even if the couple were living apart while the wife could not even get the single allowance.[2]

As was the case during the pre-1970 system, where the wife's earnings were higher than the husband's, or where the wife was the sole bread-winner, the system presented serious inequities. Since the married allowance was not transferable to a wife, if a woman was the sole bread-winner, she was taxed as a single person and could only get the single allowance. In addition, because of the substantial difference between the married and single allowances, the tax penalty for being single continued throughout this period.

(ii) 1982-1985

Because of the obvious bias against married women and the inequities that had existed under the previous provisions, an amendment was introduced in 1982 allowing a two-earner couple to elect to apportion the married allowance between them, and if the couple agreed, the total allowance could be transferred to the wife. Due to the rapid emancipation of women in the seventies, an increasing number of women were commanding salaries almost as high as men. The election to apportion the allowance, however, had to be made at least six months prior to the fiscal year and when made, the election was irrevocable. There was no explanation given for the long period of notice or a reason for irrevocability. It appears that this was essentially for administrative convenience.

(iii) 1986

In addition to sharing the married allowance, the 1986 amendment permitted the child allowance to be apportioned equally between the spouses, and if one spouse was unemployed the working spouse could claim the entire allowance.

(iv) 1987-1988

On 1 April 1987 the married allowance was increased from 2,100 K to 4,600 K[3] to be shared equally between husband and wife, i.e. if both were in receipt of income. Sharing was made optional in respect of the child allowance. Where one spouse was unemployed, the working spouse could not claim the full married allowance of 4,600 K; instead, the spouse was entitled to 60 percent of the allowance, which amounted to 2,760 K compared to the single allowance of 1,800 K. The 60-percent provision was aimed at reducing what could have amounted to a very substantial tax subsidy. These provisions eliminated the obvious bias in the income tax law against married women that had existed in circumstances where the wife had a higher income or was the sole source of income for the family.

Notwithstanding that the corresponding single allowance was also doubled from 900 K to 1,800 K, an individual was better off married than single, in that the shared married allowance of 2,300 K was 500 K more than the single allowance. Although these changes did indeed remove the disparity between spouses, marriage neutrality was still not achieved because the difference between the married and single allowances still maintained a tax penalty for being single.

The 1987 amendment (for the first time) extended the insurance allowance to married women. Prior to 1987 only married men could claim the insurance allowance in respect of a premium paid on one life, i.e. either on his own life or that of his wife or minor child. A married woman was precluded from claiming the allowance even in respect of a premium paid by herself on her own life. For example, if each spouse was paying a premium on his or her own life insurance policy, only the husband could claim the allowance. If the husband did not have a life insurance policy but the wife did, the husband could claim the allowance. All this was due to the fact that the law provided that a premium paid by the wife on her life or that of her husband or minor child was deemed to have been paid by the husband. In any case, however, only one allowance was available. Moreover, an allowance in respect of the wife's premium could only be granted to the husband if he was in receipt of income, and it was not transferable. Thus a working married woman became worse off upon marriage because, whereas as a single woman she was entitled to both the single and insurance allowances, she lost both when she married.

Precluding married women from a similar allowance in respect of even premiums paid on their own lives could not be considered encouragement for married women to save.

In explaining these changes, the Minister of Finance stated that this was a way of giving "meaningful relief to working married women on their own policies".[4] In actual fact, however, these (inevitable) changes evolved as a result of pressure from women who rightfully contended that the income tax laws were archaic and blatantly biased against married women and could not be justified in a modern and ostensibly democratic society.

(v) The 1989 amendment

A fundamental change to the income taxation of individuals was made on 1 April 1989. The concept of the family as a tax unit was abolished and replaced by complete separate taxation of individuals. The married, single and child allowances were abolished and replaced by one general exemption known as the "primary allowance". Each working individual whether married or single is entitled to the same allowance which was initially set at 6,000 K per annum in 1989. As a result of severe inflationary pressure, the 1990 budget doubled the allowance to 12,000 K with effect from 1 April 1990. Thus, by virtue of the 1989 amendment, the taxpaying unit is now the individual earner.

Apart from the disparity that had existed, the previous arrangement was cumbersome, especially when making assessments where there was a change in marital status, reduction or increase in the number of children and the sharing of child allowance because of separation or divorce. These difficulties, as the Minister of Finance explained, entailed a

2. If there was a judicially sanctioned separation the spouses were taxed as unmarried individuals and each spouse was granted the single allowance.
3. In May 1987 the exchange rate was pegged at 1 ZK = US$ 0.10.
4. Musokotwane, K.S., Minister of Finance, 1987 budget address, para. 98.

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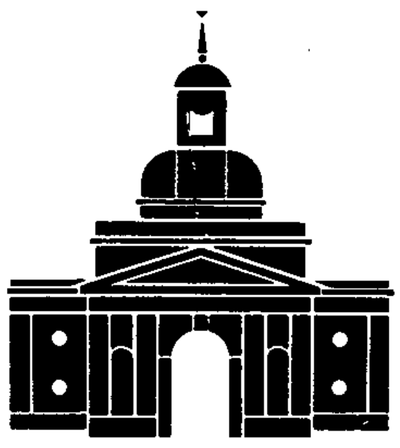
lot of paperwork, increasing the workload of tax administrators but not necessarily increasing the amount of tax collection.

Under the 1989 provision, the combined allowance for a two-earner couple of 12,000 K constituted a net relief of 5,420 K over the old provision. Under the 1988 legislation, the maximum allowance available to a married two-earner couple with six children was 6,580 K, i.e. the married allowance of 4,600 K plus a maximum of 1,980 K as the child allowance in respect of up to six children (300 K/child).

Although the scheme of separate taxation achieves the principle of marriage neutrality and eliminates the marriage penalty, it now violates the principle of equal taxation of couples with identical incomes. For example, a couple in which one spouse earns the entire income, say 50,000 K, will have a taxable amount of 38,000 K after deducting the primary allowance. On the other hand, a couple in which one spouse earns 40,000 K and the other 10,000 K will have a total taxable amount of only 28,000 K (the 10,000 K is not liable to tax). Secondly, the scheme makes no distinction between married without children and married with children. It provides greater relief to couples without children. In a way it may be an incentive to have less children.



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INTERNATIONAL FISCAL ASSOCIATION

NEWS

Some Highlights from the Secretary General's 1989/90 Annual Report

Presented at the Stockholm Congress 1990

J. Frans Spierdijk

INTRODUCTION

Another year to look back to a successful IFA Congress, the one in Rio de Janeiro, and to look forward to a new Congress in Stockholm. A year also in which we said farewell to Mr. Richard M. Hammer (U.S.A.) as President of our Association after four years of service. The three words on the Gold Medal which he received upon his nomination as Honorary President aptly describe his style: "Warmth, Leadership, Devotion". No doubt IFA owes great thanks to Dick Hammer for heading our Association in his involved and effective manner.

Mr. Karl Beusch (Federal Republic of Germany) was elected President of IFA as of the close of the Rio de Janeiro Congress. We are looking forward with confidence to the number of years during which he will be at the helm of our Association.

At the General Secretariat, a change occurred in that Ms. Sue de Groot left us after about ten years of employment. Fortunately Ms. Nel Slingerland and Ms. Thea van Dijk, who are both "old" IFA hands with some fifteen years of service, will continue to carry the IFA torch. Together with our new staff member, Ms. Sefi Vesters, who will be in charge of the membership administration, we are confident that the General Secretariat will run as smoothly as ever. As a personal note I would mention here that I indeed managed – according to plan – to give up being a practising tax lawyer from 1 May of this year, which will enable me to devote even more attention to IFA affairs. It gives great satisfaction to devote one's time to an organization like IFA, which has evolved into a unique international forum for tax experts, solely as a result of the dedicated efforts of its members.

RIO DE JANEIRO CONGRESS

With 964 participants and 497 accompanying persons attending, the many members of the Brazilian Branch who worked hard preparing the Congress were well-rewarded. I hope that all others involved in making the Congress a success will forgive me if I make special mention of Dres. Gilberto de Ulhoa Canto, Agostinho Toffoli Tavolaro, Luis Fernando Teixeira Pinto and Raphael Bernardo d'Almeida Jr. The election of Dr. De Ulhoa Canto as an Honorary Member of IFA during the General Assembly of 15 September 1989 was a well-deserved award for his many years of commitment to the Association and its goals. The opening Session of the 43rd IFA Congress in Brazil, the fourth in Latin America, was marked by an address by his Excellency, the Minister of Finance, Mr. Mailson Ferreira da Nobrega, and by the presence of the Governor of the State of Rio de Janeiro, Mr. W. Moreira Franco.

Main Subject I, "The Disregard of a Legal Entity for Tax Purposes", attracted a more than satisfactory audience at the working sessions. No doubt this was due to a great extent to the interesting General Report prepared by Dr. Condorcet Pereira de Rezende (Brazil) on the basis of 29 National Reports. The working sessions were chaired by Mr. J.M. Pinheiro Neto (Brazil) and ably steered through a structured discussion by Prof.Avv. P. Adonnino (Italy). The panelists were Messrs. H. Becker from the Federal Republic of Germany, K. Dolan from the U.S.A., E. Calvo Nicolau from Mexico and J.M. Tirard from France, whereas Messrs. M. Justen Filho and J.C. Cotrim acted as Secretaries of the subject.

The Resolutions Committee for Subject I consisted of Prof. S.O. Lodin (Sweden), Chairman, and Mr. J.S. Hausman (Canada), Prof. L. Hinnekens (Belgium), Prof. P. Massone Parodi (Chile) and Dr. K. Stocker (Switzerland).

Subject II, "Administrative and Compliance Costs of Taxation", likewise evoked interesting discussions. Its General Reporter, Prof. C. Sandford (United Kingdom), set out the subject under review in a very clear manner, which made many participants realize that the matter, which was new and perhaps unusual for IFA, was well worth their attention. The working sessions were chaired by Mr. C.A. Longo from Brazil. Discussion Leader Mr. G. Delorme from France and his panel members, Dr. M. Del Guidice (Italy), Prof. M.J. Graetz (U.S.A.), Mr. Ch.G. Krishnamurthy (India), Mr. B. Norrman (Sweden) and Mr. D.A. Ward (Canada), led the audience through the four areas of discussion into which the subject had been divided. Messrs. A. Martins de Andrade and L.C. Simoes (Brazil) acted as Secretaries of Subject II. Mr. N. Boidman from Canada assumed the role of Chairman of the Resolutions Committee. The other members were Prof. L. Fischer (Federal Republic of Germany), Mr. M. Dols Roda (Spain), Prof. J.M. Rivier (Switzerland) and Mr. K. Suominen (Finland).

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I refer to the Reports of Proceedings written by Dr. Barry Bracewell-Milnes (United Kingdom) on Subjects I and II and to the Resolutions on the Subjects and the reviews of same by the Chairmen of the Resolutions Committees as published in the IFA Yearbook 1989 for more information. Certainly IFA has every reason to be grateful to the General Reporters of both Subjects and to all the National Reporters. Our thanks go likewise to all the people mentioned above who helped to make this scientific part of the Congress a success.

Another part of the scientific programme was comprised of five Seminars. Seminar A, on "International Taxation of Services", was chaired by Prof. R. Valdes Costa from Uruguay. Mr. D. de Souza from Brazil acted as Secretary of the Seminar. The panelists nominated to the Seminar were Mr. A. Atchabahian (Argentina), Dr. E. Gnazzo (Panama), Mr. M. Krause (Federal Republic of Germany), Prof. Dr. G. Maisto (Italy) and Mr. O.P. Vaish (India).

Seminar B, on "Tax Treaties and Domestic Legislation", was chaired by Justice J.F. Rezek from Brazil. Ms. R.T. Hofmann (Brazil) acted as Secretary of Seminar B. The panelists were Dr. L. Hernandez Berenguel (Peru), Mr. D. Luethi (Switzerland), Mr. S. Shay (U.S.A.) and Mr. L. Simonet (Belgium).

Seminar C, on "Taxation Aspects of Turnkey Projects", was chaired by Mr. H. Birk (Canada), assisted by Mr. J.G. Vermeer (Canada) as Secretary. The panel comprised Messrs. N. Andreae (France), P. Olavarrieta (Mexico), E. Osterberg (U.S.A.) and K. Sonntag (Federal Republic of Germany).

Seminar D, on "Taxation for a Latin American Common Market", was chaired by Mr. D. Ordelio A. Sette (Brazil), assisted by Mr. J.L. Coelho da Rocha (Brazil) as Secretary. The panelists were Messrs. E.J. Reig (Argentina), J.M. Macedo Pereira (Portugal), J. Rodrigo (Spain) and J. Gonzalez Bendiksen (Colombia), who was prevented from attending the Congress, and was replaced by Mr. A. Arango M. from Colombia.

Seminar E, on "The Brazilian Tax System", was divided into English, French, German and Spanish language groups. The English group comprised Mr. F.A.M. Mussnich (Brazil), Chairman, and Messrs. P. Cesar Aragao, R. Branco da Silva, A. Correia Meyer and J. Cordeiro Guerra from Brazil. The French language group comprised Mr. L.R. do Nascimento e Silva (Brazil), Chairman, and Prof. I. Gandra da Silva Martins, Messrs. J.M. de Araujo Pinho and A. Xavier from Brazil. The German group comprised Prof.Dr. Gerd W. Rothmann (Brazil), Chairman, and Prof.Dr. T. Sampaio Ferraz Jr., Dr. H. Tilbery and Mr. R.A. Fernando Figueiredo from Brazil. The Spanish group comprised Mr. D. de Campos (Brazil), Chairman, and Messrs. M. Aurelio Greco, H. Arzua and Prof. E. Brito from Brazil.

There is an increased interest in our Seminars and the choice and quality available at the Rio de Janeiro Congress was welcomed by many participants. We would like to thank all those involved in the preparation and presentation of the Seminars for their contributions. As regards the social programme, the Brazilian Branch created an atmosphere and an ambience that exceeded our already great expectations. Let me recall the reception by the Governor of the State of Rio de Janeiro in the beautiful "Villa Riso", an old mansion in the style of a colonial farm dating back to the nineteenth century; the Gala Concert given by the Orquestra de Camara de Blumenau, with Jean Luis Steuerman as soloist and Norton Morozowicz as conductor; and the festive Gala Dinner at the Rio Yacht Club with a Carnival Show. Who ever dreamt of seeing some of our non-Brazilian members dancing the Samba? Thanks, Brazilian IFA friends, for a job well done!

PERMANENT SCIENTIFIC COMMITTEE

The Spring meeting was held in January 1990 in Stockholm. It was interesting to convene at the Berns' Congress Centre, the venue of our 44th Congress.

The Committee discussed and approved, in principle, a proposal made by its Chairman Prof.Avv. A. Fantozzi to form a number of subcommittees, i.e. one for preparation and discussion of the main subjects, another entrusted with a similar task as regards the seminars, and finally, a subcommittee to study the short and long-term planning of the subjects for future IFA Congresses. In this connection, the Committee welcomed an offer made by the International Bureau of Fiscal Documentation of a 10,000 Dfl. per annum scholarship for young researchers who could, under the supervision of the IBFD and by making use of its facilities, study potential subjects identified by the PSC and regularly update certain subjects. Prof. Fantozzi made it clear that the overall responsibility for the work of the subcommittees will remain with the PSC, i.e. the PSC will have the final word in drawing up its recommendations to the Executive Committee. It was generally felt that the creation of subcommittees, which will be worked out further in memoranda to be submitted at the August 1990 meeting of the PSC, would be useful and necessary to alleviate the burden on the PSC members who are faced with increasing and complicated tasks in addition to the growth of IFA and the variety of its scientific programme.

The PSC decided to recommend adding to its membership representatives from Brazil, Israel and Japan and is keeping an eye on other areas presently not represented.

Thirty-one National Reports were received for the Stockholm Congress, Subject I, "Taxation of Cross Border Leasing", which is an all-time high. Subject II, "International Mutual Assistance through Exchange of Information", was dealt with by 21 National Reporters. It was noted with satisfaction and gratitude that the General Reporters, Prof. G. Lindencrona and Mr. S. Tolstoy for Subject I, and Avv. B. Gangemi for Subject II, had their reports ready in time and I would like to thank them for all their hard work.

Preparations for the Barcelona Congress 1991 are well underway. Subject I will treat "The Determination of the Tax Base for Real Property" with Prof. Juan Ramallo Massanet (Spain) as General Reporter and Mr. L. Penuelas y Reixach (Spain) as Assistant General Reporter. Mr. Jacques Malherbe (Belgium) will be the General Reporter of Subject II, "Protection of Confidential Information in Tax Matters".

The Barcelona Seminars are as follows:
A. "Financing of Large Metropolitan Areas"
B. "Qualification of Companies to Claim the Benefits of an Income Tax Treaty"
C. "Interaction of National Tax/Local Tax with Double Tax Agreements"
D. "The Spanish Tax System"
E. "Taxation of Venture Capital"

The subjects for the 1992 Congress in Cancun, Mexico have been definitely fixed: Subject I: "Transfer Pricing in the Absence of Comparable Market Prices" with Prof.Avv. G. Maisto (Italy) as General Reporter, and Subject II: "In-

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come Tax Consequences of International Acquisitions" for which Mr. W.B. Taylor (U.S.A.) agreed to act as General Reporter.

Some initial discussions took place on the subjects for the 1993 Congress in Florence.

Finally, the Committee had to accept the resignation of Prof.Dr. Klaus Vogel (Federal Republic of Germany) as one of its members as of the close of the Stockholm Congress. His contribution to the work of the committee over many years has been extremely valuable. We regret to see him leave as a PSC member and can only hope that he will continue to contribute to the work of IFA in some way or other.

EXECUTIVE COMMITTEE (EC)

Chaired for the first time by Mr. Karl Beusch, the Executive Committee met in Stockholm on 7 May 1990. Present for the first time as fully fledged members were Mr. S.H. Goldberg (U.S.A.) and Mr. I.W. Harris (Hong Kong). Specially invited were Prof. S.O. Lodin, President of the Stockholm Congress, and Mr. M. Marin Arias, in view of the Barcelona Congress. Part of the meeting was attended by Dr. R. Lenz (Switzerland), Chairman of the Blueprint Committee.

As to the composition of the Executive Committee, it will be proposed to the General Council to re-elect the following persons for another two-year period: Messrs. J.F. Avery Jones (United Kingdom), A. Overbosch (Netherlands), Dr. K. Stocker (Switzerland) and D.A. Ward (Canada), and to add a member from Italy. Mr. F. Fernandez Ordonez from Spain will be proposed to be nominated President-Elect of IFA during the General Assembly in Stockholm.

As regards future Congresses, the Executive Committee decided, in accordance with recommendations by the Invitations Sub-Committee, to definitely accept the invitation submitted by the Swiss Branch to organize a Congress in Geneva in 1996. Regretfully the invitation from the Indian Branch could not be implemented for 1994 but perhaps 1997 will be possible. The Canadian Branch will host the IFA Congress in Toronto in 1994 and the French Branch the 1995 Congress in Cannes.

Pursuant to discussions conducted earlier on the basis of recommendations by the Blueprint Committee, the EC made it clear that from the 1992 Congress in Cancun the Excursion Day will be moved to Friday. This change is designed to bring about a reduction in the Congress fees and to save time for those who prefer to skip the Excursion Day.

At the request of numerous members it was decided to introduce an IFA Membership Certificate. Order forms will be inserted in the 1990 Yearbook.

The General Secretariat was instructed to further investigate the matter of delayed delivery of the Cahiers to some countries and try to devise a cost-efficient solution for the problem at the next Executive Committee meeting.

Following a recommendation of the Blueprint Committee, the Executive Committee decided that it would be appropriate for IFA to appeal to National Branches to contribute to research and other scientific projects the PSC may initiate. This might remove, at least partly, the need for Central IFA to dispose of funds in its own hands for the financing of its scientific programmes.

BLUEPRINT COMMITTEE

The Committee, chaired by Dr. R. Lenz, met in Stockholm on 6 May 1990. Most of the meeting was devoted to a discussion on the matter of Congress surpluses and the related question whether the financial and the organizational responsibility for IFA Congresses should remain with the National Branches or whether it should be moved to Central IFA. A factual memorandum reporting on comparable organizations and the present involvement of Central IFA in the organization of Congresses was discussed in depth. It was felt that the whole matter is complicated and sensitive and the Blueprint Committee recommends further study. Another recommendation is for future Congress organizers to consult more closely with Central IFA as regards the selection of the Professional Congress Organizer (PCO) and a number of other items, including the choice of the Congress venue. Furthermore it was decided to recommend that Congress organizing branches be required to give full disclosure of the Congress finances not only for Central IFA to be in a better position to review whether centralization would be desirable but also to feed IFA's databank for the benefit of future Congress organizers. The Blueprint Committee will study a suggestion of a gradual involvement of IFA in the financial results of a Congress – be it a profit or a loss – starting e.g. with a 20 percent interest in the first year up to, say a maximum of 70 percent in the fourth year.

The idea to approach National Branches with requests to donate to scientific or other IFA projects (e.g. facilitating the attendance of government persons and/or young persons to Congresses) was met with approval and a recommendation to that effect was made to the Executive Committee.

The Committee approved draft Guidelines for IFA Regional Congresses which it prepared at the request of the Executive Committee to which same will be submitted before the August meeting in Stockholm.

MEMBERSHIP FEES

The General Treasurer will submit to the General Council and to the General Assembly a proposal to maintain the 1991 membership fees at the 1990 level:
- 105 Dfl. for individual members of National IFA Branches
- 115 Dfl. for direct individual IFA members, and
- 250 Dfl. for all corporate members.

It appeared that the increased membership fees for 1990 will be sufficient to offset the budgeted 1990 costs.

During the Stockholm Congress, Mr. Helmut Birk from Canada will be proposed as the new Chairman of the Finance Committee. On that occasion we shall have an opportunity to thank our Honorary Member from Austria, Prof.Dr. R. Halpern, for having fulfilled that function for more than 25 years.

NATIONAL BRANCHES AND MEMBERSHIP

Two new National Branches were recognized during the Rio de Janeiro Congress: Barbados and Bangladesh. The Bangladesh Branch was inaugurated on 5 June 1990 in the presence of many dignitaries, including the Vice President and the Finance Minister of Bangladesh. Mr. Karl Beusch wrote a special message of welcome to the new Branch.

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The Barbados Branch is involved in the organization of a Seminar on the Caricom Treaty.

During one of my trips to Stockholm I had the pleasure of attending a meeting of the Swedish Branch. In March I participated in the two-day meeting of the U.S. Branch in Philadelphia. A visit to Toronto gave me the opportunity to meet with several members of the Canadian Branch, to obtain a first orientation on our Congress venue in 1994 and to pay a visit to the Canadian Tax Foundation. As I explained in my previous Annual Report, I consider it of the utmost importance to be aware of the activities and the atmosphere in as many IFA Branches as possible and I intend to make more and repeated visits in the forthcoming years. Unfortunately a trip to Hong Kong and other countries in Asia and the Far East in November 1989 did not take place because the Hong Kong Regional Conference was cancelled due to a disappointing number of registrants. In the meantime the U.S. Branch is actively investigating the possibility of organizing a Pacific Basin Regional Conference in the spring of 1991 in Maui.

In view of the political and economic developments in Eastern European countries, the development of IFA membership there will be closely monitored and stimulated. Meetings will take place between representatives from Eastern European countries and IFA officers during the Stockholm Congress.

A satisfactory response was received from many Branches to send in more regular reports about their activities. A reflection of this can be found in the IFA News Column of the *Bulletin,* published by the International Bureau of Fiscal Documentation. Is it too ambitious to think of an IFA periodical with a circulation among the total IFA membership and filled with authoritative articles, reports on the activities of National Branches, international tax news items, etc.?

MITCHELL B. CARROLL PRIZE 1989

Only one entry was received this year, which is very disappointing from a quantitative viewpoint. Fortunately the quality of the work submitted by Dr. R.S. Martha from the Netherlands Antilles, "The Jurisdiction to Tax in International Law", was such that the jury was very pleased to award the prize to Dr. Martha.

Unfortunately, it has proved to be impossible to add Spanish as a fourth language in which entries to the prize may be submitted due to an insufficient number of candidates for jury membership who are fluent in the four IFA Congress languages.

On future occasions the official award of the Mitchell B. Carroll Prize will take place at the Opening Session of a Congress rather than on the final day, as this will be more agreeable and beneficial for the young prize winner.

I would finally make an appeal to all readers to do their utmost to promote the Mitchell B. Carroll Prize within their professional circles. Winning the prize can mean a lot in the international career of a young tax expert. Please apply to the General Secretariat should you require additional information.

THE 44TH IFA CONGRESS IN STOCKHOLM

The General Secretariat maintains a close and cordial liaison with the enthusiastic team of Swedish Branch members entrusted with the organization of the Congress, in particular with Prof. Sven-Olof Lodin and Mr. Peter Sundgren. We have great confidence in their achievements. The scientific and social programmes are tempting. Those of us who remember the 1967 IFA Congress in Stockholm have an additional reason to look forward to a renewed visit to that city which is at least as nice and attractive as 23 years ago. The Berns' Congress Centre is located in the middle of Stockholm, smallish perhaps and unusual, but interesting and beautiful. It will be a great advantage to have no transportation problems as almost everything is within walking distance. This also goes for the Concert Hall, where the Opening Ceremony will take place in the presence of his Majesty, King Carl Gustaf XVI.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

The library of the General Secretariat has been enriched with a complete set of publications by the IBFD. We are very grateful for this valuable gift which can be kept up-to-date because we regularly receive all supplements at no cost. As I indicated earlier, we highly appreciate the involvement of the IBFD in the work of the Permanent Scientific Committee. Their assistance in the preparation of the Stockholm Seminar, "International Tax Aspects of East-West Joint Ventures", is another token of the fruitful cooperation between IFA and the Bureau.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

Our "Ambassadors" Messrs. R. Baconnier (France), J.H. Guttentag (U.S.A.), H.M.A.L. Hamaekers (IBFD), and Richard M. Hammer, whose reports are contained in the IFA Yearbook, deserve our thanks. We are grateful for their information on the work of the other international organizations concerned. Mr. J.W.B. Westerburgen will report in future on the activities of UNICE and Mr. L. Halpern (U.K.) will report on the activities of ICC.

Prof. J.M. Rivier (Switzerland) attended the U.N. Ad Hoc Group of Experts on international cooperation in tax matters meeting in December 1989, a report of which is in the 1989 Yearbook. Mr. P. Olavarrieta (Mexico) was present for IFA at the May 1990 CIAT (Inter-American Center of Tax Administrators) meeting in Oaxaca, Mexico.

Mr. Bomi Daruwala (India) attended a round table discussion of UNCTC held in New Delhi in March 1990. His report is available from the General Secretariat.

I represented IFA at a CIAT meeting in Paris, and at the Tax Committee of the International Chamber of Commerce in Paris and I intend to keep in touch with these organizations on an ongoing basis. The same goes for the Instituto Latino Americano de Derecho Tributario and their biannual Jornadas, which I attended in Buenos Aires in 1989.

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7TH ASIAN-PACIFIC TAX CONFERENCE
PRACTICAL PROBLEMS OF INTERNATIONAL TAXATION

at the Hilton Hotel
Orchard Road, Singapore
26 & 27 November 1990

Organised By:
Asian-Pacific Tax and Investment Research Centre (APTIRC)
2 Nassim Road, Singapore 1025
Tel.: 2351954 Telefax: (65) 7331540
Telex: RS 50257 APTIRC

CONFERENCE THEME

It is probably true to say that any project or transaction which crosses international frontiers poses an international tax problem, and the taxpayer and his adviser have to determine how to prevent being doubly taxed on the same income – while at the same time the taxing authorities are concerned to prevent such legitimate planning from descending into tax avoidance or even tax evasion.

Developments in this area include measures for the mitigation of double taxation, such as extensive double taxation agreements, foreign tax credits, and guidelines for inter-company pricing of goods and services, while anti-avoidance measures also affect the same subjects through changes in legislation and tax treaties – changes which impose withholding taxes, limit foreign tax credits, and impose special treatment on inter-company transactions through tax havens, or treaty shopping, or operations through controlled foreign corporations.

Speakers have been chosen who are at the leading edge of development in their particular subject. The speakers will provide papers which deal with the general background and developments in their respective subjects. During the Conference they will be concentrating on the special features of their subjects which will be of most immediate interest to participants, with the aim of promoting an exchange of views and information: the solution to a given tax problem in one country may help in reaching a solution to a similar problem in another country, even though the tax regimes are different.

SPEAKERS

CHAIRMAN – MR. SIDNEY ROLT
International Tax and Financial Consultant, Deputy Chairman of APTIRC, Singapore.
The problems of international taxation

MR. LAURENCE CHAN
Partner, International Accounting Firm, Singapore
Treatment of holding companies, tax haven companies, and OHQs

MR. PETER S.A. EDWARDS
Partner, Johnson Stokes & Master (Solicitors), Hong Kong
Treatment of holding companies, tax haven companies, and OHQs

MR. IAN W. HARRIS
Group Tax Adviser, the Hongkong and Shanghai Banking Corporation, Hong Kong
Exchange gains and losses

MR. IAN LANGFORD-BROWN
Senior Partner, Deloitte Ross Tohmatsu, Sydney, Australia
Controlled foreign company legislation

PROFESSOR JOHN PREBBLE
Faculty of Law, Victoria University, Wellington, New Zealand (currently visiting Professor of Law at the University of NSW, Australia)
Trends in anti-avoidance legislation

MR. S. SIVALINGAM
Deputy Director General of Inland Revenue, Malaysia
Management fees, royalties and withholding taxes

MR. JAMES J. TOBIN
Director, International Tax Services, Ernst & Young, New York, U.S.A.
Foreign tax credit legislation

MR. MARTIN VAN DE VEN
Partner, Moret, Ernst & Young, Amsterdam, The Netherlands
Double taxation agreements – Transfer pricing developments

FEE

The Conference fee is S$ 1450 (US$ 830) to cover conference facilities, documentation, lunch and refreshments each day. The fee for members of APTIRC is S$ 1300 (US$ 745).

Group discount – 10% for two or more delegates from the same company.

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New Delhi, Singhania & Co., B-92 Himalaya House, 23 Kasturba Gandhi Marg, New Delhi 110 001, 1989, pp. 95.
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IRAN: THE TAXATION OF COMPANIES AND INDIVIDUALS 549

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L'auteur utilise le terme de "transactions globales" pour se référer à la capacité des intermédiaires financiers d'exécuter des ordres financiers et de prendre des positions exclusives dans les produits financiers sur les marchés mondiaux, 24 heures sur 24. Cet article fait ressortir les difficultés de répartir entre les juridictions les droits d'imposition des profits sur les transactions globales. L'article montre le haut degré d'intégration globale de cette industrie et expose les hypothèses économiques démodées sur lesquelles reposent les règles habituelles.

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Cet article insiste sur les points les plus importants de la loi égyptienne sur les investissements telle qu'elle a été amendée – une loi destinée à stimuler de nouveaux investissements privés et à rectifier quelques défauts de la Loi no. 43 qu'elle remplace. La garantie contre l'expropriation, le traitement équivalent quant aux frais de production et un certain nombre de suspensions d'imposition font partie des nouveaux avantages fiscaux prévus par la nouvelle législation.

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Der Autor benutzt den Begriff des Welthandels in bezug auf die Kapazität von Finanzvermittlern, die Kundenaufträge ausführen und Eigentumspositionen in bezug auf Finanzprodukte wahrnehmen. Der Schwerpunkt dieses Artikels konzentriert sich auf die Schwierigkeiten, zwischen Gerichtshoheiten zu unterscheiden, die derartige Gewinnrechte des Welthandels besteuern und solchen, die es nicht tun. Der Artikel illustriert das hohe Mass der weltweiten Verflechtung dieses Wirtschaftszweiges und zeigt die unzeitgemässen wirtschaftlichen Annahmen, auf denen die gegenwärtigen Regeln beruhen.

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Mahmoud Zoroofchi et Nicholas C. Webb:
Iran: Imposition des sociétés et des personnes physiques *549*
Bien que la loi sur l'imposition directe d'Esfand 1366 soit entrée en vigueur le 21 mars 1989, un certain nombre d'ambiguités subsistent qui doivent être expliquées par des règlements officiels – il reste a savoir comment certaines dispositions s'appliqueront dans la pratique. Cet article résume des aspects importants de l'imposition des sociétés et des personnes physiques en Iran.

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Iran: Die Besteuerung von Gesellschaften und Individuen *549*
Obwohl das neue Gesetz zur direkten Besteuerung (Direct Taxation Act of Esfand 1366) am 21. März 1989 in Kraft trat, müssen noch eine Anzahl von Unklarheiten durch offizielle Verwaltungsanweisungen geklärt werden, und es bleibt abzuwarten, wie gewisse Vorschriften in der Praxis angewandt werden. Der vorliegende Artikel gibt einen Überblick über die relevanten Aspekte der Gesellschafts- und Individualbesteuerung in Iran.

International: OECD-Steuerkomitee: Aktivitäten von 1971-1990 und das gegenwärtige Arbeitsprogramm *558*
Das vorliegende Dokument enthält eine kurze Zusammenfassung der Struktur, Arbeitsmethoden und Aktivitäten des OECD-Steuerkomitees seit seiner Gründung im Jahr 1971.

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INTERNATIONAL:

THE TAXATION IMPLICATIONS OF GLOBAL TRADING

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I. INTRODUCTION

The term "global trading" as used in this article refers to the capacity of financial intermediaries to execute customer orders and to take proprietary positions in financial products in markets around the world and around the clock.[1] The financial intermediaries that trade globally are primarily banks (both commercial and investment)[2] and securities dealers.[3] Global trading also is conducted by other financial intermediaries, such as insurance companies, commodities brokers,[4] and by suppliers and users of capital or goods.[5] The products that are traded globally cover the range of financial instruments. Most currencies, many debt instruments, and some equities and other financial assets evidencing ownership in property are traded globally, as are derivative products such as forwards, futures, options and swaps.

For many products there exists a primary trading market where the bulk of trading in that product occurs.[6] Secondary markets play a vital role when the primary markets are closed, particularly in times of crisis, when volume may swell dramatically.[7] A measure of how globally a product is traded is the average liquidity of that product and the efficiency of hedges for that product outside the primary trading market.[8] Foreign exchange is widely regarded as the most globally traded product, though liquidity in many currencies drops at various times within a 24-hour period, particularly between 7 to 11 p.m. G.M.T., when market-moving news rarely emerges from London, New York or Tokyo.[9] Gold, silver and U.S. treasury bonds are next, followed by oil, money market instruments, securitized assets, derivative products and certain equities.[10]

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1. The same activity is sometimes referred to as "24 hour trading", a term which emphasizes the time dimension rather than the geographical dimension. Compare, KPMG, *Global Capital Markets* (1988), at 28 (distinguishing "24 hour trading" – trading a portfolio 24 hours a day – from "global trading" – the involvement of different business units from around the world in a single transaction). The term "financial intermediary" is used to reflect the trend toward structural integration of banks, securities dealers, insurance companies, etc. See Debs, "Globalization of Financial Markets: "What is Happening and Why", 15 *Int'l Bus. Law.* (1987), at 198, 201.

2. See, statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Task Force on the International Competitiveness of U.S. Financial Institutions, Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (4 April 1990), reprinted in *Federal Reserve Bulletin* (June 1990), at 439.

3. *Report of the Staff of the United States Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, Internationalization of the Securities Markets*, 99th Cong. 2d Sess. (27 July 1987) [hereinafter "*Internationalization Report*"].

4. Diamond, B., "24 Hour Trading: The Global Network of Futures and Options Markets", Wall Street Journal, 26 September 1989, at C1, col. 3 (discussing global trading of commodities swaps in oil and metals).

5. Capital suppliers, primarily large institutional investors, may develop global trading capabilities to manage global portfolios. See Makin, "How to Manage a Global Money Manager", *Institutional Investor* (April 1990), at 74 (discussing different philosophies of organisation of global investment firms). Capital users, such as large corporate borrowers, may also develop such capabilities as an extension of the corporate treasury department to manage their capital needs. See Roden, "Forex Funding Free of Banks", *Euromoney* (May 1989), at 24 (discussing disintermediation in foreign exchange services). Because of the complexity of the markets and the significant commitment of resources required, such in-house global trading capabilities are rare. For discussions of in-house capabilities at petroleum companies, see *Chevron World* (Summer 1983), at 13; *Oil Magazine* (February 1985).

6. For example, most U.S. Treasury, U.S. corporate, and "Yankee" (issued by foreign companies to U.S. investors) bonds trade in the United States; most Eurobonds trade in London. Due largely to specialized local knowledge, liquidity and efficient hedging, the primary trading market for debt securities is either the market of the currency in which the security is denominated or the Euromarket. *Internationalization Report, supra* note 3, at 38. See also "Sorry, It's Still a 12 Hour Day", *Special Supplement to Euromoney* (June 1989), at 22.

7. U.S. Congress, Office of Technology Assessment, *Trading Around the Clock: Global Securities Markets and Information Technology – Background Paper* (July 1990), at 23 [hereinafter cited as "*Technology Report*"]. In stable times, the secondary markets may be used for tax and regulatory arbitrage.

8. This is because liquidity generally equates to demand, and as a definitional matter a product is "internationalized" or "globalized" if it is in demand outside the national market. See generally, Thomas, "Internationalization of Securities Markets: An Empirical Analysis", 50 *Geo. Wash. L. Rev.* (1981), at 155. See also, *American Banker* (30 July 1987), at 11 (comparing trading volumes in foreign exchange – London $90 billion, New York $ 50 billion, Tokyo $ 48 billion – with U.S. Treasuries – London $ 2.5 billion, New York $ 95.4 billion, Tokyo $ 5 billion).

9. Dickins, "Round the Globe, Round the Clock", *Corp. Fin.* (June 1989), at 18, 23 (describing activity throughout world's currency markets in a 24 hour period). *American Banker* (30 July 1987), at 11 (describing activity and causes of 24 hour trading).

10. A 1987 survey of 45 leading financial services institutions found that foreign exchange was most traded globally, with disagreement of whether equities, debt instruments or commodities were next. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 18. See also "Markets Far and Wide", *Fin. World* (16 September 1986), at 106, 107 (citing global trading of debt – Eurodollar syndications and U.S. Treasury bonds – and equities – shares of L.M. Ericsson and Imperial Chemical Industries); Glynn, "A Day – and Night – In the Life of the Global Market" *Institutional Investor* (April 1986), at 293, 302 (120 minute gap between New York's close and Tokyo's opening is the only pause in the 24 hour market for U.S. Treasuries); Debs, "The Development of International Equity Markets", 4 *B.U. Int'l L. J.* (1986), at 5, 6, (defining global markets as "markets with no national boundaries, established by supply and demand from around the world and not predominantly from a single domestic market"); *Technology Report,* supra note 7, at 2, 23 and 32-3.

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The primary trading markets are often located at centers of large organized exchanges. Measured by numbers of participants, a 1987 survey of 45 leading financial services institutions revealed that almost all operated in New York, London and Tokyo.[11] A majority also operated in Hong Kong, Sydney, Zurich, Chicago, Singapore and Toronto, and, to a lesser degree, Frankfurt, Paris, Amsterdam, Brussels and Los Angeles. Inter-exchange linkages among organized exchanges and networks of formal data communication facilities (variously called "interbank markets", "upstairs exchanges" or "telephone markets") contribute to liquidity in secondary markets.[12]

II. THE CONTEXT AND OPERATION OF GLOBAL TRADING

A. Internationalization of capital markets

This section reviews the context of global trading and then analyzes the activities of multinational financial intermediaries. Three broad processes contribute to the economic integration of the world's capital markets: technological development, financial innovation and the political economy.[13] Advances in communication technology (such as satellite linkages, fiber optic cable and microwave signals) permit greater numbers of well-informed investors to participate, and enable participants to profit from arbitrage of price anomalies.[14] Data processing advances (high speed computers with software that reports deals, measures and tracks risk positions, marks products to market, and interrelates such information) bring under control the riskiness of global trading.[15] Innovative financial instruments permit more firms to conduct international transactions protected against currency, interest rate and credit risk.[16] Finally, economic integration is advanced by the modern political economy, particularly its adherence to the philosophy that unrestricted capital movement promotes international economic growth and stability.[17] The resulting condition is an efficient global capital market: large numbers of interested, informed, and active issuers, investors and traders participate to lower transactions costs, close earnings differentials between markets, impound new information quickly into prices and efficiently allocate capital.[18]

At a more specific level, global trading increases the profits of the three major classes of market participants: capital users, capital suppliers and financial intermediaries. Capital users (i.e. corporate borrowers) use global trading for liability management, incorporating it in financing decisions to lower funding costs (they may take advantage of market opportunities by issuing a debt instrument in a foreign market, or creating a synthetic that would replicate such an issuance) and to diversify funding sources out of concern with their ability to obtain funds in the future, particularly in a market or company crisis.[19] A corporation's hedging strategy also may call for a product on an overseas exchange.[20] Capital suppliers (commonly large institutional investors, such as pension fund trustees and plan sponsors) use global trading for asset management.[21] They use global trading to implement asset allocation strategies that benefit

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11. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 5.
12. Cox & Michael, "The Market for Markets – Development of International Securities and Commodities Trading", 36 *Cath. U.L. Rev.* (1987), at 833; *Technology Report,* supra note 7, at 11. Organized exchanges compete with in-house trading links. "Each exchange is involved in a bitter struggle with every other exchange for that most precious of financial commodities: liquidity. If an exchange loses it – either to other exchanges or to the growing telephone market – it is dead". Clements, "A Whale of a Sales Drive", *Euromoney* (May 1986), at 176.
13. Economists describe economic integration as both a process and a condition. As a process it is the gradual removal of impediments, whether imposed by governments or existing because of time or distance, to movements of goods and services between economic units under the jurisdiction of different nations. B. Belassa, *The Theory of Economic Integration* (1961). As a condition it is one in which impediments are absent, differential earnings opportunities are quickly seized upon, and market prices are established by supply and demand from larger, more international sources. Id. Cooper, "National Economic Policy in an Interdependent World", 76 *Yale L.J.* (1967), at 1273; R. Sannwald & J. Stohler, *Economic Integration: Theoretical Assumptions and Consequences of European Unification* (1958). See generally, *Internationalization Report,* Chapter II, supra note 3; *Technology Report,* supra note 7, at 25-8.
14. *Technology Report,* supra note 7, at 11.
15. "Risk Management: Taming the Demon", *A Supplement to Euromoney* (April 1989), at 56. The combination makes electronic marketplaces possible. See Hansell, "The Wide, Wired World of Electronic Exchanges", *Institutional Investor* (September 1989), at 171 ("trading occurs in the dimensionless geography of a computer network"); Marcom, "Welcome to Hauppauge, the World's Next Financial Capital", *Forbes* (30 October 1989), at 143 (discussing Reuters' order-execution system); Becker, "Global Securities Markets", 6 *Int'l Tax & Bus. Law.* (1988), at 242, 244 (exchange linkages include facilities for routing orders to buy or sell securities or commodities between two markets, for sharing quotation and other market data information, for permitting fungibility of options and other derivative products, and for establishing relationships between a futures market and the underlying cash markets). See *American Banker* (30 July 1987), at 17, 27 (describing technology in trading rooms).
16. Financial innovation enables the control of market risk, credit risk and other performance characteristics of a financial instrument. Financial innovation is the process of unbundling and repackaging those performance characteristics to create new instruments. Bank for International Settlements, *Recent Innovations in International Banking* (April 1986), at 169. Many innovations were created in response to the volatility resulting from (among other things) the collapse of the gold standard in March of 1973, the targeting of the money supply by the Federal Reserve after 1979 and the sovereign debt crisis of 1982. "Risk Management: Taming the Demon", *A Supplement to Euromoney* (April 1989), at 3, 8-10 (summary history of the development of derivative financial products). Thus, today's markets offer products such as currency and interest rate swaps to transfer the risk of price volatility, and securitized assets to transfer credit risk and to enhance liquidity. See S. Partridge-Hicks & P. Hartland-Swann, *Synthetic Securities* (1989). These are used in conjunction with management innovations such as indexation, futures and options hedging strategies, portfolio optimization, securities lending, portfolio restructuring and off-exchange trade matching. C. Stoakes & A. Freeman, *Managing Global Portfolios* (1989).
17. This process began after the Second World War as a result of the Bretton Woods agreement. See e.g. Articles of Agreement of the International Monetary Fund, 60 Stat. 1401, T.I.A.S. 1501; Bretton Woods Agreement Act, Pub. L. No. 171, 59 Stat. 512, 79th Cong., 1st Sess. (31 July 1945); SEC Study, *The Securities Markets in the 1980's: A Global Perspective* (26 January 1989).
18. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work", 25 *J. Fin.* (1970), at 383. See Gillman, "October Crashes Prove Global Outlook a Luxury No More", *Pension World* (April 1990), at 14 (citing studies that find low correlation among world stock and bond markets); New York Times, 6 March 1990, at D1, col. 2 (finding no firm global links in interest rate movements); *Technology Report,* supra note 7, at 6, 28.
19. See Showers & Blanton, *Hedging and Financing Strategies for the Corporate Borrower* (Solomon Brothers, Inc. 1987). Overseas stock listings also enhance corporate image and reduce the risk of hostile takeovers. "Wall Street Goes Global", *U.S. News & World Rep.* (24 March 1986), at 52, 53.
20. "Risk Management: Taming the Demon", *A Supplement to Euromoney* (April 1989), at 3 ("Most corporations...borrow on the calculation that their investment in new capital...will generate sufficient returns to service the debt and make a profit. If interest rates rise this return on the investment is reduced or eliminated".).
21. C. Stoakes & A. Freeman, *Managing Global Portfolios* (1989).

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from international diversification[22] and higher returns;[23] and use it defensively to make portfolio adjustments in volatile markets.[24]

Financial intermediaries make money by servicing the needs of capital users and suppliers.[25] They earn commissions and bid/ask spreads from brokering and dealing globally-traded instruments that evidence ownership in an underlying item, and they earn fees and spreads from trading risk in the form of derivative financial products.[26] They also earn fees by providing global custody and research services for investors.[27] Intermediaries must be able to make markets in a variety of products in order to cross-hedge and hence deliver the products clients want quickly and cheaply. Access to the widest spectrum of clients or counterparties when dealing in complex instruments makes it easier to find customers with offsetting needs.[28] Without the capacity to make markets, an intermediary will be outpriced if the price quoted a client reflects the bid/ask spread paid to a market maker and a profit for the intermediary itself.[29]

Financial intermediaries also use global trading to satisfy their own portfolio needs.[30] Global trading facilitates asset and liability management, which essentially involves bringing a firm's global balance sheet under unified management, maximizing profit (by maximizing the return on assets and minimizing the cost of liabilities) and minimizing risk (by matching the denomination, interest sensitivity and maturity of assets with liabilities).[31] Global trading also facilitates access to a variety of funding sources, thereby diversifying the risk that a bank may be unable to tap a particular source of capital to meet its continuing obligations.

Financial intermediaries also profit in the global markets by trading for their own account. The primary source of revenue of a global trading operation is from speculating and taking positions with respect to movements in prices (including interest rates and exchange rates).[32] This means that operating revenues of a global trading operation are essentially a function of price movements and the size of positions. Finally, their access to capital and investment in communications and data processing places them in an advantageous position to capitalize upon arbitrage opportunities, including tax and regulatory arbitrage.[33]

B. Organization of global trading operations

Given differences in management philosophies, investment in technology, market strategy, and other factors, few generalizations are possible regarding the way financial intermediaries organize global trading operations. However, one generalization is that the trading operation is made up of four elements: trading, management, sales and support.[34] A global trading operation pivots on the skill of its traders. Traders make two critical decisions on behalf of their firm: they quote prices that initiate buy and sell transactions, and they decide whether and how to hedge. Within parameters set by the strategist and senior management, traders are extremely autonomous in these decisions. They are grouped according to broad product types and are articulated more and more finely until at the individual level a trader is very specialized in a product and has broad discretion in its pricing.[35] In deciding upon a quote and whether to hedge, they must integrate three often unquantifiable conditions: (1) their knowledge of the firm's needs, (2) the client's needs, and (3) their expectations of price movements in the market. Ideally, a quote minimizes the position exposure of the firm and maximizes turnover. Other responsibilities of traders include making orderly markets in products for which the firm acts as a dealer and ensuring proper execu-

22. International asset allocation is used to diversity risks peculiar to a national economy. See Arnott & Henrickson, "A Disciplined Approach to Global Asset Allocation", *Financial Analysts J.* (March-April 1989), at 17.

23. Gillman, "October Crashes Prove Global Outlook a Luxury No More", *Pension World* (April 1990), at 14 (global portfolios are imperative because October market breaks have not altered statistical arguments for international diversification, widespread information and global investment management increase potential for market volatility); Bartow, "Funds Seek Global Fixed Income Alternative", *Pension World* (April 1990), at 10 (arguments for international diversification of portfolios).

24. Because technology enables instantaneous and widespread availability of information, market participants require the ability to respond quickly to potentially threatening developments. Such capabilities also allow participants to react to news that breaks after their local markets close. "Markets Far and Wide", *Fin. World* (16 September 1986), at 106, 107.

25. Competitive pressures to maintain customer satisfaction, defend market position and expand distribution power motivate many financial intermediaries to develop global trading capabilities. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987); KPMG, *Global Capital Markets* (1988).

26. A corporation that is a market maker in a particular security owns, finances and maintains an inventory in that security.

27. "Global Custody: Speeding the Paperchase", *A Supplement to Euromoney* (March 1989). Lewis, "The Shakeout in International Research", *Institutional Investor* (November 1989), at 67.

28. "Risk Management: Taming the Demon", *A Supplement to Euromoney* (April 1989), at 5; Brady, "How to Tailor your Assets", *Euromoney* (April 1990), at 83, 84 ("The key to the success of these deals has been the swap and option books of the arranging banks. The availability of the appropriate derivatives dissociates investor preference from that of the borrower. Investors get the cash flows they require, borrowers get cheap financing."). Traders may hedge by selling securities short and hoping to buy them back at a lower price. "Endless Dealing: U.S. Treasury Debt is Increasingly Traded Globally and Nonstop", Wall St. J., 10 September 1986, at 22, col. 1.

29. "Risk Management: Taming the Demon", *A Supplement to Euromoney* (April 1989), at 5. Strategically, some intermediaries prefer to be virtually fully hedged, so that they and not the counterparty can dictate terms.

30. For example, in response to the sovereign debt crisis of 1982, bank regulators required higher capital ratios, forcing banks to adjust their portfolios by selling low margin assets and generating income without use of their balance sheet (i.e. fee generating activities). Many financial intermediaries repackaged financial assets in standard forms to facilitate trading and offered them for sale in a manner similar to traditional securities (hence the term "securitization"). Global trading facilitated the marketing of securitized assets by matching the bank's portfolio needs with those of capital suppliers, who need to adjust their portfolio risk and return profiles to changing market conditions – securitized assets are traded continuously. See generally, S. Partridge-Hicks & P. Hartland-Swann, *Synthetic Securities* (1988).

31. Moskowitz, "Global Asset and Liability Management at Commercial Banks", *Fed. Res. Bank N.Y. Quart.* (Spring 1979), at 42. Brady, "Dressing Up, Without a Killing", *Euromoney* (April 1990), at 77 ("A bank with more fixed-rate liabilities than assets can use a swap, in which it pays floating and receives fixed, as a bond or loan substitute.").

32. See Cornish, "When the Trader May Relax", *Euromoney* (February 1989), at 71 ("Put through business from tame retail clients is not a big feature in today's competitive markets".). Glynn, "A Day – and Night – In the Life of the Global Market", *Institutional Investor* (April 1986), at 293 (mentioning proprietary trading); "Endless Dealing: U.S. Treasury Debt is Increasingly Traded Globally and Nonstop", Wall St. J., 10 September 1986, at 1, col. 2 (same).

33. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 5. "How Merrill Lynch Moves its Stock Deals All Around the World", Wall St. J., 9 November 1987, at 21, col. 4. (describing the taking of an arbitrage opportunity).

34. These elements are not always distinct, as salesmen can act in product development or be given limited discretion to trade, strategists can be both senior management and head traders, traders can also have clients in the same way as salesmen.

35. Cornish, "When the Trader may Relax", *Euromoney* (February 1989), at 71.

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tion of brokered transactions. Because their performance so directly determines the profitability of the firm, they often are compensated primarily by a bonus (in addition to a base salary) that is based on profitability of the book as a whole.

Overseeing the trader is the strategist or trading manager, who might himself be a head trader, a risk manager or a senior manager. The strategist is responsible for coordinating and implementing the worldwide trading strategy of the firm, and continually attempts to identify market themes. Based on his determinations he might direct the salesmen to push particular products, or direct traders to limit or extend a particular position.[36] He also is responsible for controlling and monitoring the level of risk to which the institution is exposed, and may manage this by setting absolute trading limits, or by restricting trading in individual products, issuers, economic sectors or national markets.[37] In some organizations some of the decisions that require less reaction time are made by senior management, who also make decisions regarding the use and compensation of human resources, the shifting of managerial authority overseas and cooperation among trading centers. A salesman's primary responsibility is to the customers of the firm in connection with their purchases and sales of products. Salesmen often advise clients regarding asset, liability or risk management, and must be well informed about the client's needs. Salesmen use "scenario modelling" to analyze and illustrate the impact of a particular security or financial product on a client's portfolio or risk profile. Salesmen obtain quotes for clients from the traders and receive commissions from the firm for transactions procured.

Global trading relies heavily on technology; thus, the support element's primary responsibility is to provide systems that assist the foregoing three elements.[38] The support element must deliver systems that communicate the position of the trading book worldwide and give traders current information on prices, quotes, past trades, volume, price direction and exchange rates.[39] The support staff must provide a fully integrated system for the strategist and senior management to monitor exposure, tighten controls and enhance reporting.[40] The salesmen need equipment for modelling the client's asset and liability portfolios to explore alternative scenarios and recommend a strategy.[41] Support staff also are responsible for transactions settlement, accounting, payment, invoicing and reconciliation.[42] In addition to operations staff, financial engineers[43] and economic analysts[44] support a global trading operation.

A second generalization regarding global trading relates to the location of these elements. Traders are localized in major trading centers.[45] Head traders or strategists usually also are located in those trading centers. Risk managers and more senior management may be centralized in the head office or in the primary trading market for a particular book. Salesmen usually are localized in the geographic area of their customers. Support staff usually are localized where demand is heaviest, with functions that have firm-wide application located in the head office.

A third generalization is that the basic unit of organization is the book, defined essentially as the firm's trading position.[46] A distinctive feature of global trading is "passing" the book from time zone to time zone around the clock.[47] This does not mean that the location of inventory passes; ordinarily there is no transfer of legal title at the end of a trading day in one jurisdiction.[48] Inventory usually remains located

36. "How Merrill Lynch Moves its Stock Deals All Around the World", Wall St. J., 9 November 1987, at 21, col. 3.

37. *Technology Report*, supra note 7, at 35-6.

38. Id at 19.

39. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 21 (traders must monitor trading on-line in real time). Traders also need systems that enable them to price derivative products correctly, and to avoid wasted efforts, such as duplicating hedge positions or trading against customers or colleagues for the same position. Marion, "Creating a Global Book", *Institutional Investor* (March 1987), at 231, 232.

40. Marion, "Creating a Global Book", *Institutional Investor* (March 1987), at 231, 232 (deal makers need position reports, profit and loss statements, and firm-wide or specific client risk exposure analysis for all centers for all products). The more knowledge a firm has, the more comfortable it is with larger levels of risk. Therefore, the efficiency with which information can be aggregated from different sources, processed, and acted upon is central to a firm's profitability. Shale, "The Great Risk-Management Systems Failure", *Euromoney* (February 1989), at 66 (describing information needs as evolving from mere assessment of risk to its pin-pointing minute by minute and the analysis, interpretation and distribution of firm and market data). Reporting of transactions is essential to update computations of exposure, to efficiently allocate capital to particular clients or lines of business, or to limit trading with a particular customer or in a particular market. Managers assess trader performance by monitoring the type and size of traders' bets and the results. Marion, "Creating a Global Book", *Institutional Investor* (March 1987), at 231, 232. Most systems are developed in-house, although some are available commercially from, for example, Reuters and General Electric. See, e.g. Advertisement for GE Information Services, *Euromoney* (October 1988), at 41.

41. "Risk Management: Taming the Demon", *A Supplement to Euromoney* (April 1989), at 5; Marion, "Creating a Global Book", *Institutional Investor* (March 1987), at 231 ("A salesman in a gilt customer's office in Tokyo uses a local telephone connection to dial into our network with a portable computer...That puts him in touch with the London system for inventory, rate, availability and price information. We don't need an office in Tokyo to distribute British instruments.").

42. *Technology Report*, supra note 7, at 55-70 (describing clearance and settlement).

43. These are the "lightbulb heads" that develop innovative financial products. See Hu, "Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm", 138 *U. Penn. L. Rev.* (1989), at 333, 339 (also called "quants", "rocket scientists" and "rocketo kagakushas"). Tax specialists are sometimes integrated in this process to take advantage of tax differences. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987).

44. Glynn, "A Day – and Night – In the Life of the Global Market", *Institutional Investor* (April 1986), at 293.

45. Cornish, "When the Trader may Relax", *Euromoney* (February 1989), at 71 ("The classic trading organisation is decentralised".); Makin, "How to Manage a Global Money Manager", *Institutional Investor* (April 1990), at 75 (quoting fund manager's ideal organizational culture: "You want the greatest degree of laissez-faire *without* chaos".).

46. The positions in the book are tracked electronically. Glynn, "A Day – and Night – In the Life of the Global Market", *Institutional Investor* (April 1986), at 293 ("The firm's trading position is spelled out on the screens of an in-house computer system, which, among other things, enables trading managers to monitor the firm's market exposure, profit and loss and inventory on a real-time basis".).

47. "Endless Dealing: U.S. Treasury Debt is Increasingly Traded Globally and Nonstop", Wall St. J., 10 September 1986, at 1, col. 1 (describing passing the book as "ceaselessly relaying around the globe the responsibility for executing market orders and managing securities holdings for their own firms and their firms' customers".). See also Burgess, "The Sun Never Sets on the World's Linked Markets", Wash. Post, 1 November 1987, at H1, col. 4 (Merrill Lynch equities); "Round the Globe, Round the Clock", *Corporate Finance* (June 1989), at 18 (Alexanders Rouse currency trading); "When the Day Never Ends", N.Y. Times Mag., 29 November 1987 (personal life of a 24 hour trader).

48. See R. Gordon, S. Greenberg, and S. Rosen, paper entitled "Global Trading: Tax Issues in Intercompany Pricing of Securities Transactions", delivered at the American Tax Institute in Europe conference, Intercompany Pricing USA/Europe: Developments, Strategies and Planning (Paris: 18-19 June 1990) [hereinafter cited as *"Paris Paper"*] ("It would be *impossible* to actually pass the formal ownership responsibilities along with trading discretion from entity to entity, because such an approach would require, for example, that the financing obligations and the regulatory capital requirements associated with the securities also be assumed anew by each entity at the beginning of each trading day in that jurisdiction.").

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in the primary trading market,[49] unless regulatory or other factors make it preferable for firms to locate inventory outside the primary trading market.[50] Where a product is so widely traded that there is no single primary trading market (such as the eight major currencies),[51] or is traded as a commitment without "inventory" in the common sense (such as with derivative products),[52] any particular entity may be designated as "owner" of the inventory of the book.[53]

What does pass is the location of trading authority.[54] When trading authority is passed, the receiving center usually is not a distinct profit center operating wholly autonomously because, among other reasons, of the fear of passing a well-crafted position only to "receive it back next morning in a real mess".[55] Instead, most firms operate in a "one profit center mode". A profit center is defined in accounting literature as "the smallest units of activity for which revenue and expense information is accumulated for internal planning and control purposes".[56] A profit center that crosses national boundaries and operates as a unit maximizes the worldwide profits of the book.[57] A centralized book also provides the advantages of 24-hour service, integration of all risk management products and access to the bank's global network. In order to encourage teamwork, traders are compensated based on the profits of the entire book.[58]

III. APPORTIONMENT OF THE PROFITS FROM GLOBAL TRADING

A. OECD model treaty

In the framework of treaties based on the OECD model treaty, the rights of each state to tax the profits from global trading are determined by the presence of an enterprise within a jurisdiction and the extent to which profits are connected with that presence.[59] The two measurements of jurisdictional presence are the existence of an enterprise of a contracting state and the existence within one contracting state of a permanent establishment of an enterprise of another contracting state. The first measurement is generally interpreted according to the provisions of the domestic laws of the contracting states, and is not defined in the OECD model treaty.[60] The second measurement is determined under Article 5 of the OECD model treaty. That article looks to the assets – fixed places of management, branches, offices, factories – within a contracting state.[61] It also looks to agency relationships within a contracting state; dependent agents of an enterprise may create a permanent establishment, independent agents do not.[62]

Both measurements of jurisdictional presence arise in global trading, as operations are conducted both through separate subsidiaries in each trading center, and through branches in each trading center (or a combination of branches and subsidiaries).[63]

Where operations are conducted through subsidiaries, it is of course not difficult to determine whether a particular subsidiary is organized under the laws of a contracting state. Where operations are conducted through branches, the investment in technology necessary to operate a trading center likewise makes it easy to determine whether there are sufficient assets to constitute a permanent establishment. The difficulty arises in operations conducted through subsidiaries in determining whether a resident subsidiary is a dependent agent of a foreign subsidiary such that the foreign subsidiary has a permanent establishment in the contracting state.[64] As discussed below, distinguishing dependent from

49. Glynn, "A Day – and Night – In the Life of the Global Market", *Institutional Investor* (April 1986), at 293, 306 (New York is the firm's center of gravity for trading U.S. Treasuries: when New York is open, the London operation merely services clients that call for bids or offers but otherwise has no desire to adjust its own proprietary book).
50. "Markets Far and Wide", *Fin. World* (16 September 1986), at 106, 109 ("The penalty for failing to liberalize [markets] can be stiff, however; primary markets for shares in domestic companies may materialize in other exchanges with more flexible trading rules").
51. See also *Paris Paper*, supra note 48 (citing yen equity warrants as a product for which there is no single primary trading market).
52. In derivative products trading, interest rate or other spreads are traded. Specific commitments usually are not sold so that customer relationships are retained.
53. See *Paris Paper*, supra note 48 (presenting facts under which credit and capital concerns call for location of yen swap book in U.S. affiliate).
54. *Technology Report*, supra note 7, at 32. This is sometimes called "trading off the book" to distinguish from the use of "passing the book" to describe passing inventory.
55. The idea is akin to "someone else playing with your sand castle while you are away for lunch", KPMG, *Global Capital Markets* (1988), at 16.
56. Financial Accounting Standard No. 14, para. 13.
57. "How Merrill Lynch Moves its Stock Deals All Around the World", Wall St. J., 9 November 1987, at 21, col. 1. ("At the end of each U.S. trading session, the two Americans pass on to Merrill's Tokyo traders the stock position in their Japanese "book" as well as whatever market intelligence they pick up. Despite their positions on three continents, all five members of the Japanese-stock trading team share a single profit and loss statement. Another stock "book" is traded via Hong Kong instead of Tokyo; still others shuttle between only two cities. Most U.S. stocks, for example, are traded largely by the Merrill offices in the United States and London because they remain thinly traded in Japan"). See also, "Meetings are Shifted by Chase", New York Times, 21 July 1990, at 17, col. 6 ("To improve the performance of the global finance group. . .the practice of measuring bankers' performances by earnings of each profit center would be de-emphasized and replaced by measures of market share, rankings compared with other banks and the total amount of revenues from a corporate client. Under the new system... a European-based banker would be more willing to work with a European company on a financing for a South American affiliate, even though the profit from the transaction might be recorded by the South American banking group").
58. Hunter, "The Status and Evolution of Twenty-Four Hour Trading: A Trader's View of International Transactions, Clearance, and Settlement", 4 *B.U. Int'l L.J.* (1986), at 15, 17 ("One of the earlier mistakes made by American firms was to pass the book out to Tokyo and have a few local people executing who were really interested in only getting volume or production credits because that is how they were paid. So if someone came in and bought the first offering, they would leave the offering there and he would buy twenty more offerings. So by the time you got through your whole offering list you have been picked pretty dry. What we have done is tried to blend the trading motivations with the local desire to do volume.").
59. Para. 1, Commentary on Art. 7, *Model Double Taxation Convention on Income and on Capital*, Organisation for Economic Co-operation and Development (1977) [hereinafter "OECD model treaty"].
60. Para. 4, Commentary on Art. 3, OECD model treaty.
61. See Art. 5, paras. 1, 2 and 3 OECD model treaty; and Para. 2, Commentary on Art. 5 OECD model treaty. Certain assets detailed in Art. 5, para. 4, OECD model treaty do not comprise a permanent establishment. Under Art. 5, para. 7, OECD model treaty, ownership of stock of a controlled company does not of itself constitute a permanent establishment.
62. Compare Art. 5, para. 5, OECD model treaty (and paras. 30-34, Commentary on Art. 5, OECD model treaty) with Art. 5 para. 6, OECD model treaty (and paras. 35-38, Commentary on Art. 5, OECD model treaty). See generally, Williams, "Permanent Establishments in the United States", 29 *Tax Law.* (1984), at 277.
63. Securities firms often operate through separate subsidiaries for regulatory reasons. See Hunter, "The Status and Evolution of Twenty-Four Hour Trading: A Trader's View of International Transactions, Clearance, and Settlement", 4 *B.U. Int'l L.J.* (1986), at 15, 17 (referring to operation through subsidiaries). Banks more often operate through branches. Regulatory considerations in a particular country may dictate operation through a branch of a subsidiary incorporated in a third country.
64. For a discussion of the factors important to make the distinction, see S. Roberts & W. Warren, *U.S. Income Taxation of Foreign Corporations*

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independent agents in this context rarely alters the profits taxable by the contracting state; thus, often it is a distinction without a difference.[65]

When an enterprise carries on business within a contracting state, the OECD model treaty provides an agreed principle of reference by which the profits made by an enterprise trading with a foreign member of the same group of enterprises, or made by a permanent establishment, are to be calculated.[66] This principle, contained in Articles 7 and 9 of the OECD model treaty, known as the arm's length principle, is that the profits charged on transactions between such parties should be calculated on the assumption that they are arm's length prices – those that would have been paid between unrelated parties for the same or similar goods or services under the same or similar circumstances.[67] The principle is elaborated upon in subsequent OECD reports. In general, the examination of transfer prices begins with an analysis of the functions of various entities,[68] and with a recognition of actual payments and transactions.[69] Because the attribution of profits to the management, sales and support elements do not present novel issues, this article will focus on attribution of profits to the trading element.[70]

The application of the arm's length principle to transactions between a trader in one jurisdiction and a trader in another jurisdiction is not discussed in OECD publications.[71] The two closest analogies are the discussions of transactions in goods and on the performance of services. The transactions in goods paradigm would cast traders as purchasers or sellers of goods: global trading would equate to one trader acquiring a product in one jurisdiction and selling it to another trader for resale in the other jurisdiction. Under this paradigm it is important to ascertain whether a trader is acting as a principal or as an agent.[72] If he acts as a principal, he accepts all the risks and therefore is entitled to the profits of an activity.[73] If instead he acts as an agent for another trader, he accepts only limited risks and therefore is entitled only to a limited return.[74] The results should be approximately the same if trading is conducted through branches.[75]

In practice, this paradigm is difficult to apply to global trading. Assume that a United States corporation maintains an inventory of U.S. treasury bonds, and that trading authority passes to an affiliated Japanese corporation when U.S. markets are closed. A salesman of the Japanese corporation contacts the trader in Japan, obtains a quote and makes a sale. If instead the security is sold to the Japanese corporation and then resold to the client, it may be argued that the Japanese trader acted as principal and therefore is entitled to all the profit less a commission paid to the U.S. corporation as purchasing agent.[76] If the security is sold directly to the client, and the Japanese trader acted as agent for the U.S. corporation, the U.S. corporation would be entitled to all the profit less a sales commission to the salesman and a brokerage fee to the Japanese trader. In practice the distinctions between principal and agent blur in an integrated global trading operation.[77]

The performance of services paradigm would cast traders as owners or managers of portfolios: global trading would equate to the ownership of a portfolio by a trader in one jurisdiction and its management by a trader in another jurisdiction.[78] The entity with the inventory would bear the burdens of ownership (raising capital to finance inventory, supporting operations and clearance, taking risks) and should be entitled to the profits less investment management fees to traders in other entities. This paradigm also encounters practical difficulties when applied to global trading: any particular entity (such as a tax haven entity) or a number of entities may be designated as "owning" inventory of widely traded products or derivatives, no particular permanent establishment can truly be said to be the "owner" when operations are conducted through branches, and a hedge might be owned by an entity other than the owner of the inventory.[79]

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and Non-resident Aliens, pp. IX – 167, 168; Nitikman, "The Meaning of "Permanent Establishment" in the 1981 U.S. Model Income Tax Treaty". 15 *Int'l Tax J.* (1989), at 257.

65. See para. 2, Commentary on Art. 7, OECD model treaty (drawing equivalence between profits attributed under Art. 7 with those attributed under Art. 9). *Cf.* paras. 15-23, Commentary on Art. 7, OECD model treaty (discussing three areas of difference between profits attributed under Art. 7 and those attributed under Art. 9). Accord OECD, *Transfer Pricing and Multinational Enterprises* (1979), at p. 5, n. 2 (caution regarding application of report to transactions through permanent establishments) [hereinafter cited as *"1979 OECD Report"*].

66. Para. 1, Commentary on Art. 7, OECD model treaty.

67. See e.g. Art. 9(1), OECD model treaty; *1979 OECD Report,* paras. 3, 37.

68. *1979 OECD Report,* para. 17.

69. *1979 OECD Report,* para. 23.

70. For a discussion of the allocation of profits to management and support, see "The Allocation of Central Management and Service Costs", OECD, *Transfer Pricing and Multinational Enterprises: "Three Taxation Issues* (1984) [hereinafter cited as *"1984 OECD Report*]. For a discussion of the allocation of profits to intangibles and research and development activities, see Chapter 2, *1979 OECD Report* and "A Study of Intercompany Pricing under Section 482 of the Code", Notice 88-123, 1988-2 C.B. 458. See also *Paris Paper,* supra note 48 (suggesting compensating salesmen based on a portion of the bid/ask spread, or consistent with the *1979 OECD Report,* at paras. 160-169, on a cost-plus method).

71. *1979 OECD Report,* para. 33, at 19 (the chapter on sales of goods "does not deal with problems relating to certain items of tangible property, such as... shares and bonds.").

72. *1979 OECD Report,* para. 17.

73. *Id.*

74. *Id.* See also *1979 OECD Report,* para. 35, at 20 ("It may happen that a transaction which is in law a sale of goods may on close examination appear to be more akin to the provision of services. For example, the functions of some distributors may be so minimal and the risks and responsibilities which they undertake so small that their profit is more akin to an agency fee or commission than the profit on a sale.").

75. The OECD model treaty generally adopts a "direct" (as distinguished from "indirect") method of determining the profits attributable to a permanent establishment "narrowly related to the ordinary business" of an enterprise. See para. 17 of the Commentary on Art. 7, OECD model treaty. Art. 7(5) of the OECD model treaty provides that no profits are attributed to a permanent establishment by reason of the mere purchase of goods for the enterprise. See para. 28, Commentary on Art. 7, OECD model treaty. See also the" Taxation of Multinational Banking Enterprises", *1984 OECD Report,* para. 75. However, the *1984 OECD Report* recognizes the attribution of profit to a permanent establishment that accepts the responsibilities and risk in the same manner as an independent enterprise. See *1984 OECD Report,* para. 73. That profit may vary if the permanent establishment acts as "a representative or a commission agent or a provider of services remunerated... by an appropriate fee". *1984 OECD Report,* paras. 73 and 74. Such services would not merely be "ancillary" and therefore are not ignored in accordance with paras. 18 and 19 of the Commentary on Art. 7, OECD model treaty.

76. If the U.S. corporation is viewed as a dealer rather than a purchasing agent, its profits would include the bid/ask spread or any gain or loss from market movements on the security prior to the sale to the Japanese corporation.

77. The distinction is tenuous for a number of other reasons. Traders often act as principals in some products and agents in others. The discretion (particularly the price and timing of a trade) a trader receives ranges between that of principal and agent.

78. A variation is where a product is traded on exchanges, in which the exchange member would be compensated with a brokerage fee and the trader in the selling jurisdiction would receive the remainder of the profit.

79. See OECD, *Tax Consequences of Foreign Exchange Gains and Losses* (1988), paras. 118 and 127 (discussing difficulties in allocating foreign exchange gains and losses, particularly with split hedging transactions).

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B. U.S. taxation of U.S. corporations

U.S. taxation of global trading broadly parallels the pattern established under the OECD model treaty. The nexus with the United States determines the assertion of jurisdiction to tax: U.S. corporations are taxed on all income, whether derived in the United States or not; in contrast to foreign corporations, which are taxed only on income with a sufficient nexus to the United States.[80] In the case of a U.S. corporation conducting global trading through branches abroad, the possibility of double taxation arises because the income earned abroad may be subject to tax both in the foreign country and the United States. To mitigate this double taxation, the United States grants a credit for foreign taxes paid against the tax it would otherwise impose on foreign-source income. Because a fundamental premise of the foreign tax credit is that it should not reduce the U.S. tax on U.S.-source income, a limitation is provided to ensure that the credit offsets only the U.S. tax on the taxpayer's foreign-source income. Hence source of income is a significant issue in the context of global trading, for it assigns to a jurisdiction primary taxing rights.

The source of dividends and interest generally is the residence of the payor.[81] The source of compensation for labor or personal services generally is the place of performance.[82] Subject to significant exceptions, income from the sale of personal property and from derivative instruments is generally sourced on the basis of the residence of the seller or writer (the recipient of the income). Thus trading gains (but not dealing gains, as discussed below) and certain other income and gains are sourced according to the residence of the taxpayer or its foreign office.[83] The source of income from foreign exchange transactions is the residence of the taxpayer or qualified business unit ("QBU") of the taxpayer on whose books the item is "properly reflected".[84] Similarly, the source of income from notional principal products is the residence of the taxpayer or QBU of the taxpayer.[85] An exception to the general rule that is significant for global trading is that the source of ordinary income (other than foreign exchange gain) from sales of dealer's inventory property, including equities, debt instruments and precious metals, is the place of sale.[86] Pursuant to Revenue Ruling 87-43, where linked exchanges are involved, the place of sale of an exchange traded contract is determined as though the contract were sold on the exchange whose rules govern the legal rights under the contract, and is not affected by the execution and clearance of a contract on a linked exchange.[87]

To summarize, whether the United States defers primary taxation to a foreign jurisdiction depends on the activity of the taxpayer, the type of instrument and its place of sale, the residence of the payor, or the attribution to or booking of the transaction with a foreign branch.[88] Because the existence of a foreign branch is not always relevant in determining the source of income, and because inter-branch transactions generally do not affect the source of income,[89] the amount of foreign-source income of a U.S. corporation may not be equivalent to the amount taxed by foreign countries, so that the amount of the credit may be either excessive or insufficient to eliminate double taxation. Thus, the source rules may not operate coherently in the context of global trading by U.S. corporations. In addition to lack of internationally uniform source rules, certain definitional aspects of the source rules create difficulties. For example, in 1989, the Internal Revenue Service issued regulations regarding the allocation of income attributable to certain notional principal contracts.[90] That regulation generally provides that the source of notional principal contract income is determined by reference to the residence of the taxpayer, unless foreign branches of the taxpayer are the "only active and material participants in negotiating and acquiring the notional principal contract". A firm that "trades" interest rate swap contracts (a type of notional principal contract) may transmit information from trading center to trading center about the firm's interest rate position, information that is critical to the willingness of the firm to enter into an interest rate swap contract. In such a case, arguably all trading centers are active and material participants in the acquisition of any particular interest rate swap, and such a firm may never be able to avail itself of the exception for foreign branch transactions, notwithstanding that a foreign jurisdiction may have imposed a tax on such transactions.[91]

In the case of a U.S. corporation conducting global trading through subsidiary corporations abroad, a critical issue is the determination of the amount of income that properly is the income of the U.S. member and the amount that properly is the income of the foreign members. Because of differences in tax rates and systems, the multinational enterprise may have strong incentives to shift income, deductions or tax credits among commonly controlled entities to the entity in the most favorable tax jurisdiction in order to arrive at a reduced overall tax burden.[92] Section 482 authorizes the Secretary of the Treasury or his delegate to redetermine the income that is properly the income of a U.S. entity subject to U.S. taxing jurisdiction in order to prevent evasion of

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80. See generally Norr, "Jurisdiction to Tax and International Income", 17 *Tax L. Rev.* (1964), at 431; Palmer, "Toward Unilateral Coherence in Determining Jurisdiction to Tax Income", 30 *Harv. Int'l L.J.* (1989), at 1 (discussing alternative theories of government's right to tax); American Law Institute, *Restatement of the Foreign Relations Law of the United States, Tentative Draft No. 6* (12 April 1985), at § 414, Reporter's Note 2 and 6; Nagel, "The Emergence of a Single Nexus Standard", *Tax Notes* (16 October 1989), at 327 (noting the distinction between transactional taxes, applied where least nexus with a state, and operational taxes, applied where most nexus); See *Container Corp. of America v. California Franchise Tax Board,* 463 U.S. 159 (1983).

81. Internal Revenue Code Sec. 861(a)(1) and (2); Sec. 862(a)(1) and (2). [Unless otherwise provided, all references herein to "Sec." or "§" shall be to the Internal Revenue Code of 1986 or the Treasury Regulations promulgated thereunder.].

82. Secs. 861(a)(3) and 862(a)(3).

83. Sec. 865(a), (e) and (g). For the distinction between a dealer and a trader, compare § 1.471-5 with *Adirondack Securities Corp.*, 23 B.T.A. 61 (1931).

84. Sec. 988(a)(3).

85. §1.863-7T and Notice 87-4, 1987-1 C.B. 416.

86. Sec. 865(b); §1.861-7.

87. Rev. Rul. 87-43, 1987-1 C.B. 252 (source of income from futures and options executed using a facility linking the Chicago Mercantile Exchange with the Singapore International Monetary Exchange Limited). The execution and clearance processes were given no independent legal significance for purposes of Secs. 861-863 and Sec. 1256. The exchange whose rules the contract is ultimately subject to is treated as the relevant exchange for purposes of Sec. 1256.

88. Under tax treaties, the United States generally defers primary taxation of transactions "attributable to" a foreign permanent establishment under Art. 7.

89. See e.g. §1.988-1T(a)(7). Thus, for example, if a foreign country taxes a branch of a U.S. corporation according to the principles of the OECD model treaty discussed earlier, the branch's performance of services for the home office is taxed in the foreign country without a correponding U.S. tax credit.

90. § 1.863-7T.

91. See preamble to T.D. 8258 (soliciting comments regarding the application of the rules to global trading).

92. See generally *Staff of the Joint Comm. on Taxation, 101st Cong, 2d Sess., Present Law and Certain Issues Relating to Transfer Pricing (Code Section 482)* (Comm. Print 1990).

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taxes or clearly to reflect income (i.e. when income has been improperly shifted between the U.S. entity and a commonly controlled entity in another country).[93] Section 482 also applies where a corporation reporting income or deductions does not in fact perform activities sufficient to earn or incur such items for tax purposes.[94] Although the statute does not further prescribe any specific reallocation rules, the regulations have adopted the concept of the arm's length standard as the method of determining whether reallocations are appropriate.[95] Much in the same way as the OECD reports on transfer pricing, the current regulations under Section 482 would seem to require that global trading be cast in either the sales of tangible property paradigm or the performance of services paradigm. Under the sales of tangible property paradigm, the regulations generally require transfer based on the actual prices charged in comparable sales between unrelated parties ("comparable uncontrolled prices"), which are usually available for most financial products.[96] The regulations do not specify whether to use the bid price or the ask price, but because unrelated dealers would reach agreement between the two prices, a price at the midpoint between the bid/ask spread seems most appropriate.[97] Under the performance of services paradigm, the regulations allow an arm's length profit to the service provider because the service is an integral part of the business of either the provider or the recipient – the principal activity of the "investment manager" in this paradigm is rendering services to the "owner".[98] Ultimately, however, as discussed above, neither paradigm produces satisfactory results in practice because both fail to accurately account for the synergy of an integrated operation.[99]

In contrast to a U.S. corporation conducting global trading through foreign branches (which is subject to current U.S. tax), a U.S. corporation that operates through subsidiary corporations generally may defer tax on the undistributed earnings of the subsidiaries until repatriation. Congress has enacted certain exceptions to this deferral, including subpart F, which requires any ten percent U.S. shareholder of a controlled foreign corporation to include in income (subject to a foreign tax credit) a pro rata portion of the undistributed earnings of the foreign corporation that arise from designated classes of income.[100] For global trading, the two most relevant classes are foreign personal holding company income and foreign base company sales income. Foreign personal holding company income includes interest, dividends and income equivalent to interest (such as income from notional principal contracts).[101] Net foreign currency gains and net gains from stocks and securities transactions also are included in the case of traders, but excluded in the case of dealers.[102] Such net gains from dealers may be included as foreign base company sales income in the case of certain transactions involving related persons.[103]

C. U.S. taxation of foreign corporations

The United States asserts jurisdiction to impose operational taxes (net basis taxes computed in the same manner and at the same rates as the income of U.S. persons) on the income of foreign corporations that is "effectively connected" with the conduct of a "trade or business" in the United States.[104] In a way that roughly parallels the determination of a permanent establishment, whether a "trade or business in the United States" exists is a factual determination that depends on assets, agency relationships and activities within the United States.[105] However, Section 864(b)(2) generally excludes from the phrase "trade or business" trading in stocks, securities, or commodities through a resident broker, commission agent, custodian, or other independent agent, if the taxpayer does not have an office or fixed place of business in the United States through which or by the direction of which the transactions are effected.[106] Section 864(b)(2) also excludes from the phrase trading in such products for the taxpayer's own account, unless the taxpayer is a dealer in such products.[107] Thus, Section 864(b)(2) would exempt from the U.S. operational tax described above a foreign corporation that (1) is not a dealer, and that (2) conducts global trading in the United States only in stocks, securities and the limited commodities described in Section 864(b)(2)(B)(iii). These limitations would seem to remove most global trading firms from the exemption.

The Code and regulations provide rules for determining whether income is "effectively connected" (the Code analog to the "attributable to" concept in Article 7 of the OECD model treaty) to a foreign corporation's trade or business in the United States. All U.S.-source income of a foreign corporation is treated as effectively connected to its U.S.

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93. Sec. 482.
94. See e.g. *Southern Bancorp v. Commissioner,* 67 T.C. 1022, 1027 (1977) (income received by parent corporation allocated under Sec. 482 to subsidiary that performed activities to which such income was attributable); *G.D. Searle v. Commissioner,* 88 T.C. 252, 360 (1987) (discussing application of Sec. 482 to reallocate income from transactions conducted for purposes of tax evasion or avoidance).
95. § 1.482-1(b)(1).
96. § 1.482-2(e). As discussed in the text at footnote 69, it may also be important to distinguish between principal and agent. Rev. Rul. 59-247, 1959-2 C.B. 14; *Charles Town, Inc. v. Commissioner,* 372 F.2d 415 (1967).
97. This price could be affected by the value of any services performed.
98. § 1.482-2(b)(3) and (7)(ii)(a).
99. See Langbein, "The Unitary Method and the Myth of Arm's Length", *Tax Notes* (28 February 1983), at 625; *Staff of the Joint Comm. on Taxation, 101st Cong. 2d Sess., Present Law and Certain Issues Relating to Transfer Pricing (Code Sec. 482)* (Comm. Print 1990), at 24 (discussing criticisms of arm's length standard); Mentz and Carlisle Suggest "Consistency Rule" in Accounting for Impact of Currency Fluctuations on Intercompany Pricing", *Highlights & Documents* (3 May 1989), at 1085 (noting difficulty in allocating exchange gains and losses); Matthews and Turro, "International Tax Policy in the 21st Century", *Tax Notes Int'l* (May 1990), at 545, 556 (quoting Joint Committee on Taxation Chief of Staff as saying "the arm's length standard is not viable"); *Highlights & Documents* (November 1989), at 1564 (quoting Treasury Department Associate International Tax Counsel as predicting that separate entity accounting would give way to a formulary method in the 1990's). Compare *Paris Paper,* supra note 44 (arguing that where a primary trading market exists for a product, an integrated business situation is not present because the traders in the primary trading market act as principals and "supersalesmen" in other jurisdictions act as "caretaking" agents, compensated only for their operating expenses plus a "profit margin" percentage of these expenses).
100. Secs. 951-964. See also Secs. 551-558 (foreign personal holding companies); Secs. 1291-1297 (passive foreign investment companies).
101. § 1.954-2T(a); Notice 89-90, 1989-2 C.B. 407.
102. § 1.954-2T(g) (currency gains); -2T(e) (property transactions); -2T(a)(4)(iv) (defining excluded dealer property).
103. § 1.954-3(a)(1)(i).
104. Sec. 882. The United States also imposes transactional taxes on foreign persons upon certain gross income that is derived "from sources within the United States". Secs. 871(a) and 881.
105. See generally Eisenbergh, "The "Trade or Business" of Foreign Taxpayers in the United States", 61 *Taxes* (1983), at 972; Garelik, "What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or a Foreign Corporation", 18 *Tax L. Rev.* (1963), at 423.
106. Sec. 864(b)(2)(A)(i) and (C) (stocks and securities); Sec. 862(b)(2)(B)(i) and (C) (commodities). To qualify for the exception, the commodities must be of a kind customarily dealt in on an organized exchange and the transaction must be of a kind customarily consummated at such a place.
107. Sec. 864(b)(2)(A)(ii) and (B)(ii). The exemption for trading stocks and securities for the taxpayer's own account generally is not available to corporations whose principal business is such trading if its principal office is in the United States.

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trade or business,[108] unless the income is "fixed or determinable, annual or periodical" (e.g. interest, dividends, rents, royalties) or is U.S.-source capital gains.[109] These latter two types of income are effectively connected if the activities of the trade or business are a material factor in the realization of the income or gain.[110] Similar activities result in effectively connecting to a U.S. trade or business exchange gains and income attributable to notional principal contracts.[111] Branch activities[112] are a "material factor" if there is an immediate relationship between the realization of the income and the activities of the branch.[113] The regulations specify that activities relating to the management of investment portfolios are not treated as activities of the branch, unless the maintenance of the investments constitute the principal activity of that branch.[114]

The U.S. taxation of a foreign corporation's foreign-source income depends on its maintenance of an office or other fixed place of business.[115] Foreign-source interest and dividends are effectively connected only if derived in the active conduct of a banking, financing or similar business within the United States or received by a corporation the principal business of which is trading in stock or securities for its own account.[116] Gains or losses on sales of stocks and securities that produce foreign-source effectively connected interest or dividend income are sourced domestically.[117] Gains or losses from inventory property similarly are effectively connected if the U.S. office's activities are a material factor in the sale of the property, unless sold for use outside the United States with the material participation of a foreign office.[118]

The general rule that emerges from the application of these rules to global trading by a foreign corporation is that if the activities of the U.S. branch are a material factor in the realization of income or gain, the income or gain is effectively connected.[119] Two important exceptions to this generalization are (1) foreign-source interest and dividends of dealers that are not "derived in the active conduct of a banking, financing, or similar business within the United States";[120] and (2) sales of financial products for "use" outside the United States where a foreign office "participated materially" in the sale.[121] A significant difficulty in applying these rules to global trading by a foreign corporation is that either all or none of the income from a transaction is effectively connected – where the United States and a foreign branch jointly participate, there is no authority to divide the income between them according to their relative contributions,[122] and inter-branch transactions generally are disregarded as a means of apportioning the profits between the two jurisdictions.[123] A simple illustration of the problem this creates is where a foreign corporation enters into an interest rate swap with one party out of its New York branch, and an offsetting (presumably with a spread) interest rate swap with another party out of its London branch; no inter-branch swap may be taken into account for purposes of apportioning the income from the two related transactions. Thus, for example, any gains from interest rate movements on the New York swap cannot be offset by the corresponding losses on the London swap via a "mirror" swap between the two branches which would reflect a loss to the New York branch.

D. Other taxation issues

Global trading raises a host of other tax issues, many of which certainly have not yet been identified, but among those that have are the existence of deemed partnerships,[124] and transfers of intangibles,[125] some with severe penalties if the tax law is misinterpreted.[126] The focus of this article is on the difficulties in dividing among jurisdictions taxing

108. Sec. 864(c)(3).
109. Sec. 864(c)(2).
110. Sec. 864(c)(2)(B). The statute also examines the use of assets and the method of accounting.
111. § 1.988-4T(c); § 1.863-7T(b).
112. The term "branch" is used in this discussion as shorthand for "trade or business within the United States".
113. S. Rep. No. 1707 (11 October 1966) reprinted in, 1966 *U.S. Code Cong. & Ad. News* 4446, 4464. The focus generally is on decision-making authority, capability and performance of important functions. See Rev. Rul. 86-154, 1986-2 C.B. 103.
114. § 1.864-4(c)(3)(i) and (ii) Example (1) (illustrating that traders generally are not within the scope of this exception).
115. This concept is more closely analogous to the "permanent establishment" concept than is the "trade or business in the U.S." concept in that its emphasis is on assets and agency relationships rather than activities. See generally Sec. 864(c)(4) and (5); Sec. 865(e)(3).
116. Sec. 864(c)(4)(B)(ii).
117. Sec. 865(e)(3); *Staff of the Joint Committee on Taxation, 101 Cong., 2d Sess, Background and Issues Relating to the Taxation of Foreign Investment in the United States* 18 (Comm. Print 1990).
118. Sec. 864(c)(4)(B)(iii).
119. This generalization assumes that the U.S. branch is a "U.S. trade or business" under Sec. 864(b) and an "office or other fixed place of business" under Secs. 864(c)(4)(B) and 865(e). It also assumes that the activities of the branch satisfy the "material factor" test of Sec. 864(c)(2)(B), the "attributable" test of Secs. 864(c)(4)(B) and 865(e)(2), and the "through" test of Sec. 864(c)(4)(B)(iii). See generally Dale, "Effectively Connected Income", 42 *Tax L. Rev.* (1987), at 689, 729 (discussing interpretation of "attributable" and "through" tests).
120. See §1.864-5(b)(2)(i) (referring to §1.864-4(c)(5)(i), which details a number of activities, any one of which may include a dealer in banking classification). Traders are not excepted because their principal business is trading stock or securities for their own account. Sec. 864(c)(4)(B)(ii). See generally Dale, "Effectively Connected Income", 42 *Tax L. Rev.* (1987), at 725-7 (discussing banking and trading tests).
121. Secs. 865(e)(2)(B) and 864(c)(4)(B)(iii). Note the ambiguity arising from the difficulty of determining the location of "use" of a financial product. See generally Dale, "Effectively Connected Income", 42 *Tax L. Rev.* (1987), at 689, 730-3 (discussing interpretation of "use" and "participated materially").
122. The effectively connected rules generally are an "indirect" method, in contrast to a "direct" method, of attributing profits to a branch. See Kramer, *Tax Notes Int'l* (July 1990), at 686 (discussing methods of apportioning profits of branches). Compare note 75, supra, and Secs. 863(b) (50 percent split under the regulations for exported goods with no determinable independent factory price), 863(c)(2) (50 percent split of transportation income with a U.S. connection), 863(e)(1)(A) (50 percent split of international communications income), 936(h)(5)(C)(ii) (profit split election regarding possessions income). This can lead to extreme results. Because management of a portfolio is a material factor in the realization of income, § 1.864-4(c)(3)(ii) (Example (1)), under the performance of services paradigm arguably all income of a global book is effectively connected.
123. See e.g. §1.882-5(a)(5); §1.863-7T; §1.988-1T(a)(7); Rev. Rul 89-115, 1989-2 C.B. 130. Compare Sec. 987(3). Net income is determined by allocating and apportioning deductions, rather than by recognizing expenses in transactions between branches. See generally Sec. 882, §§1.861-8(b) and (c) and 1.882-5.
124. Global trading operations involving two affiliated corporations may be characterised as a partnership between the two. If the partnership is engaged in a U.S. trade or business then the foreign affiliate also will be considered engaged in a U.S. trade or business under Sec. 875(1) and taxable on income effectively connected with that trade or business under Sec. 882(a). Under Sec. 882(c)(2), if that foreign corporation failed to file a return, it could not claim deductions or credits attributable to the effectively connected income.
125. The U.S. corporation in the situation described in the previous footnote could be liable as a withholding agent for the tax imposed by Sec. 1446, and could also be subject to tax under Sec. 1491 for intangibles or other property transferred to the partnership if the partnership is a foreign partnership.
126. Among myriad penalties are those for failure to furnish information under Sec. 6038A, and failure to file under Sec. 6651(a). See also Sec.

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rights to the profits of global trading. Its purpose is to illustrate the high degree of global integration of this industry, and to expose the outmoded economic assumptions upon which the current rules rest, among them the integrity of distinct legal entities, and the relevance of national boundaries to capital markets. It is expected that other more traditional industries will increasingly challenge the assumptions underlying international taxation as the economic integration of the world's markets progresses.[127]

IV. ALTERNATIVE APPORTIONMENT METHODS

A coordinated solution to the tax issues raised by global trading is necessary to reduce the threat of double taxation and other inefficiencies.[128] A 1988 survey found a great concern among global trading participants over the danger of double taxation, and noted that uncertain tax rules inhibit the marketing of new products and services to customers.[129] Economic efficiency dictates that taxes be applied neutrally regardless of the location of operations (foreign versus domestic), the choice of entity (subsidiary versus branch), the form of intermediation (banking versus securities, for example), or type of financial product (swaps versus futures, for example). A coordinated approach also is necessary to prevent tax avoidance and evasion (such as where a book is passed through a tax haven),[130] and to limit opportunities for tax arbitrage.[131]

The approach currently taken by the OECD model treaty may be called the "realization approach".[132] A number of clarifications would improve the taxation of global trading. If the method of attributing profits to a permanent establishment were fully conformed to the arm's length principle, the difference between operations through branches and through subsidiaries would be reduced. This would also eliminate the complexity of determining whether an associated enterprise operates as a dependent or an independent agent for purposes of determining whether one has a permanent establishment. As a starting point for assigning primary taxing rights, uniform source rules for various economically equivalent financial products could be agreed to by countries. Countries could also agree whether the method would follow the sale of goods paradigm or the performance of services paradigm. There is perhaps more to be said for the performance of services paradigm, as it avoids the often unanswerable (and perhaps unauditable) determinations of whether a trader acts as principal or agent and what appropriate arm's length prices are for possibly hundreds of deemed arm's length transactions. Ultimately neither paradigm may prove satisfactory: firms operating in one profit center mode do not divide the economic functions of a global book along national boundaries, hence any tax rules that do so would produce artificial results. Firms would have the incentive to locate inventory in the lowest tax country, where the majority of profits would be attributable. A transactional approach would be particularly unworkable for a portfolio of derivative products, where the identity of component cash flows is lost, hedges hedge bundles of cash flows from a variety of sources, and there really is no location (other than information in a computer) to inventory.

One alternative to the realization approach may be termed the mark-to-market approach. This method would first isolate trading profits by valuing a global book's assets, hedges and allocable liabilities. The profits attributable to a particular jurisdiction would be the change in value of the book from the beginning to the end of the trading day in that jurisdiction (the time of receipt to the time of passing of the book), on the theory that the economic contribution of traders in that jurisdiction will be reflected in increased or decreased value of the book. This valuation would be performed by marking the book to market at each passing of the book. The second step would be to subtract from these allocated trading profits any allocable expenses, such as commissions paid to salesmen and compensation for management and support. The allocation of these latter expenses could be performed either under the traditional realization approach or under a formula allocation. This approach is relatively objective, particularly in the case of a book for which active markets simplify valuation. It commends itself to products with relatively stable markets, such as certain securities. Its primary criticisms are that it essentially allocates profits based on market movements (and only very indirectly on trader performance and hence may

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1092(d)(3)(B)(ii) (defining the term "personal property" for purposes of Sec. 1092 as including "any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder"); Sec. 1092(d)(4)(C) (regarding treatment of flowthrough entities); and Sec. 367(a), (b) and (d) (relating to transfers of property, including intangible property).

127. See generally: McLure, "Some Lessons from the U.S. Experience", 43 *Bulletin for International Fiscal Documentation* (August 1989), at 243 (discussing European economic integration and the applicability of unitary taxation); Statement of the Hon. Nicholas F. Brady, Secretary of the Treasury, before the Committee on Ways and Means, U.S. House of Representatives (18 April 1990), reprinted in, *Highlights & Documents* (19 April 1990), at 762.

128. See Frisch, "The Economics of Tax Policy: Some Old and New Approaches", *Tax Notes* (30 April 1990), at 581 (suggesting that tax policy for the international income of multinationals focus on harmonization of tax systems). Technological advances enable market participants to surmount tax or regulatory barriers of jurisdictions that are out of step. See Marcom, "Welcome to Hauppauge, the World's Next Financial Capital", *Forbes* (30 October 1989), at 143, 146 ("If one country imposes onerous taxes or annoying trading restrictions, in the global electronic market the players just transact their business in a country that is more simpatico".). Bird, "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal documentation* (July 1988), at 292, 295 ("... countries always have the attractive option of doing nothing. Over time, the effective rate of taxation on international business is then likely to fall to the level of the least common denominator among the various countries competing for such investment which means, in practice, something close to zero.").
Tax authorities have recently begun to coordinate. Compare de Hosson, "Global Trading – A Worldwide Tax Headache", *Intertax* (1990), at 2. For a description of efforts by securities regulators, see Warren, "Global Harmonization of Securities Laws: The Achievements of the European Communities", 31 *Harv. Int'l L.J.* (1990), at 185; Goelzer, Sullivan & Mills: "Securities Regulation in the International Marketplace: Bilateral and Multilateral Agreements", 9 *Mich. Y.B. Int'l Legal Stud.* (1988), at 53. For those of banking regulators, see: Hu, "Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm", 138 *U. Penn. L. Rev.* (1990), at 333.

129. KPMG, *Global Capital Markets* (1988), at 26-28 ("The development... by fiscs of clearer guidelines for the attribution of profits is essential. No global trader, having shaped its worldwide operations into an efficient and profitable unit, can tolerate its profits disappearing in tax."). See also "A Taxing Problem for Global Trading", The Financial Times (London), 18 September 1987; Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 15-16; *Technology Report,* supra note 7, at 29 (citing tax laws as an obstacle to security trading).

130. OECD, *International Tax Avoidance and Evasion* (1987).

131. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 16 ("Those interviewed expect that over the next five years international trading will be increasingly managed with a focused view to gaining an advantage of differing tax and regulatory policies in markets around the world."); "The Rocket Men are Still At Work", *Euromoney* (September 1989), at 148, 152; *Technology Report,* supra note 7, at 8.

132. "Actual transactions" is the term used in *1979 OECD Report,* para. 23.

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be more fortuitous than rational) and provides no answer if time zones overlap or simultaneous trading is conducted.[133]

A second alternative to the realization approach is a profit split approach, which divides trading profits according to an agreed upon formula. The first step under this approach is to define the tax base upon which the formula is to be applied. This would be the gains and losses from trades and hedges, less allocable expenses such as interest and commissions to salesmen. General and administrative expenses relating to management or support could also be subtracted, or could be allocated under the realization approach. The second step would be to apply the apportionment formula to this tax base. Most in accordance with economic theory would be to select factors of production (inputs) as the basis for this formula, on the theory that if unrelated parties in each jurisdiction were to enter into a joint venture to conduct global trading, they might be expected to divide the profits in accordance with each one's relative contribution of inputs.[134] Because human resources (the traders) are usually the most significant input, relative trader compensation probably would be a prominent apportionment factor.[135] This approach commends itself to global trading because it is applicable to all products and forms of trading and reflects the reality that global trading operations are integrated units that like atoms are not susceptible to further functional division.[136] Though not generally endorsed by the OECD model treaty, such an approach is sanctioned "in specific... situations where other methods give rise to serious difficulties and the ...countries concerned are able to adopt a common approach and the necessary information can be made available".[137] As implied from this quotation, the principal difficulties in this approach are in reaching agreements as to the apportionment factors among jurisdictions[138] and in crafting arrangements to collect and report the necessary information.[139]

In implementing a solution to the tax issues raised by global trading, unilateral approaches are severely constraining.[140] Given the variety of trading arrangements and the need for acceptance by foreign jurisdictions, writing meaningful regulations on this topic is virtually impossible.[141]

Instead, bilateral and multilateral solutions are greatly preferable.[142] Though heavily in favor of the realization approach, the OECD model treaty framework is sufficient to accommodate the other two approaches.[143] Harmonized domestic legislation and protocols to treaties may provide a solution in the long term, but the advance determination ruling procedure seems a viable current way to implement a solution.[144] The process essentially is a flexible and voluntary procedure under which the taxpayer and competent authorities agree to an apportionment methodology and to reporting obligations. Experience with these agreements may lead to principles of general application that can be incorporated into protocols or the mutual agreement article of a tax treaty, but may be implemented by memorandum of understanding absent a treaty, such as where a U.S. corporation operates in Japan through a branch of a Hong Kong subsidiary.[145]

133. "How Merrill Lynch Moves its Stock Deals All Around the World", Wall St. J., 9 November 1987, at 21, col.2. ("Trading on the London exchange stays active until about 5 p.m., overlapping the U.S. market, so the [U.S. traders] often consult with London team members to find which side of the Atlantic offers the better prices.").
134. "A Proposed Reinterpretation of the Arm's Length Principle in Transfer Pricing", presented by Harry Grubert at the National Bureau of Economic Research Summer Institute (1987); Rollinson and Frisch, "Recent Issues in Transfer Pricing", Office of Tax Analysis Paper 61 (November 1988).
135. See *Paris Paper,* supra note 48 (suggesting allocation formula based on (1) relative trader compensation; (2) relative numbers of personnel, including clearance and support; and (3) relative levels of interest and dividends representing costs of risk capital – three factors that indicate economic risk, namely activity, fixed presence and risk assumed).
136. See *Tax Notes* (27 November 1989), 1048 (quoting Associate International Tax Counsel and Associate Chief Counsel (International) as offering a formulary approach to resolve many of the issues regarding 24 hour trading). See generally McClure, "The Basic Operational Interdependence Test of a Unitary Business: A Rejoinder", *Tax Notes* (10 October 1983), at 98. The term "atoms" is used in its classical sense in preference to neutrinos or quarks or other subatomic particles.
137. *1979 OECD Report,* para. 14. Accord, *U.S. Treasury Department, A Study of Intercompany Pricing* (Discussion Draft dated 18 October 1988).
138. See Bird, "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal Documentation* (July 1988), at 292, 297 ("Contrary to what many tax practitioners seem to think, however, [the unitary tax] episode illustrates not the inadequacy of the worldwide allocation approach but rather the non-viability of any approach increasing taxes on internationally mobile capital that is applied in only a few jurisdictions. The moral of the unitary story is not that the present system is in any sense better or more workable. It demonstrably is not. The moral is rather that no substantial improvement can be expected in the international tax order so long as countries (let alone parts of countries) act on their own".).
139. See McLure, "Some Lessons from the U.S. Experience", 43 *Bulletin for International Fiscal Documentation* (August 1989), at 243, 247 (offering the "Domestic Disclosure Spreadsheet" adopted by some states – e.g. State of California Franchise Tax Board Form 100-DDS2 – as a reporting standard to promote uniformity of taxation in integrated Europe).
140. *Technology Report,* supra note 7, at 71.
141. However, it is incumbent upon multinational corporations to assist in the proper formulation of tax rules. See de Hosson, "Global Trading – A Worldwide Tax Headache", *Intertax* (1990), at 2; KPMG, *Global Capital Markets* (1988), at 26-9.
142. *Technology Report,* supra note 7, at 5, 7, and 75.
143. Compare *1979 OECD Report,* para. 14 ("so-called global or direct methods of profit allocation, or ... fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates ... [are] incompatible in fact with Arts. 7 and 9 of the OECD Model Double Taxation Convention".) with para. 2, Commentary on Art. 7, OECD model treaty (making it clear that Art. 7 was intended to facilitate, rather than prevent, agreement of a set of rules by reference to which the profits of a permanent establishment are to be calculated and was drafted broadly intentionally in recognition that modern commerce organises itself with infinite variety).
144. See "Full Text of Draft Revenue Procedure on Advanced Transfer Pricing Rules", 2 *Tax Notes Int'l* (June 1990), at 565. Respondents of a 1987 survey favoured standard provisions in treaties and other agreements. Coopers & Lybrand, *Opportunity and Risk in the 24-Hour Global Marketplace* (1987), at 15.
145. See *Paris Paper,* supra note 48 (presenting this fact pattern).

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UNITED KINGDOM:

Investment in Foreign Real Property

Jonathan S. Schwarz

I. INTRODUCTION

This article examines the key tax rules applicable in the United Kingdom in the context of planning investment by U.K. persons in foreign real property. As a general matter, planning may vary significantly depending upon whether the investment is to be made in revenue-producing property, long-term holding of undeveloped land, development activity or personal residence. Given the vast scope of the subject it is intended to identify the key issues and examine them step by step so that the analysis may be applied to various combinations that might arise. This study focuses on the direct tax aspects. Indirect tax in the form of VAT, stamp duties, land transfer taxes, etc. play a key role in the analysis but are excluded for space reasons. In addition, non-tax legal issues such as foreign investment restrictions and disclosure and exchange controls are vital elements of any overall analysis.

The focus of this study is on corporate investment, although in some instances the treatment of individuals is examined. For the sake of simplicity, joint ventures are not considered.

II. PARTICIPATION STRUCTURE

At its simplest, there are broadly two approaches open to U.K. corporate investors: "direct" and the "indirect" investment.

A. Direct investment

Direct investment for our purposes means simply that the property is owned by a U.K. resident company. It may or may not be a special single purpose company. Participation may take the form of sole ownership, co-ownership or partnership.

B. Indirect investment

Indirect investment means that the property is owned by a non-U.K. resident company, which itself is owned by the U.K. investor, either directly or through one or more intermediate companies. Again ownership of the property may take the form of sole ownership, co-ownership or partnership.[1]

To assist in a systematic analysis of each of the constituent elements, we should look at the various phases of the investment commencing with financing, working through the various operational aspects and finally, disposal of the investment.

III. CATEGORIZATION OF INCOME

The U.K. income and corporation system distinguishes between income derived from property in the form of rent, and trading situations where the land is treated as inventory.

However, the categorization of income from property is fundamentally different for U.K. tax purposes depending upon whether the property is within or outside the United Kingdom. Perhaps the most important difference between U.K. and foreign property is that rental income from foreign property does not fall to be taxed under Schedule A Taxes Act 1988. Schedule A is only applicable to U.K.-situated property and its specific rules are not appropriate in considering the way in which overseas property transactions are taxed.[2]

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1. It does give rise to additional possibilities in joint venture situations, in that the non-resident company may be owned by several investors. This may give rise to several planning opportunities, the implications of which will emerge during the course of the discussion.
2. Income and Corporation Taxes Act 1988 ("Taxes Act 88"), Sec. 15.

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Foreign-source income is generally categorized as Schedule D Case V income "arising from possessions out of the United Kingdom".[3] The question in each case is to determine what the "foreign possession" is. With respect to rental income derived from land outside the United Kingdom in the hands of a resident, the possession is the foreign property itself. Rent from land overseas is always taxable under Schedule D Case V. Thus, in *Swedish Central Rail Co. Limited v. Thompson,*[4] where land abroad was leased by a company incorporated and resident in the United Kingdom, the whole of the rent accruing from the land was treated as income from a foreign possession. This may not be the case where the letting is of a right to occupy the property under unusual arrangements such as a time share, for example. Depending upon the particular governing law and rights that are conveyed, the income may arise under the time share agreement rather than the property to which the agreement relates. Where foreign land is acquired for development and sale, the test to determine whether trading has taken place is the same as that found in relation to U.K. property. Whether a trade in land is carried on depends on several judicially-developed criteria based on the intention of the taxpayer, but it is beyond the scope of this article to consider this matter any further.[5]

In the context of property outside the United Kingdom, it is important to determine whether trading income is to be assessed under Schedule D Case I in respect of "any trade carried on in the United Kingdom or elsewhere" or, alternatively, under Schedule D Case V which applies to a trade carried on wholly abroad. In the latter case the foreign trade is treated as a "possession out of the United Kingdom".

In order to fall within Case V it is necessary that the trade be exercised wholly outside the United Kingdom. If the trade is carried on partly in the United Kingdom and partly outside then it will be taxed under Case I and not Case V. This is always a question of fact. The courts have identified two elements which comprise the meaning of the word "trade" in this sense. In the context of land it refers to the place where it is used for the purposes of profit, whether it is bought or sold, cultivated or used for other purposes. The second aspect is the sense in which it refers to the conduct and management of the trading activity which may be in a different place.[6]

Typically, Schedule D Case V income will arise where the U.K. head office takes no part in the business operations, such as where a foreign branch is established and there is a clear delineation of management function between head office and local branch and where a significant amount of independence is granted to the local branch; or where the trade of the foreign branch is completely different to the U.K. trade and where the head office relationship to the trading activity is somewhat akin to a passive investment. This might be the case in a joint venture where the U.K. party contributes land and cash and the foreign party is charged entirely with managing the project.

The cases suggest that a small amount of participation such as mere supervision regularly exercised even though it does not go beyond passive supervision and tacit control will cause the trade to be taxed under Case I. In *Mitchell v. Egyptian Hotels Limited,*[7] Lord Sumner concluded that the legal right to intervene by itself will not be sufficient if the right is not exercised.

As a result and as a practical matter, the majority of assessments in circumstances of trading are on a Case I basis.

IV. FINANCING

The tax implications of the financing arrangements may have a significant impact on the results of the investment. Two key issues must be considered:

(i) the deductibility of interest and other financing costs to reduce income and gain from the investment, and to possibly reduce other source income otherwise subject to tax; and
(ii) withholding taxes on interest payments may impact significantly on the cost of financing.

Deductibility of financing charges affects the viability of a property investment. In some cases, deductibility of finance is the single most important planning aspect in determining the overall tax result in the early years of the project. Where withholding taxes represent a net additional cost to a lender, it will typically seek to recover the amount through increased interest or other charges. The main reason for this is the lender's inability to offset the withholding tax against its own tax liability. For example, U.K. resident lenders are restricted to claiming a tax credit on the margin only on interest paid by foreign borrowers.[8] Since tax is typically withheld on gross amounts, the bulk of the foreign tax would not be creditable against the U.K. banks' U.K. tax liability. The result is an increased overall tax liability which is more often than not passed on to the borrower.

A. Direct investor

1. Basic rules

Where the foreign property is dealt with as inventory, the interest is a trading expenditure and will be permitted as a deduction in computing trading income either under Section 74(h) Taxes Act 1988 for the purpose of Schedule D Case I, or where the trade is wholly outside the United Kingdom for the purpose of Case V, in accordance with Section 70(2) Taxes Act 1988.

Thus where foreign property is purchased for development and resale, the interest expense should be deductible as long as it is wholly and exclusively incurred for the purposes of the trade.

Where a foreign property investment is held to produce rental income, interest will not be deductible as a trading expense. It may qualify as a charge on income to be offset against the total profits of the company.[9] Tax relief for annual interest as a charge on income is only available to a company if:

(i) it exists wholly or mainly for the purposes of carrying on a trade; or
(ii) the interest is paid wholly or exclusively for the purposes of a trade carried on by the company; or
(iii) the company is an investment company; in other words one whose business consists wholly or mainly of making investments and the principal part of its income is derived therefrom.[10]

3. Taxes Act 88, Sec. 18(3) Case V.
4. [1925] Appeals Court (AC) 1945.
5. The categorization of property transactions as trading as opposed to investment is considered in several works; for example, Peter G. Whiteman, *Whiteman on Income Tax* (Sweet and Maxwell, 3rd edition, 1988), at 157-175.
6. *São Paulo (Brazilian) Rail Company v. Carter* [1896] AC 31.
7. [1915] AC 1022.
8. Taxes Act 88, Sec. 798.
9. Taxes Act 88, Sec. 338.
10. Taxes Act 88, subsec. 338(b).

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Thus a U.K. company investor in foreign property for rental purposes will normally be entitled to relief on interest payments made for this purpose.

The position is entirely different in relation to individual investors. In the case of *Ockenden v. Mackley,*[11] the High Court held that an individual is not entitled to deduct interest payable on a loan to purchase overseas property for letting. In that case, the taxpayer owned a residential flat in Gibraltar from which he obtained rent and the rental income was used to reduce the loan obtained for the purchase of the property. The Court first found that ownership of a single property did not constitute a trade and that the foreign possession in question was the flat itself. The Court upheld the argument of the Crown on the basis that it is an expense incurred not in procuring and maintaining the rent but towards the acquisition of the property. The Court held that the charge to tax was on "income" and not on "profits or gains". It rejected the argument that ordinary commercial principles would require the interest to be deducted in circumstances where there was no trade. Mr. Justice Nourse said:

> . . . if there is no trade, I find it difficult to see how you can talk about ordinary commercial principles in the first place. The more correct way of putting the point may be to contend that the interest is deductible on ordinary principles of good housekeeping but that concept, however admirable, is not one within the comprehension of the Income Tax Act.[12]

2. Foreign lender

In other circumstances where interest is paid to non-residents (for example, in the financing of a foreign project by a foreign lender), relief is available as a charge on income only where the basic rate tax is withheld on interest payments. Basic rate need not be withheld where:

(a) The U.K. company making the borrowing is carrying on a trade; the interest is payable and in fact is paid outside the United Kingdom; and the liability to pay the interest was incurred wholly or mainly for the purposes of activities of the company's trade carried on outside the United Kingdom. Alternatively, interest must be payable in a foreign currency and the interest expenditure incurred wholly or mainly for the purposes of activities of the trade wherever carried on.[13]
(b) The loan is made by the U.K. branch of a foreign bank.[14]
(c) The interest is payable out of income brought into charge under Schedule D Case V.[15] This would be the case, for example, where a project is financed by a non-recourse loan secured on the foreign property.

B. Indirect investor

Where a U.K. resident company uses a non-U.K. resident company as the vehicle for its investment, a number of additional issues arise. The first is whether external financing should be raised by the U.K. parent company or by the foreign subsidiary. Where the U.K. company borrows, interest will clearly not be deductible as a trading expenditure. Any relief must be based on the rules relating to charges on income. Typically interest may be available as a charge on income on the basis that it is incurred by an investment company (for example, with its investments being shared in loans to the foreign subsidiary).

Where the foreign subsidiary itself is the borrower, the question of deductibility of interest payments for U.K. purposes will not arise. In financing the foreign subsidiary some attention must be given to Section 765 Taxes Act 1988, which prohibits the issuing of shares of debentures in a non-resident company controlled by a U.K. company and the transferring of such shares of debentures which it owned to any person unless in each case U.K. Treasury consent is obtained in advance. From 1 July 1990 financing transactions which constitute a movement of capital to which Article 1 of the Directive of the Council of the European Communities relating to liberalization of capital[16] applies will not require consent.[17] A reporting requirement is substituted, however. Unlike most tax provisions, failure to comply gives rise to criminal sanctions.[18]

The most important exception to these rules relates to the creation or issue of shares or debentures to the bankers of the overseas subsidiary as security for the payment of any sums due by reason of any transaction entered into in the ordinary course of their business as bankers.[19] Consent is given either to specific transactions upon application or by way of general consents which set out classes of transaction that may be carried out without applying for special consent.[20] The general consents that have been issued are somewhat complicated and it should suffice for our purposes merely to refer to them since it is a matter that is sometimes overlooked by those more accustomed to financing domestic transactions.

It should also be borne in mind that loans made to a foreign subsidiary that bear interest at less than an arm's length rate may be open to attack under Section 770 Taxes Act 1988, which requires arm's length dealings between a U.K. parent and a foreign subsidiary.

C. Foreign and treaty issues

With respect to the foreign tax issues the question of deductibility of interest payments is common to direct and indirect investors. There are, however, additional considerations for the individual investor. First, interest payments to a related party may be disallowed to the extent that they exceed an arm's length rate. Second, thin capitalization rules may place further limitations on the deductibility of interest charges made by the U.K. parent. Canada, for example, has enacted specific statutory debt-to-equity ratios and will therefore deny interest payments made to the U.K. parent company to the extent that a debt exceeds equity by more than three to one.[21] In addition, anti-avoidance rules are typically included in order to counter back-to-back loans and similar arrangements designed to circumvent these rules. Difficulties may be encountered, for example, where the parent company is required by a financial institution to guarantee the foreign subsidiary indebtedness and this itself may cause problems in obtaining a full deduction for the interest payment.

Clearly the most significant issue in the financing context is the rules relating to tax on interest. The treaties tend to follow two approaches. The first is to exempt from tax

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11. [1982] Simon's Tax Cases (STC) 513.
12. Id. at 518.
13. Taxes Act 88, subsecs. 338(4) and 340(1).
14. Taxes Act 88, subsec. 338(3)(b).
15. Taxes Act 88, subsec. 338(4)(d).
16. Directive of the Council of the European Communities dated 24 June 1988 No. 88/361/EEC. OJ No. I178/5.
17. 1990 Finance Bill proposes to amend Taxes Act 88, Sec. 765 by the insertion of a new Sec. 765A to that effect.
18. Taxes Act 88, Sec. 766.
19. Taxes Act 88, subsec. 765(2).
20. Taxes Act 88, subsec. 765(4).
21. Canadian Income Tax Act, subsec. 18(4).

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payments of interest except in the country of residence of the recipient.[22] The second is to permit both states to tax interest, but to place a ceiling on the rate of taxation.[23] Under current treaties, interest payments made between the United Kingdom and European Community countries are generally exempt from tax with the exception of payments in respect of Belgium, Italy, Portugal and Spain.[24]

Other financing charges such as standby fees and guaranty fees may escape taxation in the host country on the basis they form part of the recipient's business profits and if they are not attributable to a permanent establishment will not be subject to taxation. These rules require careful consideration since in some countries, such payments are treated as interest and may therefore be subject to limited withholding tax, rather than complete exemption.

Apart from the issues relating to deductibility of interest as a general matter, it is often preferable to have the entity in the higher tax jurisdiction borrow the funds. In start-up situations, it may well be that the country where the investment is to be made will not have generated income in the early years and it is therefore attractive for the parent in the United Kingdom to borrow, so that the deduction may be applied against U.K. profits. The system of charges on income may make this attractive, since it is not only income from the project which may be relieved. Thus a U.K. borrowing invested through shares in a foreign subsidiary may prove attractive. If the borrowing is made in a foreign subsidiary, there may be no income to offset it against. In some situations, where the parent company guarantees the indebtedness of the foreign subsidiary, the borrowing would be treated as a share investment (such as in the United States).

V. OPERATIONAL ASPECTS

A. Direct investor

While U.K. property is subject to the detailed rules of Schedule A, rental income derived from overseas property and earned by U.K. companies is taxed in accordance with sub-sections 70(1) and (2) Taxes Act 1988 which state:

> (1) In accordance with sections 6 to 12 and 337 to 344, for the purposes of corporation tax for any accounting period income shall be computed under Cases I to VI of Schedule D on the full amount of the profits or gains or income arising in the period (whether or not received in or transmitted to the United Kingdom), without any other deduction than is authorised by the Corporation Tax Acts.
>
> (2) Where a company is chargeable to corporation tax in respect of a trade or vocation under Case V of Schedule D, the income from the trade or vocation shall be computed in accordance with the rules applicable to Case I of Schedule D.

Rent accruing from land abroad to a U.K. resident is income arising from possessions outside the United Kingdom. The possession in such cases is the land itself. In trading situations the trade is the foreign possession.

In the case of individuals the rules are set out in Section 65(1) Taxes Act 88, which reads:

> (1) Subject to the provisions of this section the sections 66 and 67, income tax chargeable under Case IV or Case V of Schedule D shall be computed on the full amount of the income arising in the year preceding the year of assessment, whether the income has been or will be received in the United Kingdom or not, subject in the case of income not received in the United Kingdom –
>
> (a) to the same deductions and allowances as if it had been so received; and
> (b) to a deduction on account of annuity or other annual payment (not being interest) payable out of the income to a person not resident in the United Kingdom.

In the case of a let property, Inland Revenue practice is to allow the deduction of certain expenses such as rates, insurance premiums and agents' fees or commissions as "expenses incurred in procuring and maintaining the rents".

Specific disallowances of certain expenses are found in respect of premiums paid under a policy of insurance against war risks[25] and in respect of injuries to employees.[26]

No specific provisions are laid down as to the treatment of losses arising under Schedule D Case V where there is no trade. They are not available for offset against other income. By way of Extra-Statutory Concession B-25, the Inland Revenue does permit deficiencies of income from letting of overseas property, including caravans and houseboats, to be carried forward for set-off against future income from the same property.

Where the overseas activity constitutes a trade, it will be important to decide whether the profits fall within Case I or Case V. The differences are of some importance for individuals given the particular rules for non-domiciled individuals. In the case of companies, the major difference will be in relation to the rules relating to relief for losses against other income. Section 393(5) permits losses in Case V. Trade is to be offset according to the usual rules only if the trade is carried on on a commercial basis. The rules are in other respects practically identical. Section 70(2) Taxes Act 1988 requires that where a company is chargeable to corporation tax in respect of a trade under Case V, the income is to be computed in accordance with the rules applicable to Case I.

Whether the income generated from the foreign property investment is taxed under Case I or Case V, it will be included in the income of the U.K. company in the year in which it arises and will be subject to corporation tax on the net amount computed under U.K. rules.

B. Foreign tax issues

As a general rule, the country in which the investment is located (the situs country) will usually tax in full the profits derived from property. It is not uncommon to find a relatively high withholding tax imposed on gross rentals. For example, in Canada, a 25 percent tax is withheld on gross rentals under Section 212(1)(d) of the Canadian Income Tax Act. Section 216 of that Act, however, permits non-residents in receipt of rental income to elect to be taxed on a net basis. This will permit the deduction of expenses relating to the rental income, such as interest, property taxes, insurance, agency fees and capital cost allowance. It does not permit loss carry-backs or carry-forwards. A similar regime

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22. See, for example, U.S.–U.K. Treaty, Art. 11(1).
23. See for example Canada–U.K. Treaty, Art. 10(1) and (2).
24. Belgium–U.K. Treaty, Art. 11(1) and (2); Denmark–U.K. Treaty, Art. 11(1); France–U.K. Treaty, Art. 11(1); Federal Republic of Germany–U.K. Treaty, Art. 7(1); Greece–U.K. Treaty, Art. 6(1); Republic of Ireland–U.K. Treaty, Art. 12(1); Italy–U.K. Treaty, Art. 8; Luxembourg–U.K. Treaty, Art. 11(1); Netherlands–U.K. Treaty, Art. 11(1); Portugal–U.K. Treaty, Art. 11(1) and (2); Spain–U.K. Treaty, Art. 11(1) and (2).
25. Taxes Act 88, Sec. 586.
26. Taxes Act 88, Sec. 587.

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is found in the United States Internal Revenue Code Sections 871(d) and 882(d). It should be noted that in both countries, the net rental elections only apply in situations where the rental income does not constitute the carrying on of a business in Canada or the carrying on of a U.S. trade or business. Typically, no business is carried on in these jurisdictions where the investor owns a single tenanted property with full repairing obligations referred to in North America as a triple net lease. In the case of multi-tenanted buildings, particularly where services may be supplied by the landlord, the activity may be regarded as the carrying on of a U.S. trade or business, requiring the foreign investor to file tax returns and generally to pay on a net basis. In most circumstances it would be appropriate to make the net rental election.

C. Tax rates

A basic but important analysis needs to be conducted to compare the rates of taxation imposed in the United Kingdom and in the foreign country. Certainly where taxable income is concerned and the investor does not have losses from other sources, for example, the minimization of the overall tax will require an examination of the comparative rates. With a full corporation tax rate of 35 percent the United Kingdom enjoys one of the lowest rates in the world. Compared with other European rates, direct investors will effectively pay the higher of the two rates. There is therefore little to be gained where the rates are higher by interposing a non-resident company in order to defer U.K. taxation. For example, in Spain where the rate of tax is 35 percent, assuming that the computation of income is the same in both countries, a direct investor would simply be subject to a 35 percent tax.

A developer operating in Greece where the rate is 46 percent would effectively have a 46 percent tax rate and no advantage is gained by interposing a Greek company.

A U.K. company owning a hotel in Guernsey, on the other hand, where the tax rate is 20 percent would do well to have it owned by a Guernsey company since profits from the hotel would be taxed at 20 percent until repatriated to the United Kingdom. The effect of the controlled foreign companies' rules, however, must be considered in such cases.[27] These rules attribute the income of such companies in low tax countries to their controlling U.K. shareholders.

D. Use of losses

Where possible, developers would wish to use net losses particularly generated by a project in its early years against other source income. In addition, where an investor has losses from other sources it may be appropriate to optimize their use against otherwise taxable income generated by the investment.

As we have seen, in the case of a direct investor, Case V losses may in several situations not be offset against income from any other source. For this reason alone it will usually be prudent to ensure that the trade does have some U.K. dimension so as to bring it within Case I which will permit trading losses to be offset against other source income, including capital gains, in the year in which they arise. The carry-back and carry-forward rules will similarly apply.

The use of a non-resident company to hold the development will effectively prevent any net losses that arise from the operation from being offset against U.K. income. Clearly, investments are not made with expectations of losses and this factor must be balanced against other requirements. In appropriate cases where there are existing losses in either a resident or a non-resident company it may be a more important consideration.

E. Depreciation

The ability to claim tax relief for capital expenditure is an area that may create significant distortions between the amount of income taxable in the situs country and in the United Kingdom. As a general rule capital allowances are not permitted in relation to property except in the case of certain industrial buildings and hotels.[28] The allowance is also permitted on plant and equipment installed in industrial and commercial properties. Qualifying industrial buildings and hotels may claim a writing down allowance at the rate of 4 percent per annum on qualifying expenditure incurred after 6 November 1962.[29] In Canada, capital cost allowance, which is the equivalent relief, is permitted also at the rate of 4 percent but on most buildings.[30] Thus a direct investor in a multi-tenanted residential building in Canada would be able to claim capital cost allowance to reduce income for Canadian purposes without a corresponding relief in the United Kingdom. Canadian tax might be reduced or eliminated in the early years of the investment but may not be on the same basis in the United Kingdom. Similarly on disposal the recapture of the capital cost allowance may give rise to a significant Canadian tax liability without a corresponding U.K. liability.

In the United States, on the other hand, the depreciation rules for buildings of a straight-line method over 27½ years for residential rental property and 31½ years for non-residential property mean that the effective rates are 3.36 percent per year or 3.18 percent per year.[31] The purchase of an industrial building in the United States would not have allowances that matched exactly with the U.K. system. Additional timing problems may arise by virtue of the U.S. "placed in service" rule as opposed to the U.K. "expenditure incurred" rule which would further de-synchronize the depreciation claims.

F. Treaty issues

The operational aspects of cross-border property investments are to be found in Article 6 of the OECD model treaty which is found in virtually all of the U.K.'s 80 tax treaties. The essence of this clause is that income earned from immovable property situated in a contracting state may be taxed in that state. This gives the right to tax income from immovable property to the state in which the property is situated without limitation and applies to income derived from the direct use letting or use in any other form of immovable property. Thus in relation to rental income typically no treaty protection is available. Some assistance may be found in Article 24 of the OECD model which prohibits taxation discrimination on the grounds of nationality. This may be useful in situations, for example, where tax relief such as personal allowances or a low rate of tax for small companies are not extended to residents. This would be the case in Canada and U.K. residents may rely on the non-discrimination provisions of the Canada–U.K. treaty to enable

27. Taxes Act 88, Secs. 747-756.
28. Capital Allowances Act 1990, subsecs. 3(1) and 7(1).
29. Capital Allowances Act 1990, subsec. 3(2).
30. See generally Canadian Income Tax Act, para. 20(1)(a) and Income Tax Regulations 1100.
31. United States Internal Revenue Code, Sec. 168(e)(2)(A) and (b)(3).

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them to use the Canadian personal allowance or small business rate of tax on corporations when a net rental election is made under Section 216 of the Canadian Income Tax Act.

It is clear that Article 6 is designed to cover exploitation of immovable property in the sense of direct use or letting of property.

It is also possible, particularly in trading situations, that the sale of properties constituting an inventory would fall to be taxed under the business profits provisions of Article 7 of the OECD model treaty. In other words, the profits would only be taxable if they are attributed to a permanent establishment in that country. In some jurisdictions, such as Canada, there has been considerable debate as to whether the property itself constitutes a permanent establishment in Canada for tax treaty purposes. The question is far from settled and the answer varies from one country to the next.[32] In most cases it will be extremely difficult to avoid a permanent establishment from a practical point of view since any local agent or office is likely to constitute a permanent establishment.

G. Distribution of profits

Traditionally, one of the attractions of direct investment in the cross-border context has been the fact that once corporation taxes or their equivalent have been paid then there is no further tax to be paid when profits are repatriated from the country of the investment to the United Kingdom. Indeed in many countries this remains the case. One of the attractions of being a direct investor in Spain or Portugal, for example, is the fact that there is no tax on branch distributions to the head office. If a foreign company is used, then typically there is a withholding tax levied on dividends paid to a U.K. parent company which effectively increases the rate of foreign tax unless it is eliminated entirely by a tax treaty. Thus a direct investor in Spain would see profits subject to Spanish corporate tax at the rate of 35 percent and U.K. tax at the identical rate which, in the absence of other distortions, would simply mean a 35 percent rate of taxation. If a Spanish company is used to hold the investment, distributions of profits by way of dividend to the U.K. company are subject to withholding tax at the rate of 20 percent.[33] For every ECU 100 of taxable profit taxed at 35 percent and leaving 65 available for distribution, 13 will be paid by way of withholding tax giving rise to an effective rate of Spanish taxation of 48 percent.

In countries with imputation systems where no withholding tax is normally levied on dividends, such as the Republic of Ireland and more recently Australia, again the direct investor will avoid the application of the advance corporation tax mechanism on distributions from the host country to the United Kingdom. Although the rate of tax is usually unaffected, there are obvious cash flow advantages.

Several countries have attempted to bring equality of treatment to direct and indirect investors not by abolishing the withholding tax on dividends unfortunately, but by imposing the so-called "branch tax" as it is known in Canada (which I believe was the first country to introduce it),[34] or the "branch profits tax" as it is known in the United States.[35] The basic mechanism of these branch taxes is that after computing income of the branch for corporation tax purposes, the after-tax income of the branch is subject to an additional tax equal to the standard rate of withholding tax. This increases the rate of tax to the level that would be paid if all of the profits were distributed currently. These rules are somewhat modified by treaty in some cases but they do constitute an important disincentive to direct investment because the branch tax is imposed on the current basis whether or not profits are repatriated to the United Kingdom. Where the effective rate of taxation in the foreign country is reduced, for example, because of depreciation allowances, it may be prudent planning to defer the repatriation of profits. In the case of an indirect investor in jurisdictions where the branch tax is imposed, it is not possible to avoid that charge by failing to remit profits.

H. Tax credit issues

The ability to offset foreign tax paid against any U.K. tax liability on the income earned from a foreign project is crucial. Even with today's low rate of corporation tax non-credibility would raise the combined rates to confiscatory levels. The concept of the foreign tax credit is quite simple. For every pound of foreign tax paid on income earned in a foreign country a £ 1 reduction in U.K. tax payable is made.[36] Thus, for example, where a U.K. resident has profits subject to 35 percent Spanish corporation tax, he will receive credit in the United Kingdom and with U.K. tax at 35 percent will not be subject to any further U.K. tax liability. However, there are several difficult areas in relation to tax credits that need detailed consideration and planning.

Where the amount of foreign tax paid is less or equal to the U.K. tax on a current basis, relatively little difficulty arises. Credit is given in the sale by way of treaty or unilateral relief. Where the foreign tax is higher than the United Kingdom tax, for example, if the project is in France with a 39 percent corporation tax rate, there is little opportunity to use up the excess credit. This is for two main reasons. First, the credit may only be used to offset tax in relation to the income from the particular source to which it relates.[37] In other words, if the French project is a multi-tenanted apartment building constituting a single source of income, the credit may not be applied to any other source of income. This would include other French-source income such as dividends from French companies or indeed perhaps another separate French property development. The result is always that the investor pays the higher of the United Kingdom and the foreign taxes. Second, the credit may only be used in the year in which it arises. To the extent that it is not used in the current year it is lost entirely. It cannot be carried forward or backwards as one finds, for example, in relation to advance corporation tax (ACT). Thus, if because of differences in timing of income between the United Kingdom and the foreign country, there are foreign profits but losses arise in the United Kingdom then the credit will be lost. In addition since it attaches to a particular source it cannot be surrendered within a U.K. group.

The restrictive approach adopted by U.K. law is well illustrated by the case last year of *George Wimpey International Limited v. Rolfe* where the taxpayer carried on a trade world-wide as a construction company.[38] For the account period in question it made profits in Hong Kong, Gabon and Jordan and paid local taxes thereon. Overall, however,

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32. For a recent Canadian perspective on this issue, see Mary Power, "The Taxation of Non-Resident Investing in *Canadian Real Estate*", 37 Canadian Tax Journal, No. 5 (1989), at 1266.
33. Spain–U.K. Treaty, Art. 10(1).
34. Canadian Income Tax Act, Sec. 219.
35. Internal Revenue Code, Sec. 884.
36. Taxes Act 88, Sec. 793.
37. Taxes Act 88, Secs. 796 (Income Tax) and 797 (Corporation Tax).
38. [1989] STC 609.

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its trading profit was nil. Non-trading income and capital gains did produce a profit chargeable to corporation tax. The taxpayer argued that its liability to corporation tax was computed by reference to its income in each of the three foreign territories. If it did not do so its losses would have been larger and its profits smaller. The Court, however, held that on the facts the computation for Schedule D Case I purposes comprising the whole trade produced no liability to U.K. tax on the trading account and there was no tax charged in respect of the income subject to foreign tax. As a result no foreign tax credit was allowed.

Where the foreign tax may not be credited against U.K. tax liability the only relief available is the deduction of foreign taxation in computing chargeable profits.[39] This is clearly less attractive than the tax credit which offsets U.K. tax liability on a pound for pound basis. Deduction will normally mean that U.K. tax is reduced by a percentage equal to the U.K. tax rate only. It should be noted that this deduction may be available where the credit is not available because of lack of U.K. tax liability and where foreign taxes are not creditable because their nature is such that they are not similar to U.K. taxes on income and capital gains.

An area of some difficulty which is not strictly a matter of double taxation arises in relation to the interplay between the foreign tax credit and advance corporation tax. This difficulty arises by virtue of the fact that all dividends irrespective of the source of profits out of which they are paid are subject to the operation of ACT. In most circumstances ACT is merely a prepayment of mainstream corporation tax liability and at the end of the account period ACT paid during the year is creditable against the final liability for the year. Where the foreign tax credit is claimed this will normally reduce or eliminate the mainstream corporation tax liability. Since ACT is not refunded, because there is either no corporation tax liability or a reduced corporation tax liability against which it may be offset, the ACT may effectively result in a higher rate of U.K. corporation tax. At current rates, assuming that all profits are currently distributed as dividends, this difficulty would arise where the foreign tax rate is in excess of 14.34 percent.

Where a U.K. company holds at least 10 percent of the voting shares of the foreign company credit is available not only for the foreign tax levied on the dividends but also for foreign underlying tax;[40] in other words, the corporation tax on the profits of the company out of which the dividends are paid. This will effectively eliminate the U.K. tax at current rates where the investment is in most developed countries.

In several countries where property development is possible, in particular less developed countries such as Israel, Egypt, Tunisia and so on, but also including some EEC states such as Spain and Portugal, various tax incentives for foreign investment are given. These include tax holidays, particularly in the early years of an investment. Tax treaties with these countries preserve the benefit of these tax incentives by treating the foreign tax as if it had been paid for the purpose of the tax credit even though in fact it has not. This tax-sparing relief ensures that the benefit is maintained in the case of direct investors who would automatically be subject to U.K. tax on the income that would benefit from a foreign tax holiday, and indirect investors when the profits are repatriated in the form of a credit for underlying tax paid on a notional basis. The rules for such tax sparing are found in the tax treaties with the countries I have referred to and several others.[41]

VI. DISPOSAL

Planning objectives in relation to disposals will typically attempt:

(a) limitation of tax to the United Kingdom in order to use losses available or other domestic law techniques for deferral of taxation;
(b) limitation of tax to the country of investment in order to benefit from lower taxes if any or to benefit from local deferral opportunities such as the U.S. "like kind" exchange rules or the U.S. instalment sale rules.

A. Direct investors

In principle, U.K. direct investors will be subject to tax on capital gains on the disposal of foreign rental property. Although there may be some opportunities for tax minimization in the foreign country, it is extremely difficult to alter the liability to U.K. tax. There may well be unused capital losses or current trading losses that may be used to offset the gain in certain circumstances. Where the property is a business asset, roll-over relief may be available if the proceeds of disposal are applied in acquiring another asset for use in the same business. There is no requirement that the assets be situated in the United Kingdom.[42]

To the extent that foreign tax is paid on the capital gains, a credit will be available against any U.K. tax liability.[43]

B. Indirect investors

The indirect investor will normally not be liable to U.K. tax on the sale of the property by the foreign company. An important exception is to be found in the case of non-resident "close companies". Where a chargeable gain accrues to a non-resident company that would be a close company if it was resident in the United Kingdom, the gains may be apportioned to shareholders resident in the United Kingdom in accordance with Section 15 Capital Gains Tax Act 1979. The gain is apportioned on the basis of the proportion of assets that a shareholder would be entitled to receive upon liquidation of the non-resident company provided that at least 5 percent of the gain is attributable to the particular U.K. shareholder. Where the parent company is resident in the United Kingdom, it is that company that is assessed to tax rather than its individual shareholders.

An exception is provided in relation to gains arising from the disposal of tangible assets whether movable or immovable which are used solely for the purposes of a trade carried on by the foreign company outside the United Kingdom. Normally this would not apply to a non-resident property investment company but rather to the business premises of a trading company.

Where the foreign company incurs a loss, it is not apportioned among U.K. resident shareholders and may not be set off against chargeable gains apportioned under these rules from other foreign companies. No relief is given for losses incurred by the same non-resident company in any earlier period. The only relief given is that where an allowable loss arises to the non-resident company during the same chargeable period it may be deducted from a gain which is apportioned in the same period where the gain is

39. Taxes Act 88, Sec. 811.
40. Taxes Act 88, subsec. 790(6).
41. See, for example, Israel–U.K. Treaty, Art. 18(2).
42. Capital Gains Tax Act 1979, Sec. 115.
43. Capital Gains Tax Act 1979, Sec. 10.

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itself apportionable. The chargeable period in this case is that of the U.K. parent rather than the foreign company.

Where tax is paid by a U.K. resident shareholder that tax is deducted in computing any subsequent gain that arises from the disposal of shares in the foreign company. As a measure of relief the payment of the tax that arises by the foreign company on behalf of the U.K. shareholder is not regarded as a distribution by the foreign company. Where such a distribution is made no deduction may be claimed for tax paid on the sale of the shares of the foreign company. If the gain is actually distributed by the foreign company within two years of the disposal by way of a dividend distribution of capital or liquidation of the company then no apportionment is required.

C. Foreign tax issues

The United Kingdom is highly unusual when compared with most countries in that it does not seek to tax the capital gains of non-residents on property disposals. Many countries tax gains on the sale of real estate investments. In several countries, such as the United States, Canada, France, Australia and others, the tax is extended to cover the sale of shares in companies where the value of the company is based on local real estate. Some jurisdictions seek to discourage speculation in undeveloped land and, for example, the Quebec and Ontario Land Transfer Acts impose significant additional tax on such speculative profits.

In several jurisdictions there are withholding procedures on the sale of real property. An example is the Section 116 procedure in Canada whereby a purchaser is required to withhold one third of the purchase price in relation to the acquisition of Canadian real estate purchased from non-residents. This is generally in excess of the ultimate liability and is designed as an incentive to encourage non-resident vendors to file Canadian tax returns. It is possible to apply for a certificate limiting the amount withheld to one third of the expected gain rather than a withholding on the gross proceeds. Other countries, such as Spain, currently use the exchange control regulations to ensure that proceeds are not repatriated without tax being paid. Where non-residents in Spain dispose of real property using the so-called Form 210 method, a certificate must be produced to the exchange control authorities showing that capital gains tax has been paid before proceeds may be remitted.

In addition, although several countries, notably English speaking countries, recognize a distinction between capital gains and income arising from trading activities, many countries do not and the rules are identical regardless of whether the gain is treated as one giving rise to trading income or capital gains according to U.K. concepts.

D. Treaty issues

The treatment of capital gains is an area that shows a wide variation in treatment in the U.K.'s tax treaties. Some treaties, such as the Cyprus treaty, have no capital gains provisions at all and the U.S. treaty simply permits both the United States and the United Kingdom to tax in accordance with their respective domestic laws.[44] Many treaties, such as the Spanish treaty, follow the proposals found in the OECD model treaty to the effect that capital gains derived from the alienation of immovable property may be taxed in the contracting state in which such property is situated. In addition, capital gains from the alienation of movable property forming part of the business property of a permanent establishment may also be taxed in the state in which the permanent establishment is located. Again little protection is to be found in such treaties.[45] Similarly one finds in the Swiss treaty authority to tax gains from the alienation of shares of a company the property of which consists principally of immovable property situated in a contracting state.[46] Usually the capital gains clauses have a general sweep-up clause which states that gains from the alienation of property other than that referred to in the specific capital gains clauses may only be taxed in the state of which the alienator is resident.

44. U.S.–U.K. Treaty, Art. 13.
45. Spain–U.K. Treaty, Art. 13.
46. Switzerland–U.K. Treaty, Art. 13(4).

CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

We welcome the submission of articles which are of interest to tax professionals, executives and scholars to be considered for publication. The author should ensure that the significance of the contribution will also be apparent to an international readership.

The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

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EGYPT:

NEW INVESTMENT LAW AND IMPLEMENTING REGULATIONS

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Egypt's long awaited revised Investment Law was passed by the People's Assembly and published in the Official Gazette on 20 July 1989. Law 230 of 1989 ("Law 230") is meant to stimulate new private investment and rectify some deficiencies which had become apparent under Law 43 of 1974, as amended ("Law 43"), which it replaces. On 6 December 1989 Prime Ministerial Decision 1531, the implementing regulations for Law 230, was published and became effective on the same day. With a few significant exceptions, noted below, these regulations are much as expected, primarily outlining procedures for implementing Law 230. On 22 April 1990 Prime Ministerial Decision 1 of 1990 on the Model Articles and Statutes for Joint Stock and Limited Liability Companies formed under Law 230 was published and became effective on the same day.

Law 230 preserves many of the features of Law 43 with some additional measures. Before dealing with the new law's benefits and privileges, we should consider how a project may qualify under Law 230. Three criteria must be reviewed: areas open for investment, local participation and the nature of the capital invested.

I. AREAS OPEN FOR INVESTMENT

Law 230 still focuses on housing, industrial, touristic and agricultural projects. (Housing projects, which had previously been limited to Arab capital, are now available to non-Arab investors.) However, the areas available for foreign investment are purposely more restrictive than those of Law 43, narrowing the scope of the current law by excluding from its ambit banking activity, transportation services, consultancy companies and construction companies.

II. LOCAL PARTICIPATION

Law 43 generally required that any project under that law include participation by public or private Egyptian capital. Law 230 provides that Egyptian, Arab and foreign capital shall have the right to act separately *or* together in the exploitation of any of the fields of investment outlined under the law. The Prime Minister has the right, however, where it is in the public interest, to specify certain fields where Egyptian participation may be required. There will also be many cases where Egyptian participation is preferable from the commercial point of view.

III. NATURE OF INVESTED CAPITAL

The definition of "invested capital" has been significantly enlarged under Law 230. The current law clarifies the fact that capital (including industrial property rights and local assets used in establishing a project) paid by an Egyptian natural person or a company, a majority of whose shares are owned by Egyptians, is considered "invested capital". The definition of foreign currency has been enlarged to include Egyptian currency which has been exchanged for foreign debts. This means that debt/equity swaps are now possible under Law 230. This is a far-sighted provision in the event that Egypt should adopt a debt/equity conversion programme. Foreign currency spent on feasibility studies, research or incorporation is no longer considered "invested capital". Law 230 further provides that capital in kind, such as machinery and equipment, need not be new, as was previously the case.

IV. INCENTIVES AVAILABLE UNDER LAW 230

Once a foreign company's investment project has qualified and received requisite Egyptian government approval, the following incentives are available to such companies.

A. Guarantee against expropriation

There is a guarantee against expropriation except where it is in the public interest and any assets of a company so expropriated will be compensated at the market value. Other government agencies are prevented from cancelling a project; however, the Investment Authority does have the power (for the first time) to cancel a project in the event it does not comply with the conditions of its approval.

Investors should be aware that further protection in this respect is contained in various treaties for the "Encouragement and Reciprocal Protection of Investment" Egypt has with Belgium, Luxembourg, France, Greece, Iran, Italy, Japan, Morocco, Netherlands, Rumania, Sudan, Switzerland, the United Kingdom,the Federal Republic of Germany and Yugoslavia. The treaty with the United States is awaiting ratification.

B. Equal treatment

Law 230 further provides that all projects be treated equally with other private sector companies (public sector companies are excluded) regarding production costs. In the past, for example, projects established under Law 43 were required to pay higher prices for energy than projects established under other laws, thus creating discrimination among different types of Egyptian companies. The new provision under Law 230, which will be phased in over time, should eventually eliminate that discrimination.

C. Tax incentives

A corporate income tax exemption is granted for a period of five years from the first fiscal year following the start of production or commencement of the activity as determined by the Investment Authority. At the discretion of the Council of Ministers, upon recommendation by the Investment Authority, this period may be extended for a further five

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years if necessitated by reasons of "public interest", taking into consideration the project's activities, its location, and its contribution to exports, employment and social and economic development.

Projects which are established in new industrial zones, new cities and remote areas are granted a ten-year exemption from corporate income tax. The Prime Minister is empowered to determine these zones and areas.

A ten-year exemption is also granted for projects for land reclamation, reconstruction, the building of new urban communities and industrial zones. The period may be extended for a further five years, to be determined by the Council of Ministers upon the recommendation of the Investment Authority.

A corporate income tax exemption is granted for fifteen years for projects of medium or low-cost housing where the units are rented unfurnished. This period can be extended for a period of five years by the Council of Ministers upon the recommendation of the Investment Authority. (Luxury housing projects enjoy a five-year tax holiday only.)

In all cases an extension of two years is granted if the local component in machines, equipment and fittings exceeds 60 percent.

An exemption from stamp duty on the capital of the project is granted for the same period as the corporate tax exemption applicable to such project.

A five-year tax exemption is also granted on the expansion of a project where the Investment Authority has approved such expansion. An expansion must involve an increase of capital which is used for installing new fixed assets which shall be used for increasing production, encouraging local manufacture in place of importation, for introducing new production or for providing new activities.

The exemption from the payment of stamp duties and registration fees on contracts, needed to establish the project and other related contracts, is extended to the duration of the project, as opposed to one year following the start of operations as provided under Law 43. Unlike Law 43, however, Law 230 does not include a tax exemption on interest payments on foreign loans.

An exemption from the general income tax payable by individual shareholders on distributed profits is granted for the same periods as the applicable corporate tax exemption extendable as above. This exemption is available provided such income is not subject to tax in the foreign individual's country of origin. Even after the period of exemption has expired, the distributed profit representing 10 percent of the original value of the taxpayer's contribution to the capital of the project shall remain exempt from general income tax. This exemption extends to 20 percent in the case of a joint stock company which has offered its shares to the public and where 40 percent of its capital has been so subscribed.

An exemption from general income tax on foreigners' salaries and benefits is granted provided that the period of their work in Egypt does not exceed one continuous year. A salary tax is still payable.

D. Customs and import incentives

Projects may import their production requirements, materials, machines, equipment and spares without the need to register in the Register of Importers, and without being subject to procedures relating to importation in general. All imports must be approved by the Investment Authority (rather than the Customs Authority); Law 43 previously provided for inspection only. Similarly, Law 230 projects may export without a licence and without being on the Register of Exporters.

Law 230 does not change the applicable flat rate of five percent customs and import duties payable on the value of materials imported for the operation and expansion of the project.

E. Exchange control

Law 230 projects are given a general right to operate foreign currency accounts. Confirming prior rules under Law 43, the new implementing regulations to Law 230 enable companies that do not have foreign currency of their own to purchase foreign currency from free currency bank account holders. The freedom to so acquire foreign currency is essential to the operation of the foreign investment programme.

Upon the Investment Authority's approval, capital shall now be repatriated in five equal annual instalments, rather than five years after the importation of the capital, as was previously the case under Law 43. If the capital is imported in kind, it may be re-exported in kind.

As far as the remittance of profits is concerned, the rule is that such profits shall be within the credit balance of the foreign currency account of the project. Incidentally, the right to remit capital and profits does not apply to invested capital paid in Egyptian pounds, unless it results from a debt/equity conversion programme.

An investor may sell his shares for foreign or local currency upon notifying the Investment Authority; no approval appears to be necessary. Shares may not be transferred, however, within the first two years of the project's life without the Investment Authority's permission.

F. Exemption from Egyptian laws

Projects formed under Law 230 are considered to be part of the private sector irrespective of whether Egyptian participation in the project is from the public sector. Therefore, such projects are not subject to the laws and statutes applicable to the public sector or its employees.

1. Company and labour law

Law 230 grants various exemptions from certain requirements outlined under both the Egyptian Company Law and Labour Law; these can be summarized as follows:

- Certain Company Law procedures relating to the incorporation of the company.
- Companies established under Law 230 will not have the discretion to determine what percentage of net profits shall be distributed annually among their employees. Law 230 provides that such percentage shall be no less than 10 percent. (Law 43 provided that companies were exempt from the requirement to distribute 10 percent of net profits, although some provision for distribution of profits to employees had to be included in the company's articles of incorporation.) Article 75 of the new implementing regulations states that the above-mentioned mandatory percentage applies only to joint stock companies, limited liability companies and partnerships limited by shares. Therefore, other entities (such as simple partnerships and limited partnerships) are not under such obligation; such other entities are generally less attractive, however, as vehicles for foreign investment.

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- It is not necessary for a director of a company formed under Law 230 to be employed in a senior position for at least two years before being eligible for such appointment.
- It is not necessary for the majority of the board of directors of a joint stock company formed under Law 230 to be Egyptian.
- Law 230 companies are exempted from the Labour Law requirement that employers can be obligated to take on certain employees according to the date they were registered at the competent employment registry.

2. Price control and profit margins

A potentially important provision of Law 230 states that there shall be no price controls or profit margin limitations on projects established under its provisions.

3. Rent restrictions

All housing constructed under Law 230 is exempt from rent control. In Law 43 this only applied to offices and above-average housing.

4. Land

Under Law 230, projects established in accordance with the Law have the right to own land and buildings "as may be necessary for the construction and expansion" of the project upon Investment Authority's approval. In the case of barren and desert land for reclamation and cultivation, however, long-term leases will be granted for 50 years which can be extended for further 50 years by the Council of Ministers on the proposal of the Investment Authority.

5. Free zones

There are still three types of free zones – the Private Free Zones, the Public Free Zones and the Free Zone City.

Although the free zones are considered to be "offshore", all Egyptian legislation is applicable unless Law 230 states otherwise.

Unlike Law 43, neither Law 230 nor the regulations set out the activities that will be permitted in the free zones. The regulations refer to certain activities such as repair, service, industrial and warehousing activities but otherwise provide no guidance as to what will be an accepted free-zone project.

The essential characteristics and benefits of the free zones are as follows:

- Free-zone projects do not require any local participation.
- The profits of a project in the free zone are exempt from taxation for the life of the project.
- An annual fee must be paid, however, of 1 percent of the value of the goods entering or leaving the free zone, or, if the project does not require the entry and exit of commodities, an annual duty of 1 percent of the proceeds realized by the project. Previously, this annual duty had been based on the value added in the project which led to disputes on the meaning of "value added".
- There are no customs duties on all equipment and plant imported for the project's activities with the exception of passenger cars. Customs duties will be applicable on exports from the free zone to Egypt as if imported from abroad; if local components are involved, the duties will apply only on the foreign components.
- Transactions by free-zone projects in the free zone or with parties outside of Egypt are exempt from the exchange control law.
- Expatriate employees in free zones are also exempt from general income tax if their period of employment does not exceed one continuous year.
- The same exemptions from Company Law and Labour Law provisions that apply to inland projects also apply to free-zone companies.

V. THE GENERAL INVESTMENT AUTHORITY

Under Law 230 the Investment Authority is now designated to be the sole governmental agency concerned with investment, and its institutional profile is upgraded by naming the Prime Minister as its Chairman. Although the Egyptian government has sought for a number of years to make the Investment Authority a "one-stop" department, thereby minimizing the bureaucratic burdens on investors, the success of this approach will depend (at least in part) on how the Investment Authority implements its role.

VI. PROCEDURAL CHANGES

Law 230 has made a number of positive procedural changes to rectify deficiencies in Law 43. These include extending the implementation period for a project; shortening the time for approval of investment applications; a preliminary approval is now given in two weeks enabling the investor to save on the expense of a feasibility study should approval not be given; and providing a right of appeal for the investor against the Investment Authority's decisions. In addition, Law 43 previously provided that joint stock companies or limited liability companies could be formed with only two shareholders. Law 230 does not contain such a provision for joint stock companies, and therefore (in accordance with general Egyptian company law) a minimum of three shareholders are required for this type of company.

VII. STATUS OF EXISTING LAW 43 COMPANIES

Law 230 is explicitly applicable to existing companies established under the prior investment law, and without prejudice to acquired rights and special treatment obtained thereunder. Therefore, companies formed under Law 43 shall continue to enjoy the privileges and benefits granted to them under that law (such as the distribution of 10 percent of the net profits to the employees).

Article 66 of the implementing regulations to Law 230 allows branches of foreign banks the right to accept local currency as settlement of their rights vis-à-vis their debtors, in the implementation of final judgements. Such foreign bank branches in Egypt were not previously permitted to deal in local currency. This "right" is subject to the proviso that the proceeds are deposited in the branches account with an accredited bank and used to meet its local expenses, i.e. salaries, fees for consultants, rents for its premises and the like.

VIII. CONCLUSION

Law 230 should prompt potential investors to reconsider the Egyptian market, but given the difficult economic situation facing Egypt today, some observers further advocate an investment policy which significantly minimizes the bureaucratic burden on investors and allows them to make company policy without undue governmental intervention.

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IRAN:

THE TAXATION OF COMPANIES AND INDIVIDUALS*

Mahmoud Zoroofchi and Nicholas C. Webb**

The Direct Taxation Act of Esfand 1366 replacing the previous Direct Taxation Act of Esfand 1345 was ratified by the Majlis and took effect as of 21 March 1989. For companies with an accounting year not coinciding with the Iranian calendar year, the new Act first applies to the accounting year ending between 21 March 1989 and 20 March 1990. A number of ambiguities in the Act have yet to be clarified by official rulings and it remains to be seen how certain of its provisions will be applied in practice.

I. TAXATION OF COMPANIES

A. Income tax

The Direct Taxation Act imposes a tax on the income of "legal entities", a term which encompasses companies, partnerships, cooperatives and other bodies. [Hereinafter the term "company" will be used to refer to all these kinds of entity except where the context demands that a distinction be made.]

1. System and rate structure

a. *Taxable persons*

Companies with Iranian nationality are subject to tax on all their income wherever earned. Non-Iranian companies are subject to tax on their income earned in Iran and also on income received from Iran for the granting of licences and other rights, the provision of training and technical assistance and the supply of films. A company has Iranian nationality if it is established under the laws of Iran.

b. *Rates*

The section of the Direct Taxation Act which deals with the rate structure applicable to companies is somewhat unclear but the position appears to be as set out below.

Article 131 of the Direct Taxation Act contains a table of progressive rates which apply for a number of income tax purposes:

Taxable income in Iranian rial (I.R.)	*Rate*
0 – 200,000	12%
200,001 – 400,000	14%
400,001 – 700,000	16%
700,001 – 1,100,000	18%
1,100,001 – 1,600,000	20%
1,600,001 – 2,200,000	23%
2,200,001 – 2,800,000	26%
2,800,001 – 3,600,000	29%
3,600,001 – 4,400,000	32%
4,400,001 – 5,400,000	35%
5,400,001 – 6,400,000	38%
6,400,001 – 8,000,000	41%
8,000,001 – 10,000,000	45%
10,000,001 – 12,200,000	49.5%
12,200,001 – 15,000,000	54%
15,000,001 – 18,000,000	59%
18,000,001 – 21,200,000	64%
21,200,001 – 25,000,000	69%
Over 25,000,000	75%

* For detailed information see *Taxes and Investment in the Middle East*, Chapter Iran, International Bureau of Fiscal Documentation (1990).

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Wholly government-owned companies, Iranian entities of a non-commercial nature which nonetheless make taxable profits and foreign concerns are liable to tax at the Article 131 rates on their taxable profits. Where a company is partly government-owned, the proportion of profits attributable to Government ownership is also taxed in this way, the remaining profits being taxed in accordance with the system for other legal entities outlined below.

All other legal entities are subject to a corporation tax at a flat rate of 10 percent and a municipality tax of 3%. The profit remaining is taxed in different ways depending on the nature of the entity concerned:

(1) *Joint stock companies and joint stock partnerships*
The remaining 87 percent of pre-tax profits, whether distributed or not, is taxed at the progressive rates set out above. In the case of profits attributable to bearer shares the rates are applied to the amount as a whole. In the case of profits attributable to registered shares or the shares of guarantor partners the rates are applied separately to the portion of each shareholder.

(2) *Other legal entities*
The remaining 87 percent of pre-tax profits, to the extent that it is distributed to shareholders or members in accordance with the articles of association, is taxed at the progressive rates set out above, the rates being applied separately to the portion attributable to each shareholder.

Pre-paid income tax may be deducted from the income tax liability computed in accordance with the rules set out above. Tax withheld and paid by the payor of dividends or partnership profits may also be deducted by the recipient company. Where pre-paid income tax exceeds the income tax due or where the recipient company's liability is less than the tax already paid on the dividends or partnership profits, the excess tax is refundable.

c. *Administration and assessment*

The Iranian tax year runs from 21 March to 20 March, though companies may have a financial year which does not correspond to the tax year.

Tax returns, supported by the balance sheet, profit and loss account, other statutory books of account and shareholder details, must be submitted to the appropriate Tax Assessment Office (in the case of foreign companies this is located either in the town in which their registered office is situated or where there is no registered office in Tehran) within four months of the end of the tax year. Companies enjoying tax exemptions are not excused from the obligation to file returns and failure to do so results in the cancellation of the exemption for the tax year concerned. A penalty equal to 5 percent of the tax due is payable for late submission of returns. Failure to submit a return carries a penalty of 20 percent of the tax due.

The taxpayer may object to an assessment within 30 days of service of the notice of assessment. Objections must be supported by documentary evidence and must be made direct to the chief assessor. If the matter cannot be resolved by the chief assessor it is referred to the Board of Settlement of Tax Disputes (BSTD). An appeal against the decision of the BSTD must be made in writing within one month. There is also a requirement that at least 10 percent of the tax assessed must be paid pending the outcome of the appeal. Should the appeallate BSTD confirm the decision of the BSTD, a fine equal to 2 percent of taxable income is payable. Further appeal may be made against the decision of the BSTD to the High Council of Taxation within one month of the notification of the BSTD's decision.

2. Computation

a. *Sources and basis of assessment*

The Direct Taxation Act does not list the sources of income subject to the tax on income earned by legal entities, but simply refers to aggregate income which is defined as the balance of income earned through various activities and different sources subject to taxation after the deduction of losses arising from activities which are not tax-exempt.

As a general rule the taxable income of companies is determined by reference to their statutory books of account. However, assessments may also be made on an "arbitrary basis", meaning that the actual profit is not computed but a deemed profit is fixed.

Where the assessment is based on the accounts the taxable income is computed by deducting from business proceeds (including capital gains) deductible expenses, depreciation, pre-incorporation expenditure and capital losses. Exempted income is also deducted.

Where the arbitrary method of assessment is used, a deemed profit is calculated by applying specified coefficients to such factors as annual purchases, turnover, production volume, etc.

For two kinds of income – income from real estate and incidental or windfall earnings – the Direct Taxation Act lays down special computational rules. These computational rules are explained below in the sections which deal with these categories of income when received by individuals. The taxation of companies' windfall earnings follows the system for individuals except that the income is also included in the aggregate income of companies and taxed in the normal way with a credit for any tax which has been paid earlier at inheritance tax rates. The position with regard to income from real estate is less clear. While the rules for computation of taxable income described below apply also to companies (with the exception of the exemptions obviously available only to individuals) it is not certain how the taxation of such income is integrated into the general rate structure applicable to companies.

b. *Exemptions*

The new Direct Taxation Act lists the following tax exemptions:

(1) Income derived from agriculture, including fish farming and beekeeping, is exempt until 20 March 1994.
(2) The income of industrial enterprises is exempt for one year from the date of commencement of operations. The basic one-year exemption is extended as follows:
- for two years where raw materials used are at least 75 percent domestically produced;
- for one year where raw materials used are more than 40 percent but less than 75 percent domestically produced;
- for three years or six years where the industry produces certain goods to be specified by the High Council of Industries;
- for one year where 20 or more workers are employed;
- for four years where the industry is set up in a deprived area;
- for two years where the industry is set up in a semi-deprived area.

Numerous activities, including the manufacture of

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cosmetics, the servicing of road vehicles, printing, the repair and maintenance of electronic goods, and filming, recording and photography, are specifically excluded from this exemption. The exemption is available to enterprises which are issued with establishment licences or permit cards after 18 April 1988 with transitional provisions applying to enterprises which were issued with licences or cards between 21 March 1979 and 18 April 1988. The legislation refers to industries located in specific areas but it is not entirely clear whether this restricts the exemption generally or only the application of the transitional provisions to industries located in these areas.

(3) Income derived from the exploitation of small mines by mining cooperatives is exempted for a period of five years. A licence from the Ministry of Mines and Metals is a prerequisite for qualification.

(4) Cooperative and guild unions are exempt from tax on membership fees. Certain other cooperatives (for example, qualifying housing cooperatives and fishermen's cooperatives) are entirely tax-exempt.

(5) There is an exemption for that part of declared profits from industrial or mining activities which is reserved for:
- expanding or developing existing industrial units or setting up new units (provided that the units are not to be used for any of the activities excluded from the exemption described at (2) above);
- approved employee housing projects.

The exemption covers reserves set aside in the year during which permission for the project is granted and the four subsequent years. There is a requirement that the expenditure against which reserves are made is actually incurred and penalties are exigible when this requirement is not met. A proviso excludes from this exemption enterprises which already benefit from the exemption described at (2) above.

(6) The income of factories with a work force of 50 or more which move their entire operations from the Tehran area to outside a 120 kilometre radius from Tehran is exempt for ten years. The qualification rules for this exemption have yet to be drawn up.

(7) Income derived from qualifying rural industries located in villages outside a 50 kilometre radius from the centre of Tehran is exempt for five years.

(8) Companies whose shares are accepted by the Acceptance Board of the Stock Exchange are exempted from the 10 percent corporation tax, provided that all transfers of the shares are made through the Stock Exchange.

(9) The following kinds of income are all tax-exempt:
- profits or bonuses accruing on fixed deposit accounts, current accounts or savings accounts with Iranian banks, but not where the deposit is made by another bank;
- bonuses accruing on government and treasury bonds;
- interest paid on overdrafts and fixed deposits by Iranian banks to foreign banks provided that reciprocal treatment is given;
- interest payable on land reform bonds.

The Direct Taxation Act provides that all exemptions granted under previous laws, which have a time limit, remain in force until the date of their expiry.

c. *Deductions*

Expenses which are deductible in arriving at taxable income are listed in the Direct Taxation Act. No other expenses may be deducted, except that the Ministry of Economics and Finance may propose other categories of expenditure which, if approved by the Council of Ministers, will be deductible. Conversely not all expenditure incurred in the listed categories is necessarily deductible, limits being placed on deductible amounts in certain categories. Prior to the new Direct Taxation Act these limits were imposed by the Ministry of Finance. Whilst the new Act refers to "prescribed limits" it is not yet clear what these limits are.

Expenditure must be supported to a reasonable degree by documentary evidence and exclusively connected with the earning of income during the year in question. Specific provisions allow the deduction of reserves for deductible expenses related to the current year and of deductible expenses related to previous years, payment of which becomes due in the current year and which have not previously been allowed.

The categories of deductible expenditure listed in the Act are:

(1) The cost of goods and raw materials sold or used to produce goods sold or to provide services.

(2) Personnel costs as follows:
- basic salaries, wages and regularly recurring benefits in cash and kind (the deductible amount for benefits in kind is the cost to the employer);
- payments which do not recur regularly such as New Year bonuses, overtime pay and travelling expenses (a regulation is to be drawn up setting limits to the deductibility of travelling expenses paid to personnel travelling abroad);
- health and safety expenditure and medical, accident and life insurance of personnel;
- retirement pensions and payments made in connection with termination of employment;
- social security contributions;
- staff meals.

(3) Rent of business premises.

(4) Rent of machinery and equipment.

(5) Costs of fuel, electricity, lighting, water and communication.

(6) Business insurance.

(7) Royalties, duties and taxes paid. Income tax, withholding tax imposed by the Direct Taxation Act and fines paid to government bodies are not, however, deductible.

(8) Research, development and training expenditure.

(9) Compensation paid for damages caused by the operations or assets of the business provided that the extent of the liability is established, that no other party can be held responsible and that damages cannot otherwise be recovered.

(10) Donations to certain charities, religious institutions, public welfare bodies, etc. up to a maximum of 30 percent of declared profits.

(11) Reserves against doubtful claims, provided that the claims are connected with the business, are unlikely to be recovered and the reserve is administered under a special heading in the company accounts until the claim is either recovered or becomes a definite loss.

(12) Expenses incurred in the maintenance and upkeep of the premises.

(13) Distribution expenses and transport and warehousing costs.

(14) Brokerage, legal expenses, conference fees, auditor's fees and fees for administrative and financial services.

(15) Interest on loans and related charges.

(16) Office supplies and office equipment with a maximum life of one year.

(17) Maintenance and repair of machinery and equipment.

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Expenditure on minor replacements of equipment and machinery is also deductible.
(18) Abortive mine exploration expenditure.
(19) Membership and subscription fees connected with the business.
(20) Bad debts to the extent that they can be proved bad.
(21) Exchange losses: the method of computing exchange losses must be in accordance with accepted accountancy practice and must be applied consistently from year to year.
(22) Normal wastage.
(23) Pre-incorporation expenses: expenses incurred in establishing a business including registration and consultation fees and also pre-trading losses may be written off using the straight-line method over a maximum of ten years from the date of incorporation.
(24) Payments which fall into none of the categories listed above but which are made in compliance with the law of Iran or a decree of the Council of Ministers.

d. *Depreciation*

Depreciation of assets is deducted in computing taxable income. Fixed assets may be depreciated if their value is subject to a decrease arising from wear and tear or obsolescence. An asset may not be depreciated because of a decrease in value simply arising from a price fluctuation.

Depreciation is computed on the basis of the cost of the asset (to which expenditure on a total overhaul or refurbishment may be added) and is calculated from the time when the asset is first at the disposal of the business and in a usable condition. Assets fall into one of two categories for depreciation purposes – those depreciated according to fixed percentage rates and those depreciated over a set number of years. Assets falling into the first category are to be depreciated using the declining balance method. For assets in the second category the straight-line method is to be used. When an asset is sold or becomes unusable, the undepreciated balance, less any sale proceeds, may be debited to the profit and loss account in the year of disposal. Depreciation rates range from 10 percent to 100 percent and the period over which assets may be depreciated from two to 15 years.

e. *Losses*

Subject to the approval of the Ministry of Finance, losses may be carried forward and set off against the income of subsequent years. The amount of losses which may be set off in this way is limited to a maximum of one third of the income shown by the accounts for the year in which the set-off is made. There is no limit to the number of years for which losses may be carried forward. Losses may not be carried back.

B. Other taxes on companies

1. *Zakat*

Iran does not levy any *zakat* on companies.

2. Municipality tax

A 3 percent municipality tax (initially abolished by the New Direct Taxation Act, but subsequently reintroduced) is levied on the net income of companies after allowing the usual deductions. Municipality tax is itself deductible in arriving at taxable income for income tax purposes under the general deduction rules (see, supra). It is not, however, deductible where taxable income is computed on an arbitrary basis.

3. Property taxes

An annual tax is levied on the owners of real property with a value in excess of 20 million I.R. at progressive rates ranging from 2 percent to 8 percent of total value. Various exemptions are provided for, the most important of which is for real property used for industry or agriculture.

As of 18 April 1988 and subject to certain exceptions a tax is levied on the owners of urban land which is kept undeveloped without an acceptable reason. The tax is based on the market value of the land and is imposed annually at rates ranging from 2 percent to 5 percent depending on the length of time that it has been kept undeveloped.

4. Stamp duty[1]

Stamp duty is imposed on the printing of cheques by banks, bills of exchange, promissory notes, all negotiable commercial instruments negotiated or employed in Iran, documents denoting title to merchandise including bills of lading, merchandise insurance policies, a range of bank transactions, the shares of joint stock companies, etc.

Some examples of the duties payable are:

Type of document	*Duty payable*
Bank cheques	2 I.R.
Bills of exchange, promissory notes	0.5% of value (minimum duty 5 I.R.)
Merchandise insurance policies	100 I.R.
Bills of lading (air and sea transport)	100 I.R.
Deeds of power of attorney	50 I.R.
Letters of guarantee	50 I.R.

5. Social security

Employers are required to pay certain social security contributions equivalent to 23 percent, or in the case of foreign employees, 20 percent of employees' gross salaries. The employee's contribution is 7 percent of gross salary. The maximum contribution is based on a salary of 120,000 I.R. per month. Contributions must be made in respect of both Iranian and foreign employees.

Under Article 38 of the Social Security Law clients of contractors are obliged to withhold 5 percent of the contract amount until the contractor produces a clearance certificate issued by the Social Security Organization. Such a certificate is issued when the social security contributions paid equal an amount arbitrarily calculated by the Organization having regard to the wages which it considers that the employees should have received. This may result in a social security contribution of more than 18 percent of the contract amount being regarded as payable before a certificate is issued.

II. TAXATION OF INDIVIDUALS

A. Income tax

Individuals of Iranian nationality resident in Iran are subject to tax on all their income whether earned in Iran or abroad. Non-resident individuals of Iranian nationality are subject to tax only on income earned in Iran. Non-Iranian individu-

1. The rules relating to stamp duty also apply to individuals.

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als are subject to tax on their income earned in Iran and also on their income received from Iran for the granting of licences and other rights, the provision of training and technical assistance and the supply of films.

The Direct Taxation Act specifies 5 categories of income earned by individuals. Each category is taxed separately and has its own computational rules. In addition a tax on aggregate income is imposed on individuals with income from more than one category.

1. Tax on salaries

a. *Taxable persons*

Individuals in receipt of income from employment in Iran whether on a regular or piece-work basis are subject to income tax on salaries. Liability also extends to wages and salaries from employment outside Iran where the employer is either the Government of Iran or a person residing in Iran.

b. *Taxable base*

Tax is levied on salaries, wages and all remuneration related to an employment whether recurring or non-recurring and whether paid in cash or in kind.

The assessable value of benefits-in-kind is normally the cost to the employer but in the following cases the assessable value is calculated as a percentage of salary and other regular remuneration paid in cash (net of deductions):

Furnished housing	25%
Unfurnished housing	20%
Chauffeur-driven car	10%
Car without chauffeur	5%

c. *Exemptions*

The following income is specifically exempted from income tax on salaries:

(1) salaries of foreign diplomats, embassy staff, etc. (subject to reciprocal treatment) and non-Iranian members of U.N. delegations and specialized agencies;
(2) salaries of foreign experts sent to Iran on aid programmes;
(3) salaries of local employees of Iranian embassies, consulates, etc. subject to reciprocal treatment;
(4) pensions, retirement allowances and termination of employment payments;
(5) foreign exchange allowances paid to Iranian Government officials working abroad, travelling expenses and allowances and hardship allowances. For private sector employees the exemption is restricted to 30 percent of such allowances except for travelling allowances connected with the employment which are fully exempt;
(6) shortage allowances payable to cashiers up to a maximum of 10,000 I.R. per month;
(7) housing, on-site accommodation, food and transport allowances and other non-cash benefits provided for manual workers;
(8) compensation from medical insurance, accident insurance, etc.;
(9) New Year bonuses and year-end allowances up to a maximum of 100,000 I.R.;
(10) housing and non-pecuniary benefits (or cash payments in lieu of such benefits) provided for civil servants;
(11) employees' medical expenses met by employers;
(12) salaries paid to members of the armed forces.

d. *Deductible expenses*

No expenses are specifically listed as deductible in arriving at income subject to the tax on salaries. The Direct Taxation Act does, however, provide for the general deductibility of two categories of expenditure in arriving at the taxable income of individual taxpayers. The two categories are expenses incurred during the tax year on medical treatment of the taxpayer himself, his wife, children, parents, brothers or sisters and life insurance premiums paid to Iranian insurance institutions.

e. *Rates*

Different rates of tax apply to private sector and public sector salaries, wages, etc. as follows:

Private sector			*Public sector*		
Taxable income in I.R.		Rate (%)	Taxable income in I.R.		Rate (%)
0 –	720,000	Exempt	0 –	840,000	Exempt
720,001 –	920,000	12	840,001 –	1,040,000	12
920,001 –	1,120,000	14	1,040,001 –	1,240,000	14
1,120,001 –	1,420,000	16	1,240,001 –	1,540,000	16
1,420,001 –	1,820,000	18	1,540,001 –	1,940,000	18
1,820,001 –	2,320,000	20	1,940,001 –	2,440,000	20
2,320,001 –	2,920,000	23	2,440,001 –	3,040,000	23
2,920,001 –	3,520,000	26	3,040,001 –	3,640,000	26
3,520,001 –	4,320,000	29	3,640,001 –	4,440,000	29
4,320,001 –	5,120,000	32	4,440,001 –	5,240,000	32
5,120,001 –	6,120,000	35	5,240,001 –	6,240,000	35
6,120,001 –	7,120,000	38	6,240,001 –	7,240,000	38
7,120,001 –	8,720,000	41	7,240,001 –	8,840,000	41
8,720,001 –	10,720,000	45	8,840,001 –	10,840,000	45
10,720,001 –	12,920,000	49.5	10,840,001 –	13,040,000	49.5
12,920,001 –	15,720,000	54	13,040,001 –	15,840,000	54
15,720,001 –	18,720,000	59	15,840,001 –	18,840,000	59
18,720,001 –	21,920,000	64	18,840,001 –	22,040,000	64
21,920,001 –	25,720,000	69	22,040,001 –	25,840,000	69
Over 25,720,000		75	Over 25,840,000		75

For employees working in villages and deprived regions up to 50% of the tax payable may be waived in accordance with instructions issued by the Ministry of Planning and Budgets.

Amounts subject to the tax on salaries which are paid by persons other than the payer of the recipients' basic salary, wages, etc. are taxed at a flat rate of 10 percent. Certain other kinds of income which are subject to the tax on salaries are also taxed at a flat rate of 10 percent, among them on-call bonuses paid to doctors, dentists, veterinary surgeons and pharmacists, overtime pay of pilots and tuition fees payable to university lecturers, teachers and tutors.

f. *Administration*

The tax on salaries is collected by deduction at source. Employers are obliged to calculate and withhold the relevant tax on the basis of the employee's annual salary. (Where the payer of an amount subject to the tax on salaries is not the payer of the recipients' basic salary, wage, etc. he must deduct tax at the rate of 10 percent.) The tax so deducted must be sent to the local Tax Assessment Office within 30 days together with a list of the names and addresses of the payees and their respective salaries in the first month. For subsequent months only changes to the original list need be reported. Persons receiving a salary paid from abroad are required to pay tax within 30 days of receiving it and to submit a tax return by 22 July of the year following the tax year in which the salary was received.

Exit visas and extensions of residence permits and work permits will only be issued to foreigners on production of a tax clearance certificate.

In cases where salary tax is not accounted for in accordance with the requirements outlined above, the Act provides for the making of assessments to include both the tax due and

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applicable penalties. Such assessments are final and conclusive and tax and penalties must be paid within 30 days unless an appeal is submitted in writing within the same time limit. The penalty for failure to comply with salary tax withholding requirements is a fine equal to 20 percent of the unpaid tax. In addition the employer or the director(s) of the employing company may be imprisoned for terms ranging from three months to two years. Claims for the refund of overpaid salary tax must be made by the recipient of the salary to the Tax Assessment Office local to his place of residence.

2. Tax on income from professions, trades and miscellaneous sources

a. *Taxable persons and taxable base*

Chapter 4 of the Direct Taxation Act imposes income tax on income earned in Iran by individuals from professions and from all other sources not specified elsewhere in the Act. The most important of these other sources is income derived from the carrying on of a trade. Civil partnerships, to the extent that they are comprised of natural persons, are also liable to tax on income from these sources. A civil partnership must be distinguished from the kinds of partnership defined in the commercial code (i.e. the general partnership, the limited partnership, the joint stock partnership and the proportional liability partnership). Unlike those, a civil partnership has no legal identity separate from that of its members, simply being an association of parties with a common interest in a property.

Assessments are made either on the basis of the figures in the statutory books of account (the journal and the ledger) or on an "arbitrary basis" which means that the actual profit is not computed, the tax payable being based on a deemed profit (see above).

A number of kinds of concern are obliged to maintain statutory books of account, among them:
(1) importers and exporters and holders of commercial licences;
(2) factories, workshops and industrial units;
(3) building and construction firms and engineering consultants;
(4) accountants;
(5) mine operators;
(6) transport businesses;
(7) brokers and commission agents, though not agents concerned with the distribution of petroleum products;
(8) representatives of industrial and trading businesses, both Iranian and foreign;
(9) lawyers.

A new list of those required to maintain statutory books of account is published annually on 20 January.

Taxpayers who maintain statutory accounts (either compulsorily or voluntarily) will generally be assessed on the basis of those accounts although arbitrary assessment may be applied, for instance where time limits are not complied with or where the accounts cannot be verified because of insufficient underlying documentation. Where the computation is by reference to the accounts, taxable income consists of the total amount of receipts for sales or the provision of services less allowable expenditure (including depreciation) plus other income.

b. *Exemptions*

With the exception of those which are available exclusively to companies, the exemptions for individuals are the same as those listed supra (see I.A.2.b.). In addition the following exemptions apply to individuals only:
(1) the maturity proceeds of life assurance policies;
(2) income derived from medical practices in villages and certain deprived regions – 50 percent exempt;
(3) the income of village inhabitants from handicraft industries;
(4) scientific awards, scholarships and income derived by scientists from inventions and discoveries;
(5) dowry payments.

Dividends payable by joint stock companies and joint stock partnerships are exempt from tax in the hands of the individual shareholders and the guarantor partners respectively. The exemption is also preserved where such dividends are channelled through other kinds of legal entity before being paid to the individual shareholders or guarantor partners.

c. *Deductions*

Deductible expenses are the same as those listed above and depreciation is allowed as outlined above. The Act contains no provisions regarding losses incurred by individuals.

d. *Rates*

Income from all sources taxable under Chapter 4 of the Direct Taxation Act is aggregated. In the case of single taxpayers without children the first 300,000 I.R. of taxable income is exempt. For married taxpayers and taxpayers with children the exempt amount is 600,000 I.R. Individuals who are members of a civil partnership are each entitled to an exempt amount as appropriate, subject to a maximum aggregate exempt amount of 1,200,000 I.R. per partnership. Where this limit applies the 1,200,000 I.R. exemption is divided equally among the partners.

Income in excess of the exempt amounts is taxed at rates ranging from 12-75 percent.

e. *Administration*

Taxpayers who maintain statutory books of account (see, supra) must file a tax return by 22 July following the end of the tax year, which runs from 21 March to the following 20 March. All other taxpayers must file by 21 May following the end of the tax year. All returns must be sent to the Tax Assessment Office local to the taxpayer's place of business or, where there is no place of business, to the office local to the taxpayer's place of residence. A single return suffices for a civil partnership and also for a manufacturing concern with a number of offices or outlets.

Taxpayers obliged to maintain statutory books of account are required to withhold tax at the rate of 5 percent on sums paid by them in respect of a number of items including medical fees, fees for arbitration, consultation, administrative and fiscal services, construction work and rental of plant and machinery. The tax so withheld must be paid to the Ministry of Finance within 30 days and the name and address of the recipient of the payment must be forwarded to the recipient's local Tax Assessment Office within the same time limit.

3. Tax on incidental or windfall earnings

Incidental or windfall earnings are defined as income, in cash or kind, which arises in Iran gratuitously either in the form of an award or otherwise. Such income is taxed at the inheritance tax rates applicable to heirs of the second degree (see, infra). Tax is payable within 30 days of the date on which the income arises. The following income is exempt:
(a) gratuitous allowances granted by charities, ministries, government organizations, etc.;

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(b) financial aid to the victims of war, earthquakes, floods, fire and other natural disasters;
(c) bonuses paid by the government to promote exports or agriculture.

4. Real estate income tax

Income from real estate is defined as income derived from the transfer of rights in real property situated in Iran and includes both rental income and gains from the outright transfer of real property.

In the case of rental income, the taxable income is deemed to be the total rent received less a fixed deduction of 25 percent to cover all expenses including depreciation. Where a property is sublet the taxable income of the sublessor is the difference between the rent which he received and the rent which he pays. If a lessee of real property makes additions to it for the benefit of, and as a result of prior agreement with, the lessor, 50 percent of the value of the additions is treated as taxable income of the lessor in the year in which he assumes title to them. Rental income from real property is considered to include any income attributable to fittings or machinery leased in conjunction with real property and also landlords' expenses met by a tenant.

The following exemptions are provided for:
- up to 30,000 I.R. per month derived from the letting of part of the taxpayer's private residence;
- in the case of single taxpayers without children, rental income is exempt if the taxpayer's aggregate monthly income including rental income (but excluding dividends, pensions, retirement allowances and dividends paid by banks on funds deposited with them) does not exceed 25,000 I.R. In the case of married taxpayers and taxpayers with children the monthly exemption is increased to 50,000 I.R. per month;
- where a property is jointly owned, the monthly rental income received by any owner is not taken into account for real estate income tax purposes if it is 5,000 I.R. per month or less.

Taxable income after exemptions is taxed at the rates of income tax on professions (see, supra).

In the case of gains arising from the outright transfer of real property the method of computation depends on the date on which the transferor became the owner of the property. If the transferor became the owner before 18 April 1988 tax is charged at a flat rate of 4 percent of transfer value. Where the transferor became the owner on or after 18 April 1988 the taxable income is the difference between the sale proceeds and the purchase price which is then taxed at the rates of income tax on professions. If the tax calculated in this way amounts to less than 4 percent of the transfer value of the property, the tax is charged at a flat rate of 4 percent of that value. Additions to the property made by the transferor during the period of his ownership are also subject to a flat rate of 4 percent on their value at the date of sale. Tax at the rate of 4 percent (or 8 percent on amounts in excess of 20,000 I.R.) is payable on any sums received for goodwill on the transfer of a business premises.

5. Tax on income derived from agriculture

All income derived from agriculture including animal rearing, fish farming and beekeeping is exempt until 20 March 1994.

6. Tax on aggregate income

Individual taxpayers in receipt of more than one category of income may be liable to a tax on aggregate income. The tax applies where tax payable on the different categories of income separately is less than the tax payable on the aggregate income calculated at the rates set out in Article 131 of the Direct Taxation Act (see, supra). The tax on aggregate income payable is the tax calculated in this way less the tax paid on the separate categories of income. The exempt amounts available to taxpayers earning salary income (720,000 I.R. for private sector employees and 840,000 I.R. for public sector employees) and income from professions, trades, etc. (300,000 I.R. for single taxpayers and 600,000 I.R. for married taxpayers and taxpayers with children) are also relevant in the context of the tax on aggregate income. However, only one such exempt amount may be taken into account in calculating taxable income for aggregate income tax purposes. Where there is entitlement to both a salary exemption and an exemption for income from professions, etc. only the salary exemption is taken into account. To the extent that the salary exemption is not absorbed by salary income it may be deducted (but only for aggregate income tax purposes) from income from professions, etc. and income from agriculture.

The following kinds of income are not included in aggregate income:
- gains from the transfer of real property taxed at a flat rate;
- certain income which is subject to salary tax but is taxed at a flat rate of 10 percent.

Taxpayers in receipt of aggregate income must file returns by 22 July following the end of the tax year specifying the taxable income from each source.

B. Other taxes on individuals

1. Municipality tax

A municipality tax of 3 percent is levied on all income of individuals with the exception of salaries and income from agriculture.

2. Property taxes

In addition to the annual tax on real property and the tax on undeveloped urban land which also apply to companies (see, supra), a tax is imposed on the owners of housing located in provinces or cities with a population in excess of 100,000 which is left unoccupied for more than six months. The tax is imposed at a monthly rate of 0.2 percent of the value of the property for the first year after the initial six-month period and at a monthly rate of 0.4 percent for subsequent years. Tax is not charged on property which is left unoccupied for reasons beyond the owner's control or on an individual's sole private residence.

3. Inheritance tax

Estates are taxed at varying rates depending on the relationship of the beneficiary to the deceased. Inheritance tax is imposed on the entire estate of an Iranian national regardless of its location. Estates of foreign nationals are only taxed to the extent that they are located in Iran. The rates of tax range from 5-80 percent, with certain exceptions.

Where both deceased and beneficiary are Iranian nationals domiciled abroad inheritance tax is imposed on the part of the estate located outside Iran at 25 percent. The estates of foreign nationals are taxed at the rates applicable to heirs of the second degree.

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4. Social security

The social security system for employees is explained in the section on companies, supra.

5. Other

Iranian nationals pay an exit tax of 50,000 I.R. for the first trip abroad in any year and 100,000 I.R. for each additional trip in the same year. Lower rates apply to families travelling on the same passport. Non-resident Iranians and students studying abroad are exempted.

All travellers, whether Iranian or foreign, pay an air fare tax of 200,000 I.R. on each air ticket issued in Iranian currency. Discounts and exemptions are available to certain travellers including government employees, children, Iranians studying abroad, foreigners studying theology in Iran, foreign experts and persons officially invited by the government and foreign medical staff working in Iran under official government contract.

A one-off wealth tax has been imposed on individuals with assets worth more than 100 million I.R. on 23 September 1988. The tax is levied at progressive rates ranging from 15 percent to 40 percent. Taxable assets include fruit tree orchards and luxury cars. Cash holdings are exempt.

III. WITHHOLDING TAXES

A. Dividends

The position regarding withholding tax on dividends depends on the rate structure applicable to companies generally and as such is somewhat unclear. A summary of the rate structure and its effect on dividends may be found at I.A.1.b.

B. Royalties and technical assistance fees

Amounts paid to foreign companies and other entities domiciled outside Iran for the granting of concessions or other rights or the transfer of motion pictures and also for the provision of technical training and assistance constitute Iranian income of the recipient and are therefore subject to tax in Iran. The taxable income in respect of both royalties and technical assistance fees is determined by applying fixed coefficients ranging from 20 percent to 90 percent. The Ministry of Economics and Finance is to draw up regulations specifying the exact coefficients to be used. Persons paying royalties and technical assistance fees must withhold tax at Article 131 rates (see, supra) taking into account amounts paid from the beginning of the year.

IV. CONSUMPTION TAXES

A. Turnover taxes

No general turnover tax exists. At municipality level, taxes or charges with respect to the delivery of certain goods or services may be imposed.

B. Excise duties

Levies with the character of excise duties are imposed under the system for taxing imports.

V. SPECIAL TAX TREATMENT

A. Contracting operations

The new Direct Taxation Act provides for a special method of computing taxable income from certain kinds of contracting operations on an arbitrary basis. The contracting operations concerned are those connected with technical or industrial installations; transportation; design and planning of buildings and installations; drawing, topographical surveying and various technical calculations; and all types of construction work with the exception of the digging of deep water wells.

Taxable income is deemed to be 10 percent of total contract receipts in a fiscal year. In the case of subcontractors this coefficient is reduced to 8 percent. Five percent of every contract payment must be withheld by the payor and accounted for to the tax authorities. This 5 percent withholding constitutes an advance payment of final tax due, which is computed at Article 131 rates (see, supra). Where the contracting entity is an Iranian company 10% corporation tax will be chargeable, Article 131 rates applying to the remaining 90% of pre-tax profits. The supply element of contracts (imported machinery, tools, equipment, etc.) is specifically exempted from tax.

The following example illustrates how the final tax liability is computed. The company is an Iranian branch of a foreign contracting company and the contract is completed within one fiscal year.

(I.R.)		
Gross receipts	– imported supply of equipment, machinery, etc.	550,000,000
	other	950,000,000
	total	1,500,000,000
Withholding tax 5% × 950,000,000 =		47,500,000
Deemed profit 10% @ 950,000,000 =		95,000,000
Municipality tax 3%		2,850,000
Tax payable at Article 131 rates		64,881,000
Less withheld at source		47,500,000
Balance due		20,231,000

The Act states that the system described above is only to remain in operation until the Ministry of Economics and Finance has completed its recruitment of technical auditing staff and sets a time limit of five years for the achievement of this task. Presumably thereafter assessments on contracting activities will be based on profits ascertained on ordinary commercial principles.

Contracts proposed before 22 February 1988 (or possibly before 18 April 1988 – the wording is ambiguous) will continue to be subject to the old Direct Taxation Act of Esfand 1345. The old Act also made special provision for the taxation of income from contracting activities, with the following differences to the new system:

- the percentage of gross receipts deemed to represent taxable income was 8 percent for both contractors and subcontractors;
- the withholding was 5.5 percent of each contract payment comprised of an additional fixed "contractor's tax" of 4 percent (now abolished) and 1.5 percent prepayment on account of final liability;

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- there was no specific provision to exclude the supply element of contracts;
- a Chamber of Commerce tax (now abolished), at a rate of 0.35 percent of taxable income was charged;
- the rates of income tax ranged from 15 percent to 75 percent;
- all contracting operations were exempt from the 10 percent corporation tax.

B. Airline and shipping concerns

Income tax is charged on foreign airline and shipping concerns at a flat rate of 5 percent of all amounts received by them in respect of passengers or freight carried from Iran. All such amounts are taxed irrespective of where payment is made (in Iran, at the destination or en route).

A representative of the taxpayer must submit a statement to the local Tax Assessment Office by the 20th of each month specifying the amounts received in the preceding month. Tax must be paid on delivery of the statement.

Iran has concluded a number of treaties to avoid the double taxation of income arising from international sea and/or air transport (see, infra).

C. Banking

All banks in Iran have now been nationalized.

VI. AVOIDANCE OF DOUBLE TAXATION

In certain circumstances Iran provides unilateral relief from double taxation but only to Iranian nationals.

It is understood that the U.K. Inland Revenue accepts contractor's tax (see, supra) as fully admissible for unilateral tax credit relief. No reason for this decision is known.

A. Comprehensive double taxation agreements

Iran has concluded the following double taxation treaties:

Treaty with	*Concerning taxes on*	*Date of conclusion*
France	Income	7 November 1973
Germany (Fed. Rep.)	Income and capital	20 December 1968

B. Treaty developments

The new Direct Taxation Act of Esfand 1366 requires the government to propose by 20 March 1990 that the comprehensive treaties with France and Germany either be extended or terminated.[2]

C. Limited double taxation agreements

Iran has concluded agreements for the avoidance of double taxation of income arising from international air and/or sea transport with the following countries:

Afghanistan	Norway
China (People's Rep.)	Pakistan
Denmark	Poland
India	Sweden
Italy	Switzerland
Japan	United Kingdom
Kuwait	United States
Netherlands	

2. At the date of this article no information is available on the government's intentions regarding these treaties.

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INTERNATIONAL:

COMMITTEE ON FISCAL AFFAIRS: ACTIVITIES 1971-1990 AND CURRENT WORK PROGRAMME

This document summarises briefly the structure, methods of work and activities of the OECD Committee on Fiscal Affairs since it was set up in 1971, and describes its activities as at January 1990 in the belief that an account of these matters would be generally welcomed by government departments, business, industry and academics. It replaces similar documents published in 1977 and 1985.

I. AN INTERNATIONAL FORUM FOR DISCUSSION OF TAXATION POLICY

When it was set up in 1971, the OECD Committee on Fiscal Affairs was given a broad mandate (reproduced in Annex I) which was designed to enable it to bring within the compass of its work all aspects of taxation policy. It showed clearly the intention of OECD Member governments to widen their co-operation in taxation matters as compared with the activities of the previous Fiscal Committee that had been centred mainly on ways and means of eliminating international double taxation.

The Committee on Fiscal Affairs (subsequently referred to as "The Committee") meets twice a year and brings together senior officials from OECD capitals all of whom play an active role in the formulation and the implementation of taxation policies in their own countries. The Committee has set up a number of Working Parties to undertake detailed work, and to hold discussions at the technical level, on specific aspects of the work programme of the Committee. The Committee acts as a steering group for its Working Parties, to which it gives specific mandates and instructions and from which it receives reports and proposals for decisions, recommendations and other action.

Besides laying down the work programme of its subsidiary bodies and following their implementation, the Committee provides a forum where OECD Member countries can meet regularly to exchange views upon the issues raised for taxation policy by events taking place in the world economy or in one or more OECD Member countries. An example is the monitoring of tax reforms that have taken place in nearly all OECD countries during the last few years.

The chart (next page) sets out in diagrammatic form the Working Party structure as at 1971 and its development over the last two decades. Though Working Parties Nos. 1, 2, 6 and 8 have been in existence for many years, their projects have been revised to take into account new policy issues which have arisen. Working Parties Nos. 3, 4, 5 and 7 were wound up when their tasks were completed, as were a number of other subsidiary bodies.

Whilst most of the work is undertaken by government officials and the OECD Secretariat, there is frequent consultation with representatives of business through the Business and Industry Advisory Committee to OECD (BIAC) and with trade unions through the Trade Union Advisory Committee to OECD (TUAC). The Committee and its Secretariat co-operate frequently with other international organisations including the various United Nations agencies, the International Monetary Fund, the GATT and the Commission of the European Communities. Occasional interdisciplinary meetings are held which may include also political figures and academics, as was the case with a symposium organised in 1987 by the French Ministry of Finance and the Committee on the topic of tax reform in OECD countries. Another meeting took place in June 1990 on taxation relationships and international capital flows between OECD and non-OECD Member countries.

Whilst some of the work undertaken in the Committee is regarded as confidential to governments or of insufficient interest to merit publication, the policy of the Committee has been to inform the public as far as possible of its work.

II. DOUBLE TAXATION TREATIES

Investment in other countries would be seriously impeded if there was a danger that income derived from this investment were to be taxed both in the country where the money was invested and in the country of residence of the investor. It is important for the harmonious development of international economic relations that the basic rules for taxing income and capital should follow an agreed standard pattern and should be as clear and precise as possible. These are the functions performed by the 1977 OECD Model Double Taxation Convention which replaced the 1963 OECD Draft Convention established by the former Fiscal Committee, and the network of bilateral tax treaties concluded between OECD Member countries and with non-Member countries.

For most types of income (and especially for investment income) double taxation is largely avoided under the OECD Model by attributing an exclusive or principal right of taxation to the country of residence of the taxpayer but for income derived from immovable property the primary right is given to the source country.

Most bilateral double taxation treaties follow not only the principles of the OECD Model but most of its detailed provisions and by the end of 1989 there were over 200 such treaties between OECD Member countries. The OECD Model has also had a considerable influence on bilateral treaties with developing and eastern European countries.

However, as the OECD recognised already in 1965, the "modified residence criterion" that is appropriate for the

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CHART

The Committee on Fiscal Affairs and its Working Parties 1971-1990*

Working Party No. 1 on Double Taxation and related questions 1971-	Working Party No. 2 on Tax Analysis and Tax Statistics 1971-	Working Party No. 3 on Company Taxation 1971-1975
Working Party No. 4 on Taxation of interest paid on International Bond Issues 1971-75	COMMITTEE ON FISCAL AFFAIRS 1971-	Working Party No. 5 on the Tax treatment of the issue and negotiation of securities 1971-75
Working Party No. 6 on Taxation and Multinational Enterprises 1973-	Working Party No. 7 on Taxation and Energy 1975-1977	Working Party No. 8 on Tax Avoidance and Evasion 1977-

* In addition to the Working Parties there have been a number of specialised Working Groups including the Estimating Methodology Group (1976-89) which reported to Working Party No. 2 and the Transfer Pricing Group (1974-77) which reported to Working Party No. 6 and others on Depreciation and Collective Investment Institutions which reported directly to the Committee.

OECD Model is not necessarily so for treaties signed with developing countries, since its application would involve a sacrifice of revenue for the developing countries with imbalance investment and related income flows. During the 1970s several members of the Committee participated in a Group of Experts which met under the aegis of the Economic and Social Council of the United Nations. In 1980, the Group established a model convention for treaties between developed and developing countries which took account of the concerns of developing countries in this matter.

The 1977 OECD Model Convention has not resolved all problems of interpretation and application and requires constant review to meet tax issues raised by new forms of business. The Working Party on double taxation acts as a forum for discussion of problems of this kind. Thus, reports on the leasing of industrial, commercial and scientific equipment, on the leasing of containers and on the international hiring-out of labour were published in 1985, a report on thin capitalisation and on the taxation of entertainers, artistes and sportsmen was published in 1987 and it is expected in 1991 to consolidate this and other work on double taxation into a first supplement to the 1977 Model. Other supplements are likely to follow during the next few years.

International double taxation can also occur with respect to taxes other than those on income and capital. In 1966, the former OECD Fiscal Committee had also completed a Draft Convention on Estates and Inheritances Taxes. This draft was updated and the new Model which was published in 1983 was extended to cover taxes on gifts.

III. TAXATION AND INTERNATIONAL CAPITAL FLOWS

Since its formation in 1971 the Committee has been involved in the conflict between encouraging international capital flows and reducing possibilities for tax avoidance and evasion from the relaxation of exchange controls and the removal of withholding taxes. This is currently one of the major preoccupations of the Committee and involves all its Working Parties. There are four main aspects to the work:

(a) A descriptive summary of the corporate and personal income tax systems of Member countries, with special emphasis on the taxation of profits;
(b) An analytical survey from both the domestic and international point of view of the rationale and effects of tax provisions which could affect international capital flows (e.g. different systems of company taxation from classical to full imputation, differences in withholding tax practices, credit versus exemption method for relieving double taxation);
(c) The quantification of effective tax rates on profits both for domestic investment and when investment crosses frontiers;
(d) An evaluation of the effect of country differences in effective tax rates and tax systems on international capital flows.

Work will be continuing in all areas over the next few years.

IV. TAX AVOIDANCE AND EVASION

Tax avoidance and evasion give rise to many serious drawbacks: the achievement of fiscal equity under domestic law is frustrated as those who cannot escape the tax net have to pay the taxes for those who manage to do so; international competition and capital flows are distorted to the detriment of countries where tax compliance is highest; the loss of tax revenues can be significant in some countries. Thus, concern with reducing the scope for tax avoidance and evasion has been for a long time among the interests of the Committee. The OECD Model Double Taxation Convention includes as part of the measures proposed in relation to tax avoidance and evasion, an Article on exchange of information between

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tax authorities. Better exchanges of information remain the major international initiative against non-compliance.

The Committee decided in 1977 that a more systematic approach to the various aspects of tax avoidance and evasion should be adopted and created its Working Party No. 8 to implement a work programme in this area. In September 1977, the OECD Council Recommendation on Tax Avoidance and Evasion informed public opinion of the collective determination of OECD Member governments to combat tax avoidance and evasion.

Delegates to the Working Party systematically inform their colleagues from other Member countries on the means at their disposal for dealing with tax avoidance and changes therein. This includes Member countries' legislation, important court decisions and audit and other techniques for detecting evasion. It is in this last context that regular meetings of tax inspectors are organised, during which, whilst identities are concealed, practical cases are examined and information shared between the people who work in this field on problems of tax auditing and detection of fraud.

New international legal instruments have also been developed. In 1981, a model convention for administrative assistance in the recovery of tax claims was published. In co-operation with the Council of Europe, a multilateral convention for administrative assistance in tax matters was drawn up and was opened for signature 1988. It will come into force when it has been signed and ratified by five countries. This is likely to happen during 1990.

In reviewing its work over the last ten years and taking into account the changing environment within which tax administrations operate, the Committee decided as from 1 January 1989 to broaden the mandate of the Working Party which is now as follows:

> To examine both from a domestic and international point of view the legal, policy and administrative aspects of tax avoidance and evasion and, in particular:
> - To undertake studies on the practical and policy aspects of exchanges of information;
> - To exchange views on measures which could strengthen the rights of taxpayers, provide a better service to them and, more generally, improve relations between tax authorities and taxpayers;
> - To study country experiences in the use of new technologies;
> - To examine the use of long-term policy planning, as a means of increasing the efficiency of compliance programmes;
> - To be responsible for the organisation of meetings of tax inspectors on subjects and at such times as agreed by the Committee on Fiscal Affairs;
>
> and to recommend accordingly.

On the first topic attention will be paid in particular to exchanges of information on international flows of capital which are expected to become more important as financial markets become more integrated and where international tax avoidance and evasion is likely to occur.

As tax controls and measures against tax evasion have intensified and necessarily have an impact even on the honest taxpayer, governments have recognised that these powers need to be supervised carefully and the new mandate emphasises the need for a more systematic approach to taxpayers' rights. An examination has already begun of measures securing the privacy and confidentiality of information on taxpayers and the rights of the taxpayer to appeal against decisions by the tax administration. It is expected that the results will be made public during 1990.

The new mandate also reflects the importance the Committee attaches to examining the ways in which computers can be used to improve the service provided to taxpayers and the control activities of tax authorities. Three broad topics will be examined: the use of computers in tax administrations; the special needs of auditing taxpayers with computerised records; the implications for tax legislation of the increasing use of computers.

V. TAXATION OF MULTINATIONAL ENTERPRISES

A large share of world trade is represented by the transfer of goods, loans, technology and services between various entities within the same multinational group of companies (MNEs) situated in different countries. Arriving at appropriate prices applied to these transactions, for determining the taxable profits of each entity, has been the major preoccupation of the Working Party on the Taxation of Multinational Enterprises which was set up in 1973. A major statement regarding tax policy approaches to transfer pricing prepared by the Working Party was issued in 1979 under the title "Transfer pricing and multinational enterprises".

The transfer pricing problem derives from the fact that the price paid for the many commercial transactions which take place between the members of a multinational group does not emerge as a result of the free play of market forces, as would be the case between two independent firms, but may be fixed according to other criteria. In such cases, prices may diverge from market prices even when the administrative policy of the group is to leave a considerable degree of autonomy to each of its constituent enterprises. The reasons for such divergences are various, for example, marketing strategies, the financial policy of the group and, of course, the aim of minimising the group's overall tax payments.

It is a long-standing, agreed principle among OECD countries, which is established in the 1977 OECD Model Double Taxation Convention and repeated in the 1979 report that, for tax purposes, prices charged for intra-group transfers should approximate as far as possible to the prices which would have been negotiated between independent firms, i.e. the "arm's length" principal. The Committee's 1979 report provides guidance for tax inspectors and for the officials of the enterprises on the numerous technical problems that arise when this general standard has to be applied to the audit of affiliated firms. This report, which was the subject of a Council Recommendation, has exerted considerable influence on legislation and practice and it has been translated into at least seven languages in addition to the two official OECD languages (English and French).

Subsequent work in this field has concentrated on means of avoiding economic double taxation arising from the tax authorities of one country adjusting the transfer prices between two affiliates, the taxation of multinational banking enterprises and the allocation of central management and service costs for tax purposes. The results of this work were published in 1984. Later publications summarised work on thin capitalisation and the taxation of foreign exchange gains and losses. Ongoing work includes a study of the taxation of pensions of the personnel of multinational enterprises, the attribution of income to permanent establishments, the taxation of new financial instruments, and the impact of taxing a secondary flow of income which has resulted from a primary and correlative adjustment of transfer prices. Work will start shortly on the taxation of cross-border acquisitions and mergers. National transfer pricing practices will continue to be monitored in the light of the principles set out in the 1979 transfer pricing report.

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VI. TAX ANALYSIS AND SOCIAL AND ECONOMIC POLICY

There are few aspects of social or economic policy which do not at some point raise tax issues. Tax measures are used to encourage investment and to subsidise different types of economic activity. Many social programmes are implemented with the aid of tax reliefs and the interaction between social benefit systems and tax systems raise complex issues. Whilst the use of tax policy to achieve social objectives is being increasingly questioned, the equity and distributional effects of the systems cannot be ignored. Work in this sphere has been carried out by Working Party No. 2 whose initial mandate in 1972 was to establish an internationally comparable classification of tax revenues, was expanded in 1975 to cover the social aspects of taxation and yet again in 1979 to cover all analytical and statistical aspects of taxation.

Statistical work

Country comparisons are frequently made of the ratio of total taxation to such overall economic indicators as GDP and conclusions drawn for economic or social policy. In the past, such comparisons were rarely consistent and the basis on which they were made was not explicit. This was due to various causes: the inadequacy of the existing breakdowns in international tax revenue statistics; the fact that similar kinds of tax may be classified in different ways in different countries; the differing views on such questions as what counts as a tax (e.g. social security charges, profits of government enterprises). Work was therefore undertaken in co-operation with the International Monetary Fund to draw up a list of taxes according to standard definitions of various types of levies with a view to facilitating global comparisons of tax receipts between Member countries. As a result, since 1974 OECD has issued an annual publication showing government revenues in OECD Member countries classified under about fifty internationally comparable categories of tax. Over the years the annual publication has been extended to include data on the breakdown of these revenues, capital revenues and grants. The publication represents the most comprehensive compilation of national tax revenues so far issued on an internationally comparable basis.

A second annual publication provides the after-tax positions of different family units at internationally comparable gross earnings levels which takes into consideration also payment of employees' social security contributions and receipt of family benefits. The basic unit adopted is a worker earning the average wage paid in the manufacturing sector, single and married with two children. Though there are limitations in the validity of such international comparisons, which are underlined in these annual reports, governments find that they fulfil a need. For many years there has been a desire in the Committee to look further at the effect of taxation on different income groups in different family situations and some publications have touched on this topic, but lack of comparable and sufficient data has until recently been a handicap. A report expected to be published in 1990 will fill that gap as it will provide data for 17 OECD countries on what sources of income are subject to personal income tax and the effective tax rates paid at different income levels.

Also there is a continuous exchange of views among government officials on techniques for measuring the effects of changes in tax laws on revenues received by governments broken down according to social/economic groups. Some of the results have been published.

Social and economic aspects of taxation

Because of the changing status of marriage and the family and the evolving role of women both within and outside the economic sphere, policy-makers have for some time been questioning many traditional distinctions – between the roles of men and women, between women working inside and outside the home, between marriage and informal alliances – which have been built into existing tax and social benefit schemes. A 1977 report contained a detailed description of countries' income tax, social security and cash transfer systems, with special emphasis on how these systems distinguish between different family units. A number of policy issues were highlighted in the report: difference of treatment for single persons and married couples; tax neutrality towards marriage; taxation and working wives. The discussions of these issues was supplemented by internationally comparable data on how different family units are affected by tax and transfer systems and this was the first time that international comparisons of this type were available. A subsequent report, published in 1980, updated the data and focussed on the tax consequences of women entering the labour force and on the tax/benefit treatment of families with dependent children. Further work will be done on this topic during 1990.

Income tax is alleged to have effects on the work supply of various kinds of taxpayers at various income levels and there is no general agreement on what these effects are. It is, however, generally accepted that among the lower income groups, there is a conflict between the "substitution effect" that would lead taxpayers to substitute leisure for work if taxation were increased, and the "income effect" which would impel them in these circumstances to work harder in order to maintain what they consider minimum standards of living. Among higher income groups the question arises, apart from a minority of taxpayers such as sportsmen and entertainers who may be driven by high taxation to migrate, whether high taxation kills their appetite for risk-taking or whether their economic behaviour is more influenced by other motives. The Committee issued a survey of the theoretical and empirical literature which was published in 1975 on these topics, which showed no clear answers to these questions, though there was some evidence that secondary earners in a family (usually wives) were more influenced by the substitution effect than the income effect. Subsequent work, referred to as second generation studies, emphasises more the deadweight loss effects, but there remains disagreement on the interpretation of the results. A brief review of these studies is provided in the Committee's 1986 publication on personal income taxes.

Reliefs through the tax system, generally referred to as "tax expenditures" to emphasise the analogy with direct government subsidies, have been examined by the Committee from a number of points of view over the last ten years; how to take into account countries' different reliance on them in interpreting total tax to GDP ratios? how to define and measure them on an internationally comparable basis both generally and in particular sectors where they are most frequently given (for example expenditures on housing, pensions and insurance)? how to compare their cost with that of direct expenditures and to ensure that they do not escape the budgetary control associated with the latter – a particularly important consideration these days when improving techniques for controlling increases in public expenditures is a concern of most OECD governments? A 1984 report examined the relative advantages and disadvantages of direct expenditures and expenditures through tax systems and of the various approaches adopted by OECD countries

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in presenting and measuring the cost of expenditures through the tax system. It is intended to update this report during the next two years in the context of OECD's general work on structural adjustment.

Major surveys have been carried out during the last five years of all the main revenue sources of OECD countries with the exception of corporation taxes (on which work is now under way) and social security contributions. These include surveys of taxes on immovable property, personal income taxes, capital gains and wealth taxes and consumption taxes. All these surveys give detailed descriptions of the main policy problems that arise and the reasons for countries' different choices, including a summary of the argument for and against possible options; full details are also given of each country's tax system, rates, base, methods of administration, etc.

Of other ongoing work, priority is at present attached to the quantification of effective corporate tax rates on an internationally comparable basis – in the context of the wider exercise on tax obstacles and distortions to international capital flows. Some work has already been done in this area by use of model firm approach and the results were derestricted in 1985. However, since then techniques have become more sophisticated and data availability has improved in many countries. It is intended to take advantage of these developments.

In 1990 work will begin on taxation and saving. It will examine the tax treatment of different saving instruments and their impact on the level and composition of saving.

Work will also start in 1990 on the tax treatment of incorporated and unincorporated small to medium-size enterprises. Their role in improving economic performance and the difficulties such enterprises face in gaining access to risk capital has led a number of countries to examine the way in which they are treated under the corporate and personal income tax codes.

VII. CO-OPERATION WITHIN OECD AND WITH OTHER INTERNATIONAL FORA

Taxation questions enter into a number of economic and social policy issues and the general need to develop a horizontal approach to such discussions in the OECD has led the Secretariat of the Committee to participate in a number of joint activities with other parts of the Secretariat and the Committees they service. In addition, the latter have been able to make use of the work of the Committee on tax revenue statistics, the average production worker and various inventories of tax expenditures. Of numerous activities, the following are probably the most important:

- *Economic performance and structural adjustment:* an inter-Secretariat project, being led by the Economics and Statistics Department;
- *Taxation of the international allocation of capital:* the tax obstacles project referred to above is being carried out in co-operation with the Economics and Statistics Department;
- *Relations between taxpayers and tax authorities:* work in this area will continue to be done in co-operation with the Public Management Service;
- *Relations with non-Member countries:* the 1990 symposium on taxation relationships and international investment flows between OECD and non-OECD countries was organised with the OECD's Development Centre and the International Monetary Fund;
- *Tax treatment of new financial instruments and cross-frontier mergers and acquisitions:* this work will be done in co-operation with other Divisions in the Directorate for Financial, Fiscal and Enterprise Affairs (those on Capital Movements and Services, Enterprise and Consumer Affairs and Financial Markets).

The following are the main examples of continuing co-operation with other international fora:

- *United Nations* (ECOSOC) holds meetings on tax relations between developed and developing countries at which the OECD Secretariat plays an active part;
- *International Monetary Fund* (IMF) and OECD set up a classification of taxes and have evolved a joint reporting system for the collection of revenue data;
- *The Commission of the European Communities* regularly attends meetings of the Committee and its Working Parties and co-operates actively with the Secretariat on a number of projects of common interest such as practical aspects of exchanges of information and the taxation of cross-frontier mergers.

ANNEX I

EXTRACT FROM THE RESOLUTION OF THE OECD COUNCIL SETTING UP THE COMMITTEE ON FISCAL AFFAIRS

Resolution of the Council

"The Council, ...

DECIDES:

1. The Committee shall henceforth be known as the Committee on Fiscal Affairs.
2. The Committee on Fiscal Affairs shall be responsible for investigating the methods by which taxation can be used to promote improved allocation and use of economic resources, both domestically and internationally and for proposing ways of increasing the effectiveness of taxation as a policy instrument for achieving Governmental objectives, but excluding work on the use of fiscal policy for demand management purposes".

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IFA NEWS

INTERNATIONAL FISCAL ASSOCIATION

BRITISH BRANCH

The first meeting of the 1990/91 season was held on 27 September in London. The main topic for discussion was the national reports for the 1991 IFA Congress in Barcelona.

GERMAN/ITALIAN BRANCHES

Several papers were presented during the 27-28 May 1990 meeting between the German and Italian branches. Extracts of several of the papers are set forth below.

THE SIGNIFICANCE OF VAT HARMONIZATION FOR THE ECONOMY (EXTRACT)

By Mr. A. Willemsen

By the end of 1992 the European Communities will have created a large internal market where the free movement of goods, persons, services and capital is guaranteed. According to the EC Commission, many restrictions will need to be abolished, including internal frontiers. Current attention in this respect is focused on VAT.

The concept of an internal market is more comprehensive than realization of the "four main freedoms" because other objectives of the EEC Treaty must also be attained. An example is the prevention of distortion of competition.

The First and Sixth VAT Directives established the objectives for VAT, i.e. imposition of tax on importation and refund of tax at exportation should be abolished and the common VAT system must not be discriminatory as regards the origin of goods and services. With this statement the EC Member States committed themselves to introduce the "country of origin" principle, meaning that domestic and intra-Community transactions will be treated equally, i.e. for purposes of VAT it will be immaterial whether goods cross an intra-Community frontier. Border controls will be rendered superfluous.

Another objective is to eliminate all bureaucratic measures to simplify business transactions and thus grant smaller enterprises access to intra-Community trade.

Some landmarks of VAT harmonization are:
- 1967: introduction of a common VAT and the determination of its structure and most significant modalities;
- 1977: comprehensive harmonization of the taxable base for VAT purposes was introduced by the Sixth VAT Directive.

The remainder of the VAT harmonization problems primarily concern the number and level of rates and categories of goods and services to which VAT should apply (as well as some questions regarding the deduction of input tax and exempted transactions). These problems should be resolved by the 1987 Commission proposals which provide for conversion to the country of origin principle, introduction of a clearing house system and reduction of the number of VAT rates to two, i.e. a normal rate (14% to 20%) and a reduced rate (4% to 9%).

It quickly became apparent that the majority of EC Member States rejected proposals which entailed a major encroachment on their "tax autonomy". The proposals for a clearing house system were also severely criticized. In 1989 the Commission mitigated its proposals by introducing only a minimum VAT rate and allowing a zero rate for a limited number of products. These proposals were also rejected by Member States (with the exception of the Federal Republic of Germany (FRG)). By the end of 1989 the Council issued guidelines for a transitional system and requested that the Commission draft a new proposal for a directive based on these guidelines. This transitional system would employ the country of destination principle, no harmonization of VAT rates would be envisaged and no clearing house system would be required. This concept seems surprisingly simple, but has nothing to do with the introduction of a real internal market.

The significance of the VAT harmonization for enterprises is not that it creates conditions which ensure neutrality in competition, since such conditions have already been realized to a large extent. This would, of course, be quite different if, without harmonization of the VAT rates, the internal borders would be abolished. A substantial distortion of competition may be expected in such a case. Small enterprises might be eliminated and the larger ones might contemplate moving to another country. Because of the FRG's moderate VAT rates, it has a strong starting position, but should the FRG favour such a policy for this reason, it would show short-sightedness.

The most significant effect of the VAT harmonization would be the reduction in administrative costs. The harmonization procedure during the transitional period is expected to result in the abolition of intra-Community borders and border controls. If enterprises were hampered with an onerous burden in the form of additional recording and tax audits, this goal would be frustrated.

The Treaty of Rome (Articles 100-102) implicitly requires Member States to harmonize their direct taxes. Results, however, have not been achieved, no directives have been adopted and even fewer directives incorporated in national law (the only exception is the Directive on Mutual Assistance (1977-1979)).[1]

On 23 April 1990 plans for the harmonization of the direct taxes were abandoned. However, adoption of three draft directives was urged. These directives aim to ease cross-border cooperation of enterprises (abolition of withholding taxes between parents and subsidiaries of other Member States, deferral of taxation of hidden reserves upon merger and other reorganizations of companies of different Member States and creation of an arbitration council for disputes on transfer pricing).[2] These directives should be supplemented by a directive which allows the set-off of losses incurred by branches and subsidiaries in one Member State with the income of the head office or parent company in another Member State and the abolition of withholding tax on inter-company payments of interest and royalties.

It is a condition sine qua non to remove all obstacles to intra-Community cooperation between parent and sub-

1. However, see below.
2. These directives were adopted by the Council on 11 June 1990 and will become effective on 1 January 1992.

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sidiary companies and to intra-Community corporate acquisitions and mergers in order to meet the challenge of American, Japanese and Korean industry.

SOME CONSIDERATIONS FOR A FAIR TAX SYSTEM IN THE GERMAN DEMOCRATIC REPUBLIC TO PROMOTE ECONOMIC DEVELOPMENT (EXTRACT)

By Mr. A. Willemsen

The revolutionary changes in the economic system of the German Democratic Republic (GDR) and – a fortiori – the future merging of the two German economies within the framework of a uniform monetary and economic union will no doubt profoundly impact GDR tax legislation and constitutional provisions on public finance. The intensification of trade between the two countries and increasing investment activities in the GDR by enterprises of the Federal Republic of Germany (FRG) will also necessitate a number of adjustments in the FRG tax legislation.

The GDR elections of 18 March 1990 will presumably culminate in the unification of the two Germanies so that the FRG's tax legislation and constitutional provisions on public finance will, in principle, apply throughout the GDR. However, economic and administrative factors preclude complete and immediate implementation of this legislation; the legislation will need to be introduced gradually.

The GDR has already adopted its first tax reform plans which may be summarized as follows:

A first step is the introduction of the Tax Amendment Law 1990 which essentially provides for a reduction in the individual and corporate income tax rates and the net wealth (worth) tax rate. Currently, the aggregate rates of these taxes per taxpayer may not exceed 75 percent of the taxpayer's income. However, the law does not contain any provisions for computation of profits so the precise impact of these taxes remains unclear. An additional complication is that different rates apply to different categories of income (e.g. salaries, income from trade or business, income from property, etc.). These rates differ from the corporate income tax rate and from the profits tax on cooperatives for craftsmen. No mention has been made of the necessary abolition of turnover taxes and subsidies as well as contributions made to public funds which are incorporated in the joint venture legislation. A uniform tax rate for earned income is only envisaged as of 1 January 1991.

As from 1 January 1991 the following measures will be taken:
- adjustment of State-owned enterprises to the tax system;
- taxation of cooperatives in conformity with uniform principles;
- introduction of a VAT.

As from 1992:
- reform of the valuation rules and the taxation of net wealth (worth) of individuals and enterprises.

As from 1993:
- reform of the administrative rules for tax assessment and collection.

No details or transitional measures have as yet been mentioned.

Considerations for the gradual introduction of FRG tax law in the GDR include the following:

(a) For all practical purposes, the GDR tax system is much simpler than the system in the FRG and fewer taxpayers are included in the tax net. The reason for this difference lies in the fact that the main source of revenue for the GDR is income generated by State-owned enterprises, which hitherto have been excluded from normal taxation. Taxes have only been levied on cooperatives, craftsmen, (small) enterprises and individuals. As a result the GDR tax administration is a small operation which will not be able to manage a sophisticated FRG type of tax system, even in a simplified form. Modern offices and additional technical equipment will be needed as will more qualified staff; for this purpose the support of the FRG authorities and institutions will be indispensable. More qualified tax advisers will also be needed. Even in the best possible circumstances it will take two to three years to create a tax administration and train tax advisers who will be able to cope with the task at hand.

To ensure adequate legal protection independent tax courts must be set up.

(b) FRG accounting methods and rules for the determination of income in the GDR must be introduced. A first step in this direction was taken in the Third Regulation on the creation and activities of enterprises with foreign participation of 21 February 1990. The minimum requirements of the Third Regulation concerning balance sheets and profit and loss accounts may be extended to other types of enterprises.

With respect to balance sheets, the FRG is bound by the provisions of the Fourth EEC Directive so that harmonization is possible only in conformity with this Directive. The decisive significance of the commercial balance sheet vis-à-vis the balance sheet for FRG tax purposes should be adopted by the GDR. The experience gained by introduction of the D-Mark-Bilanz-Gesetz and incorporation of the Saarland in the FRG may be valuable in this respect.

GDR State-owned enterprises should generally be converted into corporations (Aktiengesellschaften) or limited liability companies (GmbHs). The State could then sell the shares and reorganize the companies and cover the companies' long-term liabilities with the profits. Liabilities deriving from the supply of goods and services should be assumed by the companies themselves (against their stated value in DM) whereas business assets should be contributed against their fair market value.

Private enterprises in the GDR were already subject to tax. They maintain financial records which are used to compute income, although the pertinent legal provisions are much less stringent than those applicable in the FRG. These enterprises should also adopt FRG legislation in this respect.

Transitional problems, of course, may be expected, particularly with respect to the State-owned enterprises. Depending on their size, the qualifications of personnel and quality of their accounting departments, it may take two to three years before State-owned enterprises will be able to conform to FRG standards.

The GDR should, in principle, introduce the FRG individual income tax rates, but should apply a lower top rate. Businessmen subject to the individual income tax, business tax and net wealth tax should in the aggregate not pay more than 45 percent of their income.

The GDR should introduce the FRG imputation system with respect to the corporate income tax, and the total tax burden (corporate income tax, business tax and net worth tax) should not exceed 45 percent.

For a transitional period GDR enterprises could be granted

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tax incentives to compensate for inherent disadvantages (e.g. poor infrastructure, lack of qualified personnel, etc.). Such incentives could take the form of the incentives the FRG grants to enterprises established in West Berlin and the regions bordering the GDR.

The so-called FRG wage tax (pay-as-you-earn) and the FRG social security contributions which are also withheld from employment income cannot as yet be introduced in the GDR. It is expected that it will take at least two to three years before the FRG system of withholding tax at source for employment income may be implemented in the GDR. Perhaps a simplified wage tax system applying only a few tax rates could be adopted in the interim.

Currently a business income tax of 5 percent (increased by a multiple of 400 percent to 20 percent) is levied in the GDR. However, the revenue derived from the business tax is not sufficient for the colossal expenditure needed to finance an improvement in the GDR infrastructure. Increasing the tax would be counter-productive; however, the business tax could be suspended and reintroduced with a new system of business tax which is currently being prepared in the FRG.

The business net worth tax (0.8 percent) will be too great a burden on enterprises, in particular when these businesses (as expected in the coming years) incur losses. The tax should be abolished. A similar argument holds true for the net worth tax which will hamper creation of capital.

The GDR land tax is an insignificant tax because most of the land is held by the State. This tax could be reactivated as a municipal tax with the necessary privatizing of land. Introduction of municipal contributions and fees as in the FRG should be envisaged.

The FRG VAT legislation should be introduced as soon as possible in the GDR so that the GDR would have a VAT system conforming to the EEC VAT Directives and any special provisions applicable to the FRG and the GDR could be eliminated. It may be possible in the interim period to maintain the relatively low level of turnover tax. To further investment in the GDR, incentives (such as those in West Berlin) could be offered.

The current GDR system of subsidies and levies on products should be abolished and replaced by a few special consumption taxes (excises) which should follow as much as possible EEC recommendations. The taxation of hydrocarbon oil, tobacco, alcohol and beer would no doubt yield substantial revenue.

THE EFFECTIVENESS OF ENVIRONMENTAL TAXES AS AN INSTRUMENT OF CONTROL (EXTRACT)

By Mr. Matthias Werra, BASF AG

I. INTRODUCTION

The debate on environmental protection measures in the Federal Republic of Germany (FRG) primarily focuses on the imposition of taxes. Other measures, such as the issuance of transferable emission licences, offsetting emissions between a number of enterprises and voluntary measures warrant little attention. However, it is generally believed that legislative protection measures – even in a more flexible form – will not be adequate. The advantage of taxes over legislative control is assumed to accrue because the taxpayer may choose between investing in environmental protection or paying taxes; taxation will provide a powerful incentive to invest in anti-pollution devises. In fact, experience with effluent charges in Germany shows that these expectations are not justified.

II. SUMMARY OF THE DISCUSSION IN GERMANY

The views of the main political parties seem to converge, i.e. taxes and legislative protection measures together would be effective instruments for environmental protection.

Water pollution

The Federal government and the Socialist Party (SPD) as well favour increasing the tax on discharging waste water. This tax is levied on enterprises and municipalities and also applies to inevitable residual pollution, i.e. waste water which under best available technology cannot be further purified.

The Christian Democratic Party (CDU) wants to extend the so-called "Wasserpfennig", currently levied in one of the Federal States, to all other States. This is levied on persons transporting groundwater or surface water and the revenue is - rather inconsistently - used to compensate farmers for the restriction in the use of fertilizer.

Air pollution

The main thrust of the party programs is combatting the greenhouse effect by taxation of the consumption of energy. Although the global share of the FRG in the emission of CO_2 is relatively small, a majority is prepared to let the FRG take the lead.

The SPD embraces the idea of imposing additional excise duties on mineral oil and natural gas, and extending this tax to mineral oil used for the manufacture of chemical products, although such use does not affect CO_2 emissions. The SPD also wants to introduce an air pollution tax to be imposed on inevitable residual pollution.

The Federal Government, and the parties which support it, are in favour of taxing the use of fossil fuels (mineral oil, natural gas, pit coal and lignite). The Government also wants to replace the tax on motor vehicles (which is currently based on cylinder capacity) with a tax on the emission of gas.

Ground pollution

Plans for the introduction of a deposit tax on industrial and household garbage have not yet materialized. Political parties are directing attention to "special garbage" in an attempt to halt production of such garbage.

The SPD favours imposition of a tax on disposable bottles, cans, etc.

III. EVALUATION OF CONTROL FUNCTION AND FINANCING FUNCTION OF ENVIRONMENTAL TAXES

All parties agree that the environmental taxes should primarily be used as instruments of control. However, in practice, no analysis of their effectiveness has been made; none of the measures introduced indicate their precise goal and none of the proposed measures provide for abolition of the tax if a goal is attained. Enterprises are so restricted by environmental protection provisions (including legal responsibility and criminal law provisions) that they have a minimum of latitude to opt for alternative solutions.

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What remains is the taxation of inevitable residual pollution with severe financial effects. To be effective these taxes would have to be prohibitively high so as to motivate enterprises to expend the huge required amounts for more sophisticated anti-pollution devises. Even so, environmental taxes would not offer a better solution than environmental protection provisions, because they would necessarily have to be increased with future development of technology and, determining the rate of tax to achieve the desired effect would be onerous. Some economists are of the opinion that the tax rate could be established by experimental methods. However, the question may be raised whether such a trial and error method would not result in substantial market distortions.

Environmental protection legislation is superior to environmental taxation. Environmental protection provisions are more accurate and their effects are visible. They also provide an incentive to create an environmental products industry.

The budgetary and constitutional aspects also evidence that the imposition of environmental taxes is highly problematic. For instance, the Government may be tempted to use the revenue for purposes other than the environment (e.g. to finance the unification of the two Germanies). Because of their goal-orientedness, environmental taxes are not subject to normal budgetary control and there is a danger that a "shadow budget" will emerge. The Federal Constitutional Court has ruled that government expenditure may, in principle, only be financed out of taxes which are exhaustively listed in the Constitution. The Court also held that when the legislature introduces control measures, it must remain within the limits set for financing of such measures. A pure "control" tax does not conform to the Financial Constitution.

A further disadvantage of environmental taxes is that they increase production costs insofar as such costs cannot be passed on to the consumers. Such taxes will not be refunded when products are exported nor will an additional tax be imposed on imported products. In other words, German industry will be put in a relatively disadvantageous position and foreign industry in a relatively advantageous one. It is therefore argued that such taxes should be imposed by the EC Commission in all EC Member States. However, many EC States are opposed to such measures, and ultimately it would only relocate the problem, since non-EC states would have a relative advantage over EC Member States.

The recently proposed environmental taxes will have more of a "finance" function than a "control" function and, in general, will not alter taxpayer behaviour. One should, therefore, be skeptical of the environmental and economic efficiency of environmental taxes. It would be more sensible to rely on environmental control measures which could be made more flexible by the introduction of emission licences or the offsetting emissions between a number of enterprises.

THE CONVENTION BETWEEN THE FEDERAL REPUBLIC OF GERMANY AND THE REPUBLIC OF ITALY FOR THE AVOIDANCE OF TAXATION

Prof. Avv. Guglielmo Maisto

THE TAXATION OF BUSINESS PROFITS

Articles 5 and 7 of the treaty govern the tax regime applicable to business profits realized in one contracting state by an enterprise of the other state. The provisions follow very closely the OECD model convention with some departures which reflect the tax policy of the two states. For instance, Article 5 of the treaty does not contain the provision reflected in paragraph (3)(f) of the OECD model whereby the combination of auxiliary activities does not constitute a permanent establishment.

The exclusion of paragraph (f) reflects Italian policy on the matter (many other treaties concluded by Italy do not include the "combined activity" clause). It is worth noting that Article 5 shall be interpreted by the Italian Ministry of Finance, taking into account the reservation made by Italy to Article 5(2) of the OECD model, i.e. that the existence of one fixed place referred to in paragraph 2 (a branch *or* a place of management *or* an office, etc.) shall constitute a priori a permanent establishment regardless of the conduct of a business activity. If the taxpayer has not carried on an activity (i.e. if the condition set forth in paragraph 1 is not met), he must prove that and rebut the presumption.

With regard to the determination of the profits attributable to the permanent establishment, Article 7 also closely follows the OECD model. However, the protocol (point 5) clarifies the rules in the case of building sites, construction or installation projects, i.e. no profits shall be attributed in case of delivery of material. Similar classification is made by the same provision for permanent establishments regarding planning, delivery, installation or manufacturing of equipment for industrial, commercial or scientific installation, or in the case of public building activities.

Article 9 reflects Article 9(1) of the OECD model, which governs the relations between associated enterprises residing in the two contracting states. Following Italian tax treaty policy, Article 9 does not include the clause on corresponding adjustments (i.e. Article 9(2) of the OECD model) which, on the contrary, is included in the protocol (point 7). Such clause does not make the adjustments compulsory and therefore its effectiveness is severely jeopardized.

Taxpayers of the two countries shall make recourse to the EEC Convention on the transfer pricing arbitration procedure which requires a compulsory procedure (and adjustment) and sets forth time limits to be complied with by the tax authorities.

ITALIAN/GERMANY TAX TREATY

Professor Adonnino

Professor Adonnino discussed the new Italian/Germany tax treaty. Although the new agreement generally follows the OECD model, it contains more precise definitions and in some cases provides for different solutions than under the previous treaty – these differences will be relevant in the interpretation of doubtful cases.

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Basic Life Office Taxation. London, 9 November (English):
Oracle Business Information, 8 Bartok House, 30 Lansdowne Walk, London W11 3LT, United Kingdom. Tel.: 01-792 3105.

Second Annual Soviet Business and Joint Ventures Conference. Moscow, 12-15 November (English):
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Tax Planning for International Treasury Operations in Europe. London, 12-15 November (English):
Gerard Strahan, Director, Euromoney Publication PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom. Tel.: 071 236 3288. Fax: 071 248 3350.

Comment Eviter l'Abus de Droit dans vos Opérations Fiscales? Paris, 13 November (French):
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Accounting & Taxation for New Financial Instruments. London, 21-23 November (English):
Gerard Strahan, Director, Euromoney Publication PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom. Tel.: 071 236 3288. Fax: 071 248 3350.

13th Annual Congress of the American Tax Institute in Europe; topics e.g. Transfer Pricing, Pending U.S. Tax Legislation (Foreign Tax Equity Act 1990), Eastern European Integration, Earnings Stripping. Cannes, 14-16 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

ITPA Maui Seminar: e.g. Private Banking in the Pacific Rim; Investment in Taiwan; New Offshore Centres, Belize, Labuan, Western Samoa, Maui, Hawaii, 15-16 November (English):
Ms. Elizabeth Husband, ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

International Conference on Corporate Tax Strategy and Intercompany Pricing. Brussels, 19-20 November (English, French):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

Controlling Foreign Subsidiaries in Europe. London, 22-23 November (English):
Ms. Mary Parker-Jervis, Business Research International, 57/61 Mortimer Street, London WIN 77TD, United Kingdom. Tel.: 01-637 4383. Fax: 01-637 4383.

7th Asian-Pacific Conference – Practical problems of International Tax Practice. Singapore, 26-27 November (English):
APTIRC, 2 Nassim Road, Singapore 1025.

MCE Second Moscow Seminar – Joint Venture and Other Business Opportunities in the U.S.S.R. Moscow, 27-30 November (English):
Management Centre Europe, Rue Caroly 15, 1040 Brussels, Belgium. Tel.: (32 2)5161911. Fax: (32 2)5137108.

Recent Developments in International Tax from the Revenue's Perspective. Manchester, 28 November (English):
British Branch of IFA, Manchester sub Branch, Mr Brian Whitefoot, Arthur Anderson & Co., Bank House, Charlotte Street, Manchester M1 4EU, United Kingdom. Tel.: 061 228 2121.

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Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

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Internationales Steuerseminar Zürich, c/o Bank Leu AG, z.Hd. Frau M. Salzberg, Postfach CH-8022 Zürich, Switzerland. Tel.: 01 219 23 99.

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La Strategia Fiscale Internazionale. Milan, 29 November (Italian):
C & S International S.r.l., Via Besana 8, 20122 Milan, Italy. Tel.: 55191109. Fax: 55191120.

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British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071 936 3000.

Trusts, Companies and High Net Worth Individuals – A World in Transition – The Use of Atlantic, Caribbean and other Offshore Centres in International Tax and Financial Planning. London, 13-14 December (English):
Legal Studies & Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: 071-236-4080.

Taxation of Branches and Subsidiaries, Brussels, 13-14 December (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

De Praktijk van fusies en overname. Rotterdam, 18-19 December (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

JANUARY 1991

Beginners Course on the Principles of International Taxation and the Tax Systems of Selected Countries from an International Perspective. Amsterdam, 14-25 January (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

The Eighth Annual Waidring Conference – The Transnational Person / 1992. Waidring, 20-26 January (English):
University of the Pacific, McGeorge School of Law. Att. Mr. Stanley E. McCaffrey International Programs Center, Ferdinand-Porsche-strasse 6/II, A-5020 Salzburg, Austria. Tel.: (0662) 75 5 20; Fax: 662 75 5 23.

FEBRUARY 1991

Supervised Study Programme on Double Taxation Treaties. Amsterdam, 28 January-22 February (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

MARCH 1991

Beginners Course on the Principles of International Taxation and the Tax Systems of Selected Countries from an International Perspective. Amsterdam, 4-15 March (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

Advanced International Tax Course on Controlled Foreign Corporations, Transfer Pricing, International Joint Ventures, the Use of Tax Treaties, Treaty Shopping. Amsterdam, 18-21 March (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

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La Protection du Contribuable

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Der Schutz des Steuerbürgers

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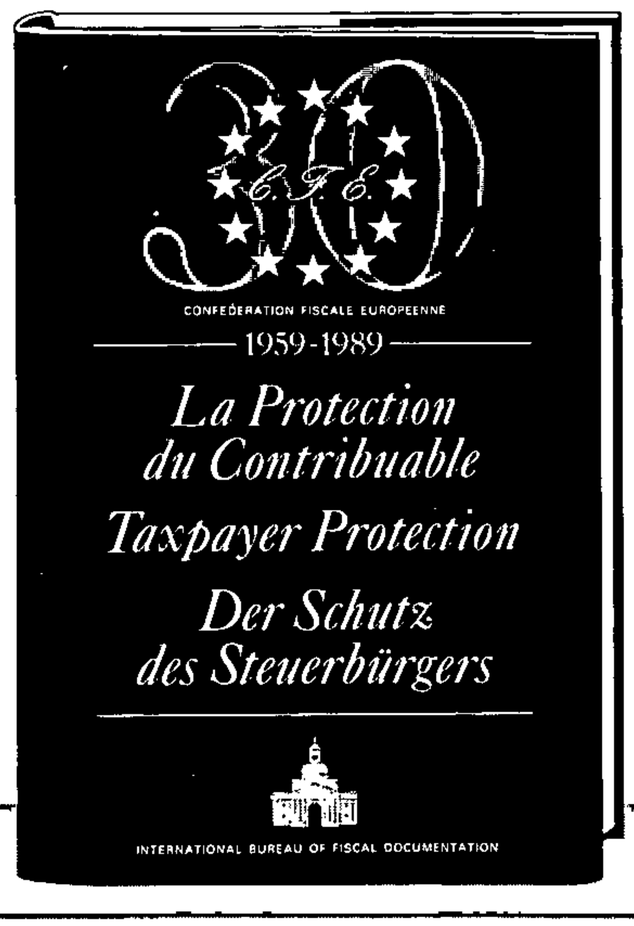

In recent years, the rights and obligations of the tax authorities and the taxpayer when dealing with each other have become a subject of growing importance.

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MALAYSIA: LABUAN: A NEW TAX HAVEN 600
The Malaysian Parliament recently passed legislation designed to transform the Island of Labuan into a tax haven – once the legislation takes effect Labuan will be Southeast Asia's only international offshore financial centre. This article surveys various features of the legislation, including the rules relating to trust companies, banking and insurance.

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This article addresses the problem of sales tax evasion in India. A brief theoretical discussion leads to the conclusion that no single policy measure is likely to succeed in curbing tax evasion significantly, and it must be tackled through all kinds of policy measures available. The article identifies various methods of sales tax evasion used in India and suggests administrative measures to limit the use of each method. The author concludes that no fundamental overhaul of the tax system is necessary to limit tax evasion.

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SOMMAIRE

Lee Burns et Rick Krever:

Australie: Application des réformes de l'impôt sur les revenus de source étrangère 579
Le Bulletin a publié plusieurs articles donnant des informations sur les différentes modifications du système d'imposition australien des revenus de source étrangère. La législation instituant ce système a été finalement présentée devant le parlement australien en septem-

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Australien: Steuerreformen, die Einkommen aus ausländischen Quellen betreffen, abgeschlossen 579
Das Bulletin veröffentlichte mehrere Artikel, die die verschiedenen Veränderungen in Australiens neuem Einkommensteuersystem für Einkommen aus ausländischen Quellen dokumentieren. Im September 1990 wurde schliesslich die Gesetzgebung zur Errichtung dieses

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bre 1990. Cet article analyse l'évolution des réglementations et les caractéristiques des propositions finales adoptées par le Gouvernement.

David Hay:

Nouvelle Zélande: Anomalies contenues dans l'imposition des revenus agricoles *586*
Le système d'imposition des revenus de la Nouvelle Zélande a été considérablement modifié au cours de ces dernières années. Les réformes fiscales contiennent entre autres des modifications afin d'éliminer les dégrèvements fiscaux qui s'appliquaient auparavant aux exploitations agricoles. Le régime amendé applicable aux exploitations agricoles contient néanmoins un certain nombre de domaines où les dispositions de la législation fiscale sur le revenu peuvent encore influencer la gestion agricole ou les décisions d'investissements.

Jefferson P. VanderWolk:

International: Action de jouissance: Nouvel outil de gestion fiscale permettant d'effectuer, de façon fiscalement subtile, une acquisition ou une réorganisation de société américaine *590*
Les acquéreurs étrangers de sociétés américaines ont traditionnellement payé comptant les actions ou les biens de sociétés américaines. Toutefois ces structures sont en train de changer, les investisseurs étrangers étant mieux informés des possibilités de gestion fiscale américaine. Le recours à une forme d'"actions de jouissance" est l'une de ces possibilités; il s'agit d'actions spéciales qui pour l'essentiel n'accordent aucun droit à l'exception de celui de recevoir des dividendes.

S.I. Chelvathurai:

International: Evasion fiscale, fraude fiscale et économie souterraine – L'expérience du C.A.T.A. *594*
L'élaboration de plans d'évasion fiscale a considérablement augmenté au cours des deux dernières décennies dans de nombreux pays membres du C.A.T.A. afin de réduire la charge fiscale globale. Cet article analyse comment le fisc doit aborder les problèmes d'évasion et de fraude fiscales, l'auteur mentionne quelques unes des dispositions législatives et la jurisprudence de différents pays membres.

Dr. Arjunan Subramaniam:

Malaisie: Labuan: Un nouveau refuge fiscal *600*
Le parlement malais vient d'adopter une législation destinée à transformer l'île de Labuan en refuge fiscal – à partir du moment où la loi entrera en vigueur, Labuan sera le seul centre financier international offshore de l'Asie du Sud-Est. Cet article résume différentes dispositions se rapportant aux trusts, aux banques et compagnies d'assurances.

Rup Bahadur Khadka:

Népal: Aperçu du Budget 1990/91 ..... *602*
Un gouvernement intérimaire a été constitué au Népal après la réintroduction en avril 1990 du pluripartisme. Le Budget 1990-91 reflète la nouvelle politique suivie par le Gouvernement, à savoir une conduite ferme vers une diminution de l'inflation et la sortie du pays de décennies de mauvaise gestion économique. Les dispositions budgétaires ont donc pour but de réduire les problèmes posés par certaines questions urgentes. Cet article mentionne les points les plus importants du Budget.

Carnet des Congrès *604*

Tapas Kumar Sen:

Fraude portant sur les taxes sur le chiffre d'affaires en Inde: Enumération de certains problèmes *605*
Cet article aborde le problème de la fraude sur les taxes sur le chiffre d'affaires en Inde. Après une brève analyse théorique, on peut conclure qu'il n'est pas possible de réduire considérablement cette fraude fiscale par l'application d'une seule mesure: il faudrait aborder le problème sur différents fronts. L'article énumère différentes méthodes suivies en matière de fraude sur les taxes sur le chiffre d'affaires et suggère l'application de certaines dispositions administratives permettant d'en limiter l'usage. L'auteur considère en conclusion qu'il n'est pas nécessaire de réformer le système fiscal pour en réduire la fraude.

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Systems in das australische Parlament eingeführt. Der vorliegende Artikel gibt einen Überblick über die Bestimmungen und erklärt die Hauptmerkmale des letztendlichen Vorschlags, der von der Regierung angenommen wurde.

David Hay:

Neuseeland: Besonderheiten in der Landwirtschaftsbesteuerung . *586*
In den vergangenen Jahren wurde das neuseeländische Einkommensteuersystem nicht unbedeutend modifiziert. Die stattgefundenen Steuerreformen enthalten unter anderem Veränderungen in der Landwirtschaftsbesteuerung. So wurden früher bestehende steuerliche Zugeständnisse aufgehoben. Jedoch bietet auch die modifizierte Besteuerung der Einkünfte aus Landwirtschaft Gebiete, in denen die diesbezüglichen Gesetzesbestimmungen das Landwirtschaftsmanagement oder Investitionsentscheidungen noch beeinflussen können.

Jefferson P. VanderWolk:

International: Aktien, die (nur) zum Dividendenempfang berechtigen: Ein neues Instrument der Steuerplanung für steuereffektive Käufe oder Umgestaltungen von US Körperschaften *590*
Ausländische Erwerber einer US Körperschaft haben traditionellerweise in bar für Aktien oder Vermögensanteile an US Zielgesellschaften bezahlt. Diese Methoden sind jedoch im Begriff, sich zu ändern, als ausländische Investoren sich mehr und mehr über die zur Verfügung stehenden Steuerplanungsmöglichkeiten bewusst werden. Eine dieser Möglichkeiten ist die Verwendung von Aktien, die zum Dividendenempfang berechtigen, so zum Beispiel besondere Aktien, die im wesentlichen keine anderen Rechte beinhalten als dasjenige zum Dividendenempfang.

S.I. Chelvathurai:

International: Steuerumgehung, Steuerhinterziehung und die Untergrundwirtschaft – Die CATA-Erfahrung *594*
Steuerumgehungstechniken als ein Mittel zur Verringerung der allgemeinen Steuerlast erlebten in vielen CATA-Mitgliedsstaaten während der letzten zwei Jahrzehnte einen Aufschwung. Thema dieses Artikels ist, wie der Steuerverwalter mit Steuerumgehung und Steuerhinterziehung umgehen sollte. Der Autor untersucht einige der gesetzlichen Bestimmungen und Präjudizien in den verschiedenen Mitgliedsstaaten der CATA.

Dr. Arjunan Subramaniam:

Malaysia: Labuan: Eine neue Steueroase *600*
Das malaysische Parlament verabschiedete in jüngster Vergangenheit eine Gesetzgebung, die dazu bestimmt ist, auf der Insel Labuan eine Steueroase zu errichten. Mit Inkrafttreten dieser Gesetzgebung wird Labuan das einzige internationale offshore Finanzzentrum in Südostasien sein. Der Artikel gibt einen Überblick über die verschiedenen Grundzüge dieser Gesetzgebung, einschliesslich der Bestimmungen über Investmentgesellschaften, Banken und Versicherungen.

Rup Bahadur Khadka:

Nepal: Ein Umriss des Budgets 1990/91 ..... *602*
Nachdem das Vielparteiensystem im April 1990 in Nepal wieder eingeführt wurde, wurde eine Übergangsregierung gebildet. Das 1990/91 Budget spiegelt den Kurs der Regierung wieder, so z.B. die beharrliche Bemühung, die Inflationsrate zu senken und das Land von den Folgen jahrzehntelangen wirtschaftlichen Mismanagements zu befreien. Ziel der Haushaltsmassnahmen ist es daher, einige dringende Probleme zu lindern. Der vorliegende Artikel gibt einen Überblick über die hervorstechendsten Merkmale des Budgets.

Veranstaltungskalender *604*

Tapas Kumar Sen:

Hinterziehung der Verkaufsteuer in Indien: Einige Schwerpunkte *605*
Der vorliegende Artikel beschreibt das Problem der Verkaufsteuerhinterziehung in Indien. Eine kurze theoretische Diskussion führt zu der Schlussfolgerung, dass die Erfolgsaussichten einer einzelnen politischen Massnahme, die Steuerhinterziehung einschneidend zu bremsen, gering sind. Vielmehr muss das Problem mit allen zur Verfügung stehenden politischen Massnahmen, angegangen werden. Der vorliegende Artikel beschreibt verschiedene der in Indien benutzten Methoden der Verkaufsteuerhinterziehung und schlägt Verwaltungsmassnahmen zu deren Bekämpfung vor. Der Autor kommt zu der Schlussfolgerung, dass eine fundamentale Überholung des Steuersystems nicht notwendig ist, um die Steuerhinterziehung zu begrenzen.

AUSTRALIA:

FOREIGN-SOURCE INCOME TAX REFORMS SETTLED

Lee Burns and Rick Krever

Legislation establishing Australia's long awaited new foreign-source income tax system was finally introduced in the Australian Parliament in mid-September 1990. The legislative proposals have undergone dramatic changes from their genesis half a decade earlier, changes that have been well documented in the pages of this journal.

This article explains the principal features of the final proposals adopted by the government. To put these rules into context, their evolution is briefly reviewed first.

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I. BACKGROUND TO ORIGINAL REFORM PROPOSALS

Moves to overhaul Australia's foreign-source income tax system were first foreshadowed in the mid-1970s when a government-appointed committee, the Asprey Committee, in a plan for comprehensive tax reform, put forward a number of reform proposals relevant to the taxation of foreign-source income. However, a change of government shortly after the release of the Committee's final report and an apparent lack of interest in substantial tax reform by the new government meant that almost none of the Committee's recommendations contained in the report was adopted in the period following the report's release. Subsequently, fundamental defects in the Australian income tax base were successfully exploited by a generation of tax scheme promoters whose efforts led to an era of unparalleled avoidance and evasion.

In 1983 a new government was elected partly on the promise to end the tax avoidance rorts[1] and its reform programme commenced almost immediately after the transfer of power. Major reforms awaited its re-election in 1985, however, when it commissioned Treasury to draft blueprints for a complete overhaul of the Australian tax system. The resulting document, known as the 1985 *Draft White Paper,*[2] proposed a wide range of significant income tax base-broadening reforms, including the adoption of a capital gains tax and a fringe benefits tax, as well as the implementation of a full imputation system for companies and shareholders.

With regard to foreign-source income, the document proposed replacement of Australia's exemption system for foreign-source income with a full foreign tax credit regime. It also suggested that, in the longer term, consideration should be given to the adoption of a foreign-source income attribution system for profits earned and retained in non-resident companies or trusts.

The government moved quickly to implement the principal reforms advocated in the *Draft White Paper.* In quick succession it introduced a capital gains tax and fringe benefits tax and a full company/shareholder imputation system. The last major step in the immediate reform agenda was the adoption of a foreign tax credit system in mid-1987. At that point attention was turned to the secondary reform proposals, including the foreign-source income attribution system.

The government's first proposals in this regard,[3] announced in May 1988, were largely modelled on New Zealand proposals that had been released five months earlier, in December 1987.[4] Ironically, shortly before the Australian proposals were announced, New Zealand released a revised set of proposals that retreated significantly on some of the more "radical" features of the original proposals.[5] However, the May 1988 Australian proposals contained few of the later New Zealand compromises.

1. *Editor's note: Rort* is a common term in the contemporary Australian lexicon. A "rort" is a deliberate and blatant exploitation of an opportunity in an improper, if not entirely technical illegal, manner. It is used to describe a variety of situations, but tax lawyers most commonly apply it to the grossly exploitive tax schemes of the 1970s when taxpayers made use of a wide range of deliberately marketed and highly artificial avoidance schemes to reduce substantial real incomes to nil or negative balances.
2. Aust., *Reform of the Australian Tax System (Draft White Paper)* (Canberra: AGPS, 1985).
3. Aust., *Taxation of Foreign Source Income: A Consultative Document* (Canberra: AGPS, 25 May 1988).
4. New Zealand Treasury, *Consultative Document on International Tax Reform* (Wellington: Government Printer, December 1987).
5. New Zealand, Consultative Committee on Full Imputation and International Tax Reform, *International Tax Reform, Part 1: Report of the Consultative Committee* (Wellington: Government Printer, March 1988). Further details of the New Zealand proposals were found in a second report released after the announcement of the first Australian reforms: *International Tax Reform and Full Imputation, Part 2: Report of the Consultative Committee* (Wellington: Government Printer, July 1988).

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The Australian proposals[6] comprised two main elements. The first was the adoption of what would probably have been the world's most comprehensive foreign-source income attribution system, scheduled to go into effect on 1 July 1989 (the Australian tax year runs from 1 July to 30 June). The proposed attribution regime would have applied to an Australian shareholder who held any interest in a foreign private company resident in a designated low tax jurisdiction. In the case of a foreign public company resident in a designated low tax jurisdiction, attribution would only have applied to an Australian shareholder with a ten percent or greater interest in the company. Unlike virtually all other foreign-source income attribution systems, the proposed Australian system would not have applied only to "controlled" foreign companies.

Also, unlike almost all other foreign-source income attribution systems (the only significant exception being New Zealand), the proposed attribution system applied to all income derived by foreign companies caught under the regime. There was no exemption proposed for active business income.

The second main element of the proposed foreign-source income reform package was the reintroduction of an exemption system for repatriated foreign-source income, albeit on a more limited scale. Two different factors explained the government's renewed interest in an exemption system. The first was the fact that most income from low tax jurisdictions should have already been taxed in Australia under the proposed new attribution regime, provided the recipient was a ten percent or greater shareholder in the non-resident public company or a shareholder with any interest in the non-resident private company which originally derived it. The foreign tax credit system would have been retained for individual taxpayers and for income that slipped outside the attribution regime.

The second factor prompting resurrection of the exemption system was the decision in May 1988 to lower the company tax rate from 49 percent to 39 percent. Although Australia has a federal system of government, the States levy no separate income taxes and the 39 percent tax is the total income tax borne by resident Australian companies. In terms of Australia's principal trading partners, the rate reduction left Australia as a sort of quasi-tax haven. With only a few exceptions, foreign subsidiaries located in OECD countries paid at least equal or higher taxes. And with the addition of foreign withholding taxes on dividends, repatriated profits could be subject to much higher total taxes than those which would be imposed on the income when it was paid to Australia.

Although the foreign tax credit system had been in effect less than a year at that point, revenue officials realised the system would come under considerable pressure when foreign taxes exceeded Australian taxes. The limited quarantining provisions in the Australian system would have invited manipulation and avoidance schemes designed to allow resident companies to utilise excess foreign tax credits related to income derived from subsidiaries in higher tax jurisdictions. The answer, it was thought, was the readoption of an exemption system for income from non-portfolio investments in comparable tax jurisdictions.

II. APRIL 1989 REFORMS

The May 1988 proposals were subject to considerable debate. Representatives of the business sector made strong, and ultimately persuasive, representations to the government about a number of features of the proposed attribution system. In particular, they argued that the attribution rules would be unfair and unenforceable unless they were limited to investments in controlled foreign companies (CFCs). They also argued that an exemption was needed for companies deriving active business income from legitimate commercial activities in low tax jurisdictions.

The government gave way on both these issues and in April 1989 released an *"Information Paper"* detailing its new proposals.[7] While the broad thrust of the new proposals was similar to the May 1988 predecessor proposals, the 1989 regime was far more complex.[8] The limitation of the attribution system to CFCs necessitated the adoption of complicated tracing rules and definition provisions, and similar changes were needed to cope with the proposed active business income exemption.

Another change was the formula for identifying comparable tax jurisdictions and low tax jurisdictions. The first group comprised those countries from which repatriated dividends would be exempt from Australian taxation. The second group contained those countries in which Australian controlled companies would be subject to the attribution rules. The May 1988 proposals would have required the government to list low tax jurisdictions, with unlisted countries automatically qualifying as comparable tax jurisdictions. The government soon realised, however, that there were far more low tax jurisdictions in the world than there were comparable tax jurisdictions, or at least it was easier to keep track of known comparable tax jurisdictions. Accordingly, the April 1989 proposals were based on a list of designated comparable tax jurisdictions, with all other countries being treated as low tax jurisdictions. The government indicated that procedures would be established to add countries to the comparable tax jurisdiction list if taxpayers brought information to the government's attention to show that such a change was appropriate.

Finally, the April 1989 proposals noted the impossibility of having a new system up and running by 1 July of that year and accordingly indicated that implementation of the new system would be delayed until 1 July 1990.

III. 1989 DRAFT LEGISLATION

It was the government's intention to close debate on the policy issues underlying its foreign-source income proposals with the release of the April 1989 proposals and, accordingly, it invited comments only on technical issues arising out of the proposals.

The line between policy and technical advice proved elusive, however, and many comments received by the government straddled the uncertain distinction between the two. As a result, when draft legislation was finally released in December 1989 (the December 1989 *Draft*), it contained some

6. A detailed description of the original proposals may be found in R. Vincent, "Taxation of Foreign-Source Income", 42 *Bulletin for International Fiscal Documentation* (November 1988), at 493.
7. Aust., *Taxation of Foreign Source Income: An Information Paper* (Canberra: AGPS, 12 April 1989).
8. The April 1989 proposals were detailed in R. Krever, "New International Tax Regime", 43 *Bulletin for International Fiscal Documentation* (July 1989), at 327 and M. Friezer, "Proposed System for the Taxation of Foreign-Source Income", 44 *Bulletin for International Fiscal Documentation* (January 1990), at 14.

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new policy approaches.[9] In particular, the draft legislation relaxed the conditions for the active income exemption and expanded the foreign loss quarantining proposals.[10] Comment was invited on "the technical details, but not the broad design features, of the draft legislation."[11] Once again, however, the limited nature of "technical" questions proved easier to define in theory than to police in practice and, partly as a result of further submissions, the second draft legislation, released in June 1990 (the June 1990 *Draft*) and the final legislation, released in September 1990, contained still further changes.

IV. 1990 FINAL LEGISLATION

Legislation establishing the new foreign-source income system was introduced to Parliament in September 1990 (it will have retrospective effect from 1 July 1990) in a bill called the *Taxation Laws Amendment (Foreign Income) Bill 1990* [hereinafter referred to as the "Bill"]. The remainder of this article reviews the principal features of the new law. In particular, it describes how the new law differs from the earlier proposals that are described briefly above and which were reviewed in more detail in the previous articles in this journal that are cited in the footnotes.

A. Control rule

The basic design of the control rule utilised in the final package is substantially the same as that proposed in the April 1989 *Information Paper,*[12] although the Bill includes some changes to the technical detail.

The first change is to one of the tests provided for determining a shareholder's direct control interest in a foreign company. The test in question took into account a shareholder's total rights to capital or profits on a winding-up or (if different) otherwise than on a winding-up. The problem with this test as originally drafted was that there could have been circumstances where, at the time the control interest was to be determined (the "test time"), it would not have been possible to measure a shareholder's total rights to a distribution of capital or profits. For example, if a company had issued preference shares entitling other shareholders to a fixed return of capital and/or profits and the potentially controlling shareholders to the residue, the rights of the other shareholders (and hence the potentially controlling shareholders) could not be determined until after a taking of the company's accounts at the end of the statutory accounting period of the foreign company. Consequently, in its original form, this test could never be applied if the test time was some time other than the end of the statutory accounting period.

To overcome this problem, the Bill amends the December 1989 *Draft* so as to permit the determination of the shareholder's total rights to a distribution of capital or profits at the end of the statutory accounting period rather than the test time.

The second change is to the tests for tracing control interests through trusts. The problem with the original tracing tests is similar to that described above with regard to companies with preference shareholders. It may not be possible to trace interests through a trust prior to the taking of trust accounts if the beneficiary's right to income or corpus cannot be determined at the test time. The solution adopted is similar to that described above for tracing interests through companies.

The third change addresses a particular concern which the banking sector had with the December 1989 *Draft.* As that draft stood, a foreign company which was being financed by a resident bank through a preference share arrangement could become a CFC of the bank. The banks argued that the preference shares were akin to a loan arrangement and did not represent genuine ownership rights in the foreign "borrower".

The Bill now provides that "eligible finance shares" are not to be taken into account in determining control interests. An "eligible finance share" is a share held by an Australian financial institution or its subsidiary where dividends paid in relation to the share may reasonably be regarded as equivalent to the payment of interest. A "shareholder" bank may still be subject to the attribution system with regard to a company in which it holds preference shares if the company is a CFC based on the interests of other Australian resident shareholders. In this case, dividends paid in relation to eligible finance shares are treated as interest for the purpose of calculating attributable income.

The Explanatory Memorandum accompanying the Bill warns that the general anti-avoidance provision in the Australian Income Tax legislation (Part IVa of the *Income Tax Assessment Act*) will be relied upon to defeat any attempt to use finance shares to dilute the control interest of resident shareholders so as to avoid a foreign company becoming a CFC.

Finally, in relation to each of the above changes, there have been corresponding amendments to the rules for determining attribution interests in applying the "substantial" shareholder test. Only substantial shareholders (basically shareholders with ten percent or greater interests in a CFC) are assessable on a share of the income of a CFC. Eligible finance shareholdings will not be taken into account to see if a financial institution is a substantial shareholder.

B. Comparable tax jurisdictions

As noted above, the government's original intention was to list those jurisdictions with a low or zero rate of tax. Because of the problems in maintaining such a list,[13] it subsequently decided to move to a list of comparable tax countries (referred to in the legislation and this article as "listed countries"). However, it recognised that there would be leakages from the attribution system if companies located in comparable tax jurisdictions could exploit concessions and gaps in the tax base found available in some comparable tax countries. To prevent such leakages, the comparable tax jurisdiction list is accompanied by a "designated concession income" list, which enumerates various categories of income that may be attributable even if a CFC is resident in a comparable tax jurisdiction.

There are two types of "designated concession income". *General designated concession income* is a class of income which is either untaxed or lowly taxed. For example, capital

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9. Aust., *Taxation of Foreign Source Income: Draft Legislation December 1989* and *Taxation of Foreign Source Income: Draft Legislation: Explanatory Notes December 1989* (Canberra: AGPS, December 1989).
10. The principal changes found in the December 1989 Draft Legislation were reviewed in M. Friezer, "Draft Foreign-Source Income Legislation", 44 *Bulletin for International Fiscal Documentation* (June 1990), at 285.
11. Aust., *Taxation of Foreign Source Income: Draft Legislation December 1989,* Preface (Canberra: AGPS, December 1989).
12. See Friezer, *supra* note 7, at 15.
13. See Krever, *supra* note 7, at 328; and Friezer, *supra* note 7, at 15.

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gains would constitute general designated concession income in a jurisdiction which had no capital gains tax. *Specific designated concession income* refers to income which has been subject to a special tax incentive in the comparable tax country.

Draft regulations setting out the list of comparable tax jurisdictions have been released by the government. The list accords with that set out in the April 1989 *Information Paper.*

The draft regulations also contain the list of general and specific designated concession income. There have been two changes to the list of general designated concession income set out in the *Information Paper.*[14] First, unremitted foreign income subject to a remittance basis of taxation in a listed country has been removed from the list of general designated concession income. This is now automatically included in the attributable income of a CFC (see below). Secondly, certain offshore finance, insurance and investment income which is subject to a reduction of tax under the law of the listed country has been added to the list of general designated concession income. The draft regulations also contain a number of additions to the list of specific designated concession income in the *Information Paper.* The new list was first released with the June 1990 *Draft.* The Treasurer's Press Release accompanying the June 1990 *Draft* stated that the additional designated concessions would apply from the date the Bill was introduced into Parliament. This was 13 September 1990. The Regulations are still only in draft form.

C. Active income exemption

The active income exemption is the design feature of the CFC rules which has undergone the most change as part of the consultative process. Initially, the Government favoured an "entity" approach under which *all* income of the CFC would be attributed unless 95 percent of its income was active income.[15] The government has now decided to adopt a "transaction" approach.

The 95 percent threshold has been maintained. However, where a CFC fails the active income test, attribution will only apply to its "tainted income".

"Tainted income" is divided into three subcategories: "passive income", "tainted sales income" and "tainted services income". The Bill includes some changes to the definitions of these terms.

The main change in relation to the definition of passive income concerns royalty income. Under the December 1989 *Draft,* all royalty income was treated as passive income. Now only royalty income which is "tainted royalty income" will be included. All royalties are "tainted royalty income" unless:

(a) they are derived from carrying on a business;
(b) the payer is not an associate of the payee; *and*
(c) the "matter or thing" in respect of which the royalty has been paid was originally produced by the payee or the market value was substantially enhanced by the payee.

The move to the transactional approach has seen some tightening up of the definition of "tainted sales income". Under the April 1989 *Information Paper,* it was intended that sales would be tainted where the CFC purchased from, *or* sold to, a related party. In other words, there only needed to be a related party on one side of the transaction. As a concession to alleviate the harshness of the entity approach, this requirement was relaxed in the December 1989 *Draft* so that sales were only tainted if there was a related party on both sides of the transaction (i.e. the CFC purchased from, *and* sold to, a related party). With the move to the transaction approach, the government reverted to the position under the April 1989 *Information Paper.* Consequently sales will be tainted where there is a related party on one side of the transaction.

It was proposed in the *Information Paper* that same country transactions with unrelated parties would not be tainted. The Bill now provides that such sales will not be tainted only where the CFC alters goods transferred in the impugned transactions so as to substantially enhance their value.

D. Calculation of attributable income and losses

1. Components of attributable income

The taxable income of a domestic taxpayer under the tax rules applicable to ordinary residents is calculated as gross income (called "assessable" income in the Australian legislation) other than exempt income less allowable deductions. The December 1989 *Draft* of the CFC rules would have established a parallel system for calculating the attributable income of a CFC to be included in the taxable income of resident attributable shareholders. Although the *Draft* did not expressly set out the formula, its construction clearly assumed it would operate along these lines. To distinguish attributable income from ordinary taxable income, the *Draft* determined the attributable income of a CFC as its "notional" assessable income (excluding "notional" exempt income) less "notional" allowable deductions.

The Bill now expressly provides for this taxing formula. The change has necessitated some changes to the structure of the rules for determining attributable income, although the substance of the rules is basically the same.

The attributable income of a CFC resident in an unlisted country comprises:

(a) tainted income (where the CFC fails the active income test);
(b) income derived as a beneficiary of a trust estate;
(c) income attributed under the transferor trust measures (described below);
(d) amounts covered by each of the above categories which have been derived by the CFC through a partnership.

The attributable income of a CFC resident in a listed country comprises:

(a) tainted income in respect of certain designated concession income where the CFC fails the active income test;
(b) income derived outside the CFC's country of residence which was not comparably taxed in a listed country;[16]
(c) income derived as a beneficiary of a trust estate which was not comparably taxed in a listed country;
(d) income attributed under the transferor trust measures (described below); and
(e) amounts covered by each of the above categories where the amount has been derived by the CFC through a partnership.

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14. See Friezer, *supra* note 7, at 15.
15. The mechanics of the active income test were set out in Friezer, *supra* note 7, at 16. In the case of a CFC resident in a listed country, the active income test is only applied to designated concession income.
16. A *de minimis* exception applies where the sum of the amounts covered by (a) and (b) does not exceed the lesser of $ 50,000 or 5 percent of the CFC's gross turnover.

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In the case of a CFC resident in an unlisted country and a CFC resident in a listed country, all income other than the types listed above is deemed to be notional exempt income. Furthermore, certain amounts which may otherwise be notional assessable income are deemed to be notional exempt income. These are:

(a) amounts derived by the CFC that were subject to ordinary Australian tax;
(b) the franked part of a dividend paid by an Australian resident company to the CFC;[17]
(c) non-portfolio dividends paid to the CFC by a company that is resident in an unlisted country to the extent to which the dividends are paid out of the exempt profits of the company;[18]
(d) non-portfolio dividends paid to the CFC by a CFC resident in an unlisted country in relation to which an Australian resident shareholder is an attributable taxpayer;[19]
(e) dividends paid to the CFC out of the attributed profits of another company.

In relation to a CFC resident in an unlisted country, two further categories of notional exempt income are provided. These are:

(a) income or profits derived by the CFC in carrying on a business at or through a permanent establishment in a listed country; and
(b) non-portfolio dividends paid to the CFC by a company resident in a listed country.

In the case of a CFC resident in a listed country, a dividend received from a company resident in the same or another listed country is also included in notional exempt income.

2. Calculation of attributable income

Once the components of attributable income are determined, the amount of attributable income is calculated in accordance with Australian tax rules, subject to some modification, and on the assumption that the CFC is a resident of Australia.

The Bill contains details on further modifications of Australian taxation law for this purpose, particularly in relation to capital gains tax and losses.

One area which has been the subject of much debate is the allowance of a notional deduction for certain capital expenditure. The *Income Tax Assessment Act* allows residents deductions for certain capital expenditures (incurred, for example, in regard to mining activities) where the relevant activity or investment occurs in Australia. In calculating attributable income, notional deductions would not be allowed for such activities or investments where they are carried on, or made, by the CFC outside of Australia.

In the August 1990 budget, the Treasurer announced that deductions for such expenditures will also be available to residents where the activities or investments are carried on, or made, outside of Australia. This applies to capital expenditures in relation to mining and petroleum activities, mine site rehabilitation, copyrights, patents and buildings. The deductions are only allowed in respect of expenditure incurred after 21 August 1990. As the CFC is assumed to be a resident, such expenditures will now be taken into account in calculating attributable income.

The Treasurer has indicated that the treatment of trading stock and depreciation is still under consideration insofar as some modification of the Australian rules might be needed for the calculation of the attributable income of a CFC.

3. Capital gains tax

Although capital gains are taxed under the ordinary Australian income tax legislation, they are dealt with in a discrete part of the Act and the capital gains tax (CGT) provisions are most often considered to be something of a separate code, integrated with the income tax only insofar as special measures prevent double taxation of gains also assessed as ordinary income and to ensure the correct marginal tax rate applies to these gains.

The Bill contains changes to the application of the CGT to CFCs. Australia generally only levies CGT on gains made on the disposal of assets which have been acquired after 19 September 1985. In the December 1989 *Draft,* this rule was automatically applied to CFCs. This was heavily criticised as having a retrospective effect, in that part of the gain may have accrued during the period 20 September 1985 – 30 June 1990, being prior to the operation of the CFC rules.

It is now provided that only the gain or loss accruing after 1 July 1990 will be taken into account in determining attributable income. For this purpose, the cost base of assets will be either their cost base or market value at 1 July 1990, whichever results in a lower gain or loss. Importantly, however, the rules will now apply to all assets regardless of when the CFC acquired them. In other words, there will be no grandfathering of the exclusion from the Australian CGT base of assets acquired before 20 September 1985. The only assets excluded from the application of these rules are "taxable Australian assets", but these are otherwise covered by the normal operation of the CGT rules.

The Bill also provides for an adjustment to be made to the consideration received by the CFC in respect of the disposal of an interest in another CFC where income in that other CFC has been attributed but not yet distributed. While this is mainly relevant to the application of the CGT rules, it is not confined to such rules. It may apply, therefore, where the gain on disposal is taxable under the income tax, for example because the shares in the other CFC are inventory (trading stock) of the first CFC or a "revenue asset" of the first CFC (i.e. an asset whose disposition gives rise to ordinary income because of the nature of the taxpayer's business).

4. Losses

The Bill also contains rules for the claiming of notional allowable deductions and the carry-forward of losses incurred by the CFC. CFC notional assessable income is divided into four baskets: interest, modified passive income, offshore banking income and other income. It is not entirely clear why interest was included as a separate class of income rather than being included as part of the passive income basket. It would seem that this has been done out of abundant caution given that interest is probably the most movable of all income.

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17. Australia's imputation system categorises dividends as franked or unfranked. Franked dividends or franked parts of dividends are those paid from fully-taxed company profits, i.e. company profits that have borne the full 39 percent company tax rate.
18. The exempt profits of a company are basically profits which are taxable in Australia; have borne tax in a listed country not being designated concession income; non-portfolio dividends paid by a company out of exempt profits; and non-portfolio dividends paid by a CFC resident in an unlisted country and in relation to which an Australian resident is an attributable taxpayer.
19. In which case an Australian resident will have already been assessed on the profits under the CFC attribution rules.

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Notional allowable deductions are quarantined according to these four classes of income. In relation to each class of income, notional allowable deductions are applied first against notional assessable income of that class, and then against any exempt income of that class. There are two ways in which the income may be exempt: either because the CFC passes the active income test or because the *de minimus* exception applies.[20] Any excess of notional allowable deductions is then treated as a loss in relation to that class of income. The loss is not attributed to Australian taxpayers to be set against domestic-source or non-CFC-source income. Rather, it may be carried forward indefinitely. In subsequent years of income, the loss is applied first against exempt income of that class and then against notional assessable income of that class.

5. Attribution in relation to certain inter-CFC dividends

Under the December 1989 *Draft,* separate attribution rules applied to non-portfolio dividends paid out of active income or pre-1 July 1990 profits by a CFC resident in an unlisted country to a CFC resident in another unlisted country or a listed country where the dividend is not taxed at the normal corporate rate of tax. In the case of a dividend paid to a CFC resident in an unlisted country, the Bill now only provides for attribution where the dividend is paid as part of a dividend stripping scheme.

6. Attribution and migration of companies

The Bill contains a separate attribution rule in relation to a CFC resident in an unlisted country which changes its residence so as to become either a resident of a listed country or a resident of Australia. The assessable income of an attributable taxpayer in relation to the CFC includes that person's proportionate share of the CFC's "adjusted distributable profits" less profits which have already been attributed. A CFC's distributable profits are basically its profits (whether realised as ordinary income or capital gains) which are available for distribution as a dividend. The amount of the distributable profits is determined according to the CFC's accounts.

In the case of a CFC which becomes a resident of a listed country, the amount of its distributable profits is adjusted to exclude exempt profits.[21] Further, distributable profits include a notional profit based on the assumption that at the date of change in residence the CFC disposes of all its assets for their then market value.

Where the CFC becomes a resident of Australia, the only adjustment is that distributable profits are reduced by exempt profits.

E. The taxation of dividends

1. Dividends in general

The Bill provides for the treatment of dividends received by a resident shareholder as follows:

(a) non-portfolio dividends paid by a company which is a resident of a listed country to an Australian resident company is exempt from Australian tax;
(b) dividends paid out of attributed income are exempt from Australian tax; and
(c) all other dividends are taxed in the shareholders' hands, subject to credit for foreign taxes levied on the dividends, including foreign underlying taxes (levied on the company income from which the dividends were paid) where certain minimum ownership requirements are satisfied.

2. Disguised dividends

The December 1989 *Draft* contained an anti-avoidance provision designed to prevent the avoidance of Australian tax by distributions of profits otherwise than by way of dividends. Such distributions made after 12 April 1989 (the date on which the *Information Paper* was released) were deemed to be dividends.

Concerns were expressed about the breadth of operation of this provision, particularly in relation to upstream loans (loans from a subsidiary to a parent). The Bill now excludes arm's length loans from the operation of this provision. However, a loan which has the effect of facilitating the payment of a dividend which would be exempt from Australian tax or of facilitating avoidance transactions will be treated as a disguised dividend.

This measure will now apply from 3 June 1990. However, some upstream loans made between 12 April 1989 and 3 June 1990 may still be deemed to be dividends under a modified application of the general provisions of the legislation.

F. The taxation of branches

In conjunction with the introduction of the CFC rules, branch profits derived by a resident company in a listed country will be exempt from Australian tax. The Bill makes it clear that this exemption also applies to capital gains derived by the branch.

The exemption is not available for designated concession income derived through a branch. This is the case even where the branch may satisfy the active income test. This aspect of the exemption has been criticised on the ground that it is inconsistent with the treatment of CFCs resident in listed countries. If a CFC resident in a listed country pays a non-portfolio dividend to an Australian company out of designated concession income which has passed the active income exemption, then the dividend is exempt. It has been argued that a similar test (and a similar exemption) should apply to branch profits which consist of designated concession income but which would escape attribution under the active business income exemption, were it available for branches. However, the Treasurer has stated that the Government has considered this issue and has decided that the active income exemption is not to apply to branches.

The Treasurer has indicated that further consideration is being given to the treatment of branch losses incurred through a partnership or trust.

It was stated in the *Information Paper* that the profits of a foreign branch of an Australian life assurance company referable to the provision of life assurance for the benefit of non-resident policyholders would only be taxed when remitted to Australia. It has now been decided that these profits will be exempt from Australian tax. The exemption will apply even where the profits have not been comparably taxed and is justified on the grounds of administrative convenience.

G. Information collection

The effectiveness of the CFC rules will depend largely on the Commissioner's ability to obtain the information neces-

20. See *supra* note 15.
21. See *supra* note 17.

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sary to enforce the rules. The Bill imposes detailed record-keeping obligations on Australian taxpayers who are subject to the CFC rules. Unfortunately, these obligations have not been backed up with heavy penalties – the maximum fine for failing to comply is $ 3,000.

The Commissioner's investigation powers have been strengthened with the introduction of a provision similar to U.S. Internal Revenue Code Section 982. Where a taxpayer refuses or fails to comply with an "offshore information notice", the information or documents sought by the Commissioner are only admissible in proceedings disputing the taxpayer's assessment with the consent of the Commissioner. A refusal or failure to comply includes a situation where the taxpayer is capable of complying. Further, in exercising his discretion, the Commissioner is to ignore the possible application of foreign secrecy laws.

Doubts about the effectiveness of this provision have already been raised. The danger is that the provision may create an "incontestable tax" which would not be constitutionally valid. In an attempt to overcome this problem, it is provided that the Commissioner must give his consent in any case where a refusal would have the effect of making any tax or penalty incontestable.

H. Trusts

The CFC attribution rules are complemented by a "transferor trust" regime under which income of discretionary trusts not resident in listed comparable tax jurisdictions is attributable to resident "transferors". A transferor is broadly defined to catch anyone transferring value to a trust for less than arm's length consideration.

The effectiveness of the transferor trust regime will largely depend on how successful the Commissioner is in obtaining information on the existence of such trusts. It was thought that many taxpayers who established such trusts when they were effective tax minimisation vehicles might not want to run the risk of relying on non-disclosure to conceal from the Commissioner the existence of the trusts after the adoption of the transferor trust rules. As an incentive to these taxpayers to report the existence of the trusts and to wind them up before the trust transferor attribution rules would apply, the April 1989 *Information Paper* and the December 1989 *Draft* proposed a special low tax rate of ten percent for repatriations of trust income prior to the commencement of the transferor's 1990-91 tax year (for most taxpayers 1 July 1990). The Bill has extended the incentive rate to income from non-resident trusts that are wound up prior to 30 June 1991.

The Government has decided not to apply the transferor tax rules to arm's length purchases of units in a non-resident public unit trust.

The Treasurer indicated that any deferral of tax arising as a result of this concession will be covered by the proposed passive foreign investment fund rules.

I. Matters still to be finalised

The Treasurer has indicated that the following matters are still under consideration:

(1) the treatment of share financing arrangements other than those involving Australian financial institutions or their subsidiaries, particularly those arrangements in place prior to 1 July 1989;
(2) specific anti-avoidance provisions to prevent the use of stock stapling arrangements to circumvent the legislation;
(3) the design of rules to prevent dividend stripping in relation to non-portfolio interests in relation to companies resident in comparable tax countries;
(4) the provision of relief from multiple taxation where the Australian CFC rules apply to income of a CFC which is simultaneously or subsequently taxed in a listed country under similar rules; and
(5) measures to deal with changes in residence of a non-resident trust estate and trust distributions to CFCs resident in listed countries occurring after 29 June 1990.

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Professeur Arye Lapidoth:

Israël: La réforme fiscale de 1990 ..... *609*
La "mini réforme fiscale" de 1990 suit la réforme de 1987 en réduisant encore les taux de l'impôt sur les personnes physiques et sur les sociétés, élargissant la base d'imposition et limitant ou abolissant des exemptions. Pour le Professeur Lapidoth, bien que la réforme soit un pas dans la bonne direction, elle n'est pas encore allée assez loin.

Professeur A.C. Ezejelue:

Nigéria: Modifications fiscales de 1990 et politique suivie *611*
Des modifications ont été introduites dans différents domaines afin de réduire encore la charge fiscale pesant sur les personnes physiques et sur les sociétés, par exemple une modification de l'impôt minimum sur les personnes physiques, des allocations personnelles, des intérêts sur les comptes de dépôts des non-résidents, de l'impôt minimum dû par les sociétés et des quitus fiscaux. Cet article résume ces différentes modifications et quelques autres introduites dans le système fiscal nigérian.

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Professor Arye Lapidoth:

Israel: Die Steuerreform 1990 ..... *609*
Die „Ministeuerreform" des Jahres 1990 folgt im wesentlichen der Steuerreform des Jahres 1987, indem die Steuersätze für Individuen und Körperschaften weiter verringert wurden, die Steuerbemessungsgrundlage verbreitert und Steuerbefreiungen beschränkt oder abgeschafft wurden. Professor Lapidoth kommt zu dem Schluss, dass die Reform, obwohl ein Schritt in die richtige Richtung, nicht weitreichend genug ist.

Professor A.C. Ezejelue:

Nigeria: Änderungen in Steuerrecht und Steuerpraxis im Jahr 1990 . *611*
Im nigerianischen Steuerrecht wurde eine ganze Anzahl von Änderungen vorgenommen, um die Steuerbelastung für natürliche Personen und Körperschaften weiter zu verringern. Die von den Änderungen betroffenen Gebiete sind zum Beispiel die Mindeststeuer für natürliche Personen, persönliche Steuerfreibeträge, Zinsen von Depotkonten, die beschränkt Steuerpflichtigen gehören, die von Gesellschaften zu bezahlende Mindeststeuer und die Ausgabe von Unbedenklichkeitsbescheinigungen. Der Artikel gibt einen Überblick über diese und noch einige andere Änderungen im Steuersystem Nigerias.

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NEW ZEALAND:

ANOMALIES IN THE INCOME TAXATION OF FARMING

David Hay

From 1984 onwards, the New Zealand government embarked on a programme of tax reform. Its aims included broadening the tax base, reducing tax avoidance and improving income tax neutrality between different sectors of the economy.[1] One of the most important sectors is the farming industry. Farming in New Zealand is characterized by small family-owned businesses, with the occasional involvement of external investors in particular projects.

Prior to 1984, taxation considerations had a significant influence on the investment returns achieved in farming, and the decisions made by farm businesses.[2] Many tax shelter effects were present and it is widely believed that some farm development was taking place to obtain these benefits rather than for productive reasons. There were 34 different categories of tax expenditure,[3] of which only six relatively minor categories now remain in full effect.

However, the modified regime for the taxation of agricultural business includes a number of areas where the provisions of the income tax legislation may still influence farm management or investment decisions. These areas include the exclusion of farmland from provisions which require that some gains on the sale of land are taxable as income. Other areas where the income tax provisions may affect farming decisions include the method of valuation of livestock; an income equalization deposit scheme; favourable treatment for some items of personal expenditure by farmers; and the write-off of farm development expenditure. The information reported was drawn from sources which are relatively widely available. However, the scope of my research did not permit me to establish how widely these factors are known to farmers or farm advisors and whether they do in fact affect investment or management decisions.

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I. INTEREST

"Interest clawback" applies to land (and certain other assets) sold in excess of cost within ten years of purchase.[4] The effect of this provision, where it applies, is that the interest previously allowed as a deduction in respect of land is added back to the land owner's assessable income in the year the land is sold. The amount of interest to be included in the clawback is limited to the lesser of the profit on sale of the land, and the total interest deductions claimed.

There is an exclusion for land (or other assets) used primarily and principally in the carrying on of agricultural, horticultural, viticultural or aquacultural business. The exclusion of farm land from this provision appears to provide an advantage for investment in farming land for some investors in some circumstances. This applies particularly where an investor is planning an investment for less than ten years, in which a capital gain is anticipated and which is financed by borrowing.

II. LAND SALE GAINS

There are complex rules for taxation of gains from the sale of land (including improvements).[5] This part of the tax law also includes some provisions which exclude farm-related transactions from tax.

1. Douglas, R., 1986 Budget Speech (Wellington, Government Printer, 1986).
2. See *Consultative Document on Primary Sector Taxation* (Wellington, Government Printer, 1986).
3. Lattimore, R. and Wood-Belton, M., *Tax Expenditures in New Zealand Agriculture,* unpublished research report (Agricultural Economics Research Unit, Lincoln College, 1986).
4. Income Tax Act 1976, Sec. 129.
5. Id. Sec. 67.

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Gains are taxable where the land was bought with an intention of selling; or the taxpayer or an associated person is in the business of dealing in land, is a property developer or a builder; or gains are partly due to a change in zoning; or an undertaking for the land to be developed or subdivided was commenced within ten years of the land being acquired; or there was significant expenditure in developing land for industrial, commercial or residential purposes.[6] There are several exemptions which apply to land transactions which would otherwise give rise to taxable profit. The exemptions include some situations where the land was held for more than ten years, where the land was used as the taxpayer's residence, or where the land was used for business. There are also a number of exemptions relating to land used for farming or agriculture.

There is evidence that the exemptions for farming land are used. In each of three comparatively recent cases,[7] the taxable income of the taxpayer depended on showing whether the lots into which land had been subdivided were capable of being worked as an economic unit as a farming or agricultural business and were sold primarily and principally for use in a farming or agricultural business. If the taxpayers responsible for the subdivisions could establish these points, the gains made would have been exempt.[8]

These provisions provide an advantage for investment in agricultural land in comparison with investment in other land, and in comparison with other investments.

III. INVESTMENT IN LIVESTOCK

New taxation rules for the valuation of livestock were introduced in 1986, largely because the previous standard value system offered a significant tax deferral to livestock owners which were not enjoyed by other traders.[9] This advantage, it was believed, may have distorted investment decisions. However, it was not considered practicable for New Zealand farmers to keep the detailed records which would be necessary if cost was to be required as a method of livestock valuation. As a result, a new standard value system was introduced. Stock values to be used in establishing income for taxation are set on a national basis for all farming businesses.

The new system includes two options based on national average market values (the "herd scheme" and the "trading stock scheme"), together with an option to value stock at the lower of cost and market value, and a separate cost-based scheme for high-priced livestock. The national average values are calculated for very broad classes of livestock. For example, the same average applies to all sheep of a particular age and gender.

The new standard value scheme is not completely free from factors which may distort investment decisions. Farmers were advised that "some room exists to save tax, but not as much as in the past".[10]

A. The herd scheme

The herd scheme provides some tax advantages for investment in particular kinds of livestock. Under the herd scheme, eligible livestock is valued at the beginning and end of the income year at the "herd value", which is 100 percent of the national average market value of the appropriate livestock (as declared by the Inland Revenue Department for that income year). Once in the herd, fluctuations in the market value of herd livestock do not affect the amount of taxable income.

When livestock are bought or sold, any difference between their cost and national average market value becomes an adjustment against income for tax. The "national average" sometimes varies significantly from the value of particular stock. Where the national average is lower than the cost of particular stock, the operation of these provisions provides a tax incentive for investment. For some categories of livestock the national average appears to be consistently lower than cost.

For example, the highest national average market value required to be used for any class of dairy cow for the 1989 income year was NZ$ 419.[11] However, reported market prices for dairy cows at the same time were much higher, in the region of NZ$ 700-800 per head.[12] A farmer buying such an animal for $ 800 and using the herd scheme for livestock valuation would gain an immediate tax write-off in the 1989 year of nearly $ 400 or half the cost of the animal. This situation also applied to some other livestock categories, for example Merino sheep (which produce fine wool) or stock in Southland province, which are of higher quality than the national average.

This situation arises as a result of short and long-term factors, each of which has different tax consequences.

1. Short-term factors

National average market values are established on an income year basis, i.e. for a year ending 31 March, and published in April or May each year. These values are then used by taxpayers with an equivalent accounting year. For farmers, the accounting year frequently ends on 30 June, 31 July or 30 September. If there are significant trends in market prices, an opportunity arises to save tax. This occurs because farmers can buy stock in the period after 31 March at current market prices, in the knowledge that the "average market value" which they will be required to use for taxation is lower than the current price. If there has been a short-term increase in market prices this is likely to be reflected in the following year's national average market values, and it may give rise to a tax-free gain.

2. Long-term factors

For some categories of stock the national average market value can be expected to remain below the actual value of the particular category for the foreseeable future. This situation applies in particular to livestock which is in demand, e.g. Merino sheep, Southland stock or other stock which is of higher than average quality. In these cases, the tax provisions provide an advantage for investment in these classes of stock in preference to others.

This situation also provides an advantage for investing in livestock in comparison to other assets. Part of the price

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6. Hay, D.C. and Clark, M.B., "Taxation", in Burtt, E. and Fleming, P. (eds.) *Financial Budget Manual* (Lincoln University, 1990), at 14-15.
7. Taxation Review Authority case E42 (1982) 5 New Zealand Tax Cases at 59,255; *O'Toole v. CIR* (1985) 7 New Zealand Tax Cases at 5,045; *Bruhns v. CIR* (1988) 10 New Zealand Tax Cases at 5,033.
8. Income Tax Act 1976, Sec. 67(9).
9. *Report of the Consultative Committee on Primary Sector Taxation* (1986), at 15.
10. Graham, D.S. "Livestock Values One-year Review", 63 *The Dairy Exporter,* No. 11 (May 1988), at 70-71.
11. For raising 2-year old Jersey heifers. Inland Revenue Department, *Public Information Bulletin No. 182* (July 1989).
12. *MAF Farm Monitoring Report,* Ministry of Agriculture and Fisheries (1989).

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may be written off for tax, allowing farmers to reduce the cost of holding stock. (There is also a contingent liability, since farmers ceasing business and selling their stock will be required to pay tax on the difference between "national average market values" for tax and the price for which the stock is sold.)

B. Advantages from the options within the scheme

Farmers may alternatively elect to value stock under the "trading stock" scheme or the "cost price" scheme. The trading stock scheme is based on 70 percent of the mean over the previous three years of the declared national average market value, and the cost scheme uses the actual cost or market value of a particular farmer's stock. Selecting either of these alternatives may also have advantages.

1. Choice of option

It can be argued that allowing taxpayers a choice of several valuation options provides a tax advantage for some farmers. The alternatives were set up to avoid the administrative difficulty of valuing livestock at cost.[13] However, they allow farmers to choose whether or not changes in the value of an asset (livestock) should be assessable and deductible for tax. This option is not available to other taxpayers.

The advantages of choosing the correct option appear to have been recognized by farmers. A survey conducted in 1988[14] showed that 67 percent of sheep farmers and 64 percent of cattle farmers had adopted the herd scheme, while 67 percent of deer farmers and 54 percent of goat farmers had adopted the trading stock scheme. The choices appeared to reflect a prevailing view that sheep and cattle prices were likely to increase, while the values of deer and goats would fall. (This view was correct for most classes.)

2. Switching between options

When the new schemes were proposed in 1986, it was recognized that it would be advantageous for a farmer to be in the trading stock scheme when prices fall and in the herd scheme when prices rise. (This is because the trading stock scheme requires a proportion of any changes in stock value to be included in or deducted from income, while corresponding increases or decreases in stock value are not taxable for farmers in the herd scheme.) To prevent taxpayers from obtaining the advantages of both schemes, the Consultative Document[15] proposed that an election to adopt a particular scheme would be irrevocable, unless a taxpayer ceased to own the particular type of livestock for five years. However, in the view of the Consultative Committee,[16] this was an undue restriction on a taxpayer's flexibility of choice.

Under the provisions as they were introduced, two years notice was required (e.g. notice would be required by 30 June 1988 for a change to become effective in the year ending on 30 June 1990). A recent change[17] provided that, with effect from the 1990 income year, elections to change to the herd scheme may be made within the time in which the return of income is required. This allows taxpayers using the trading stock scheme (or cost price scheme) to wait until after livestock values are released, and then to make a decision whether to switch to the herd scheme.

In some livestock categories market values have recently varied considerably. Some advisers have recently suggested that it may be appropriate for taxpayers to switch to the herd scheme and gain the advantage of not being taxed on increases in values.

This suggestion has been made because the national average market value of some livestock categories is currently very low (compared to their values in earlier years). The trading stock scheme is usually based on 70 percent of average market value over three years. The herd scheme is based on 100 percent of current market value which would in normal circumstances be a higher amount. However, if the current national average market value is less than 70 percent of the average over the last three years, the value for the trading stock scheme is reduced to current market value. In these circumstances, farmers may switch from the trading stock scheme to the herd scheme and achieve potential future gains free of tax at minimal immediate cost.

There appears to be an advantage in investing in livestock whose prices are relatively volatile, since in circumstances such as these it has been possible to treat declines in value as tax-deductible, while increases in value are tax-free.

To summarize, in certain circumstances the livestock valuation requirements allow a tax deferral, because the value at which stock is required to be accounted for is lower than the actual value of the stock. In addition, under some circumstances the livestock valuation regime may operate to allow declines in value to be deducted from assessable income, while corresponding gains are tax-free (providing the taxpayer switches between valuation schemes at the appropriate time). These effects add to the advantages of farming as an area for investment. In addition, the operation of the livestock valuation regime provides greater tax advantages for investment in livestock which is more expensive than average. This factor may influence buying decisions by farmers.

IV. INCOME EQUALIZATION RESERVE DEPOSIT

Income equalization reserve deposits are paid to the Inland Revenue Department and may be deducted from current income. The deposits are included in income when withdrawn from the scheme.[18] These deposits allow farmers to smooth their assessable income, allowing them to take advantage of lower tax brackets. They also prevent cash flow difficulties which result from the operation of the provisional tax system, particularly as it applies to taxpayers with fluctuating incomes.

This scheme has also been used to obtain other tax advantages. Graham[19] explained to farmers that in 1988 additional benefits could be obtained as a result of the reductions in the tax rate announced for 1989 and 1990. Taxpayers with 1988 incomes greater than $ 30,000 were able to achieve an after-tax return on funds of approximately 25 percent, by depositing part of their 1988 income (which would have been taxed at 28 percent) in an income equalization reserve account, and withdrawing it in the 1990 income year (when the tax rate would be 33 percent). The benefits of depositing money in an income equalization account included the change to a lower rate of tax, the cash flow advantage which resulted from reduced provisional tax and the availability of terminal tax money for investment. These benefits were

13. See supra note 2, at 18.
14. Clark, M.B., "Tax Elections Made by Farmers – Livestock Taxation", 68 *Accountants' Journal,* No. 9 (October 1989), at 44-48.
15. See supra note 2.
16. See supra note 9.
17. Income Tax Amendment Act (No. 4) 1989, Sec. 10(3).
18. Income Tax Act 1976, Secs. 175-187.
19. Graham, D.S., "Income Equalization Account Saving", 64 *The Dairy Exporter,* No. 3 (September 1988), at 72.

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available for a one-year deposit (e.g. from 30 November 1988 to 30 November 1989). In this situation, where a reduction in tax rates has been announced, the scheme provides significant benefits through the tax system. (The scheme includes provisions to protect farm taxpayers from being disadvantaged by an increase in tax rates.)[20]

The existence of this scheme provides another advantage for investment in the agricultural industry which does not apply to other investments. In addition, for farmers, this scheme provides an alternative investment which under certain circumstances is more attractive than other forms of investment.

V. PRIVATE EXPENDITURE

It is sometimes difficult to distinguish between farm business expenditure and personal expenditure on behalf of the farm proprietor. As a result, farming sometimes provides tax benefits by allowing personal expenses to be deducted from taxable income.

Lattimore and Wood-Belton[21] identified dwelling costs (mortgage interest, depreciation, maintenance, etc.) and domestic electricity expenses as areas of tax expenditure from which farmers benefit. All interest costs and property rates, including those which relate to the farm dwelling, are treated as deductible, together with all telephone rental and newspaper subscriptions. In addition, under an Inland Revenue Department ruling, 25 percent of depreciation on the farm dwelling, 25 percent of repairs and maintenance to the dwelling and 25 percent of the cost of electricity consumed by a farmer's household is allowed as a deduction.[22]

Some other examples of expenses which have an element of personal expenditure but which are deducted in practice are well known. For example, a deduction for depreciation on a swimming pool installed on a farm as a means of storing water to be used "primarily for fire fighting purposes" is allowed.[23] In addition, there is only a "minimal requirement" to account for farm produce consumed by a farming family.[24]

These administrative provisions of the tax system allow farmers the ability to deduct some expenditure which might otherwise be non-deductible. In addition, some forms of expenditure may be considered more advantageous as a result of their tax treatment than the alternatives available to a farmer.

VI. LAND DEVELOPMENT EXPENDITURE

The provisions which applied until 1987 allowed immediate tax deduction of capital expenditure on the development of farm land. The Consultative Document noted that these provisions resulted in biased investment decisions, and diverted investment into agricultural land development instead of other areas.[25] They are being phased out over the period to 1992. According to King,[26] the phasing out of the scheme also led to distortion – there was a "sudden acceleration" of some types of development expenditure.

In development of a farm business, any land development expenditure of the categories listed in the thirteenth schedule of the Income Tax Act 1976 is not immediately deductible. However, other expenditure related to development (such as interest on capital, wages of employees or upkeep of the property) can be fully deductible. Expenditure such as repairs to existing fencing or other development, and application of fertilizer is also fully deductible.

In practice this approach may cause difficulties. It will be difficult to distinguish between capital expenditure and repairs to existing assets. It is also expected that some capital expenditure could be classified incorrectly as repairs and maintenance, possibly providing tax advantages.

Some advantages for particular investment decisions are provided by the remaining provisions regarding land development. These advantages include the treatment of land development expenditure under the transitional rules, and the immediate deductibility of other forms of development expenditure. Both effects provide an advantage for farm investment compared to other investment and encourage particular types of investment.

VII. "HOBBY" FARMERS

The taxation system as it affects farming provides tax shelters for part-time "hobby" farmers in a number of ways. These arise mainly from matters discussed in the two preceding sections on personal expenditure and development expenditure.

A farmer with income from other sources is in a position to operate his or her farm with objectives other than producing income. These may include concentrating on farm development to produce future capital gains, not current income or obtaining a deduction for personal expenditure. An investor may manage a farm property in such a way as to maximize its capital value while producing current losses (e.g. by herd improvement, orchard development or application of fertilizer).

The ability to deduct items of personal expenditure or development expenditure provides some tax advantages for hobby farmers. These factors may provide an incentive for investing in a hobby farm, or for developing it, in preference to other investments.

VIII. CONCLUSION

There are a number of remaining areas which represent anomalies in the income tax treatment of New Zealand farmers. Although the income tax provisions relating to agriculture in New Zealand have undergone a process of reform in recent years, there are a number of areas which allow tax advantages for particular types of expenditure by farmers and which are not otherwise available.

20. Income Tax Act 1976, Sec. 185(3).
21. See supra note 3, at 13.
22. Inland Revenue Department, *Public Information Bulletin No. 178* (July 1989).
23. *New Zealand Income Tax Law and Practice* (Commerce Clearing House, 1989), at para. 30-669.
24. King, J.M., "Primary Sector Taxation Reform", in Sandrey, R. and Reynolds, R. (eds.), *Farming without Subsidies* (Wellington, Government Printing Office, 1990), at 82.
25. See supra note 2.
26. See supra note 24, at 93.

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INTERNATIONAL:

DIVIDEND-ACCESS SHARES: A NEW TAX-PLANNING TOOL FOR TAX-EFFICIENT ACQUISITIONS OR REORGANIZATIONS OF U.S. CORPORATIONS

Jefferson P. VanderWolk

Baker & McKenzie, Hong Kong

Traditionally, foreign acquirers of U.S. corporations have simply paid cash for the shares or assets of U.S. target companies. The U.S. tax cost to the seller is normally factored into the price. This traditional structure is changing, however, as foreign investors become more conscious of U.S. tax-planning possibilities.

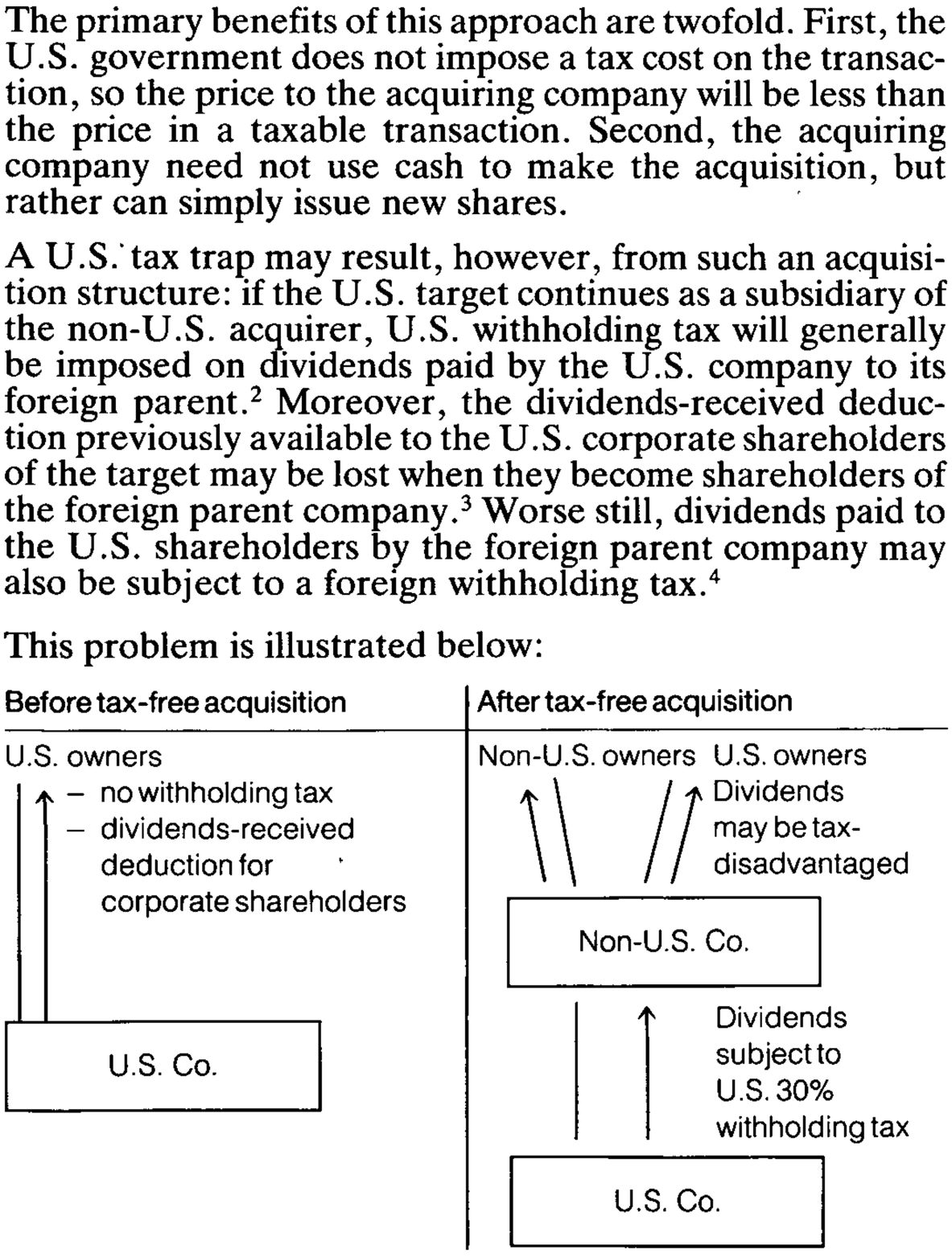
I. TAX-FREE ACQUISITIONS OF U.S. COMPANIES

The cost of acquiring the shares or assets of an existing U.S. corporation can be minimized if the acquisition is structured as a tax-free reorganization of the U.S. company. There are alternative methods of achieving this result, the technicalities of which are beyond the scope of this article. In essence, however, a tax-free acquisition involves the issuance of shares of the acquiring company to the shareholders of the acquired company, so that the "old" shareholders become minority owners of the "new", expanded corporate business.[1]

The primary benefits of this approach are twofold. First, the U.S. government does not impose a tax cost on the transaction, so the price to the acquiring company will be less than the price in a taxable transaction. Second, the acquiring company need not use cash to make the acquisition, but rather can simply issue new shares.

A U.S. tax trap may result, however, from such an acquisition structure: if the U.S. target continues as a subsidiary of the non-U.S. acquirer, U.S. withholding tax will generally be imposed on dividends paid by the U.S. company to its foreign parent.[2] Moreover, the dividends-received deduction previously available to the U.S. corporate shareholders of the target may be lost when they become shareholders of the foreign parent company.[3] Worse still, dividends paid to the U.S. shareholders by the foreign parent company may also be subject to a foreign withholding tax.[4]

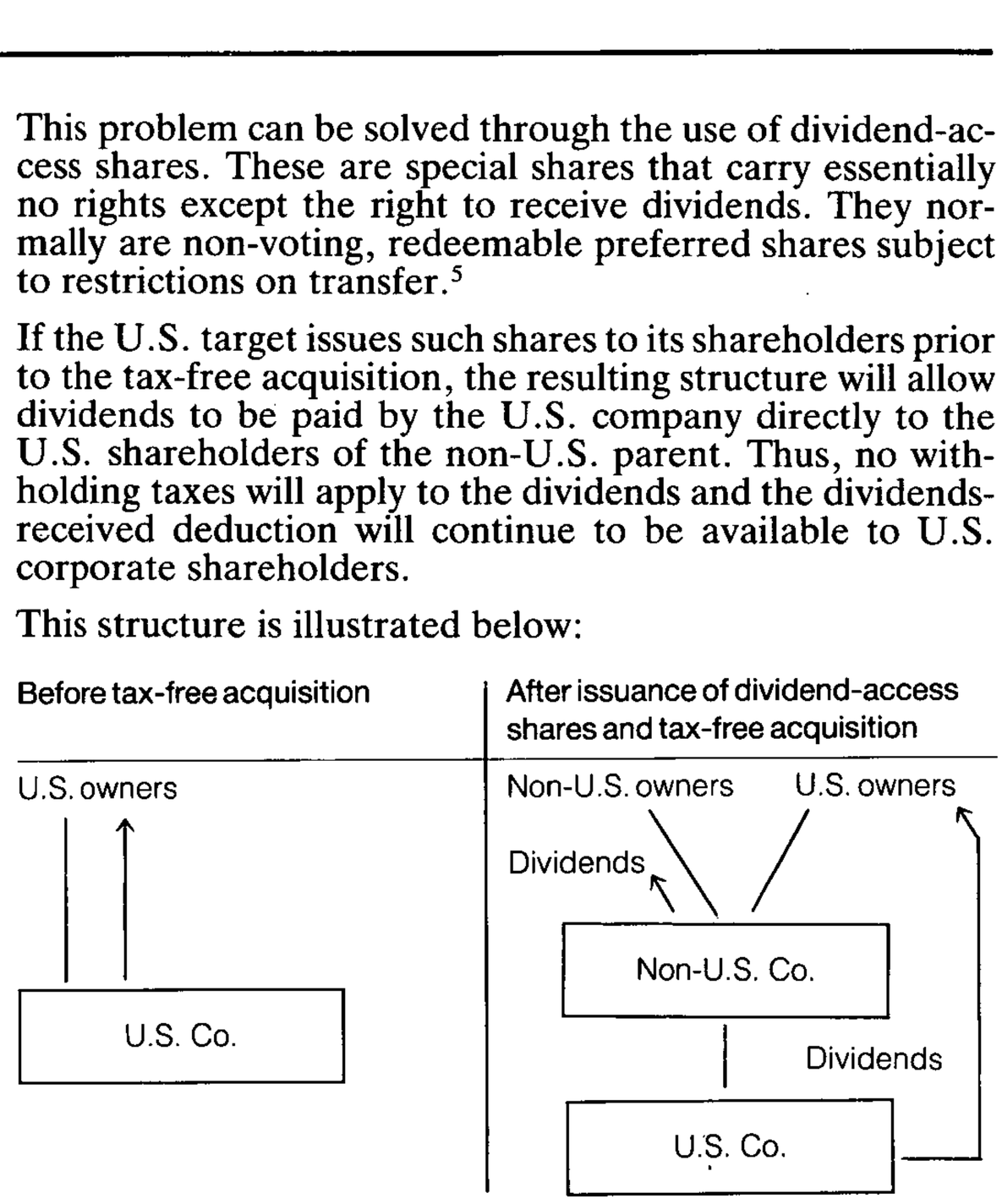
This problem is illustrated below:



This problem can be solved through the use of dividend-access shares. These are special shares that carry essentially no rights except the right to receive dividends. They normally are non-voting, redeemable preferred shares subject to restrictions on transfer.[5]

If the U.S. target issues such shares to its shareholders prior to the tax-free acquisition, the resulting structure will allow dividends to be paid by the U.S. company directly to the U.S. shareholders of the non-U.S. parent. Thus, no withholding taxes will apply to the dividends and the dividends-received deduction will continue to be available to U.S. corporate shareholders.

This structure is illustrated below:



The use of dividend-access shares in this way raises certain U.S. tax issues, which will be considered in turn.

A. U.S. tax consequences of the issuance of the dividend-access shares

For U.S. tax purposes, the U.S. shareholders' receipt of the dividend-access shares would be treated as the receipt of either a tax-free stock dividend or a taxable dividend in kind.[6] If the U.S. company had any non-U.S. shareholders, who would not normally receive dividend-access shares, tax-free treatment would not be available. The receipt of

1. See Gold and Welles, "Tax-free Acquisition by Foreign Corporations of U.S. Corporations Owned by U.S. Persons", 1 *Intertax* (1990), at 17.
2. Internal Revenue Code (IRC) Secs. 881 and 1442. The 30 percent withholding tax may be reduced by an income tax treaty.
3. See IRC Secs. 243-246.
4. This would be true, for example, if the foreign parent were incorporated in Japan or in any European country.
5. See Ballard, "Income Access Shares: A Cross Border Dividend Solution", *International Tax Review* (November 1989), at 3.
6. IRC Secs. 301 and 305(a).

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dividend-access shares would thus be a taxable receipt to the extent of the fair market value of the dividend-access shares.

The question then is, what is the fair market value of such shares? Assume they are subject to redemption at a nominal price (say, one cent) at any time, and they carry no rights other than the right to a dividend declared at the discretion of the directors of the U.S. company.

For tax purposes, the redemption price of one cent should fix the fair market value of the shares at one cent, on the authority of the Supreme Court's decision in *Salvage v. Helvering*[7] and subsequent case law in accordance with that decision.[8]

The Internal Revenue Service ("IRS") has published a series of rulings dealing with the valuation of corporate stock that is not publicly traded. One such ruling, Revenue Ruling 80-213,[9] relates specifically to the valuation of stapled stock. The ruling sets forth certain considerations, none of which are relevant to the valuation of dividend-access shares in this scenario. The ruling also refers to an earlier ruling, Revenue Ruling 59-60,[10] which sets out factors to be considered in valuing stock for estate and gift tax purposes.

Revenue Ruling 59-60 is more relevant to the valuation of the dividend-access shares. It states: "Where shares of stock were acquired . . . subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes". A later ruling, Revenue Ruling 68-609,[11] states that the approach outlined in Revenue Ruling 59-60 is applicable to valuation of corporate stock for income tax purposes as well as for estate and gift tax purposes.

Thus, the IRS position appears to be consistent with the courts' view that the price under a repurchase option generally fixes the fair market value of stock for tax purposes. Unless there is evidence that the option arrangement is not a bona fide business arrangement, the option price should be determinative, according to the relevant authorities.[12] Thus, it would appear that the fair market value, for tax purposes, of the dividend-access shares issued by the U.S. target in the above scenario would be virtually nil. Consequently, the U.S. tax consequences of the receipt of the shares should be negligible.

B. U.S. tax treatment of dividends paid on the dividend-access shares after the acquisition

The tax savings offered by the use of dividend-access shares will be realized only if dividends paid by the U.S. target with respect to such shares after the tax-free acquisition are respected by the IRS and the courts as dividends of the U.S. target paid directly to the holders of the dividend-access shares, as opposed to being treated for U.S. tax purposes as dividends paid by the U.S. target to its foreign parent and then by the parent to the holders of the dividend-access shares.[13]

A recent article by a leading U.S. tax expert which touches on this issue states:

> Whether the United States would respect the purported payment of dividends [on the dividend-access shares] . . . largely would be a function of whether, and to what degree, there was economic significance to the holding of [the dividend-access shares] as opposed to [shares of the parent company]. Business concerns would seek to minimize such differentials to avoid conflicts of interest, while tax concerns would favour some discrepancies.[14]

Thus, the goal would be to create formal (but meaningful) differences between the treatment of holders of the dividend-access shares and the treatment of the other shareholders of the foreign parent, while preserving substantive equality. For example, paying dividends from the U.S. target in U.S. dollars would be one such difference.

The structure should eliminate, to the extent possible, any legal connection between the declaration of a dividend by the foreign parent and the declaration of a dividend by the U.S. subsidiary on the dividend-access shares. The subsidiary's directors should be free to declare dividends on the dividend-access shares without regard to whether or not a dividend is payable by the foreign parent. In addition, it would be preferable for the U.S. company to declare and pay its dividend either significantly earlier or significantly later in the year than the time at which the foreign parent pays a dividend; this would result in a meaningful timing difference as between the different groups of the foreign company's shareholders.

Moreover, the declaration of a dividend to be paid with respect to the dividend-access shares should give rise only to a right against the U.S. company. Similarly, to the extent that the foreign parent would be required to pay dividends to holders of dividend-access shares in order to equalize distributions among all shareholders, the shareholding should be structured so that the claim of a U.S. shareholder against the foreign parent arising from the declaration of such a dividend was limited to the equalizing amount, as opposed to the amount of the foreign parent's total distribution to non-U.S. shareholders.

Assuming these distinctions can be achieved as a legal matter, the dividends paid on the dividend-access shares should be respected for U.S. tax purposes as U.S.-source dividends paid by the U.S. company directly to the holders of the dividend-access shares.

C. Applicability of Internal Revenue Code (IRC) Section 269B

Section 269B of the IRC provides that if a U.S. corporation and a foreign corporation are "stapled entities", the foreign corporation shall be treated as a U.S. corporation for U.S. tax purposes.[15] The term "stapled entities" means "any group of 2 or more entities if more than 50% in value of the beneficial ownership in each of such entities consists of stapled interests".[16] The statute provides that "two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests, the other such interests are also transferred or required to be transferred".[17]

In our scenario, a U.S. shareholder's dividend-access shares would be redeemed when the U.S. shareholder transferred his shares in the parent company. Thus, common shares of

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7. 297 U.S. 1906 (1937).
8. E.g. *Kalech v. Commissioner,* 23 T.C. 672 (1955).
9. 1980-2 C.B. 101.
10. 1959-1 C.B. 237.
11. 1968-2 C.B. 327.
12. See authorities cited at notes 7-11, supra.
13. See text accompanying notes 2-4, supra.
14. Canellos, "Combining United States and United Kingdom Corporations", 42 *Tax Lawyer* (1989), at 935.
15. IRC Sec. 269B(a)(1).
16. IRC Sec. 269B(c)(2).
17. IRC Sec. 269B(c)(3).

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the foreign parent and dividend-access shares of the U.S. subsidiary held by U.S. shareholders would be "stapled interests" for purposes of the statute.

Section 269B does not apply if the relevant corporations are "foreign owned", which means less than 50 percent owned, by vote and value, directly and indirectly, by U.S. persons.[18] This exemption would apply to our scenario unless the U.S. target was more valuable than the foreign acquirer, which could be the case in some instances.

In such cases, for the foreign parent and the U.S. subsidiary to be "stapled entities" for purposes of Section 269B, more than 50 percent in value of the beneficial ownership in *each* corporation must consist of stapled interests.[19] Clearly, if more than 50 percent of the parent's shareholders also hold dividend-access shares of the subsidiary, more than 50 percent in value of the beneficial ownership of the parent will be "stapled" to the dividend-access shares. However, the beneficial ownership of the subsidiary will remain almost entirely unstapled, provided that the common voting shares of the subsidiary can be transferred separately from the dividend-access shares.

The only stapled interest in the subsidiary would be the dividend-access shares, and they would have little or no value. The dividend-access shares would be redeemable by the subsidiary at a nominal price and they could not be sold to a third party. Most of the subsidiary's value would still be owned by the parent, which would have all of the voting power, all of the rights on liquidation and the ability to sell the subsidiary's common shares if it wished.

If the parent wished to sell the subsidiary to a third party, it should be able to do so without having to cause the subsidiary to redeem the dividend-access shares. The new shareholder of the subsidiary could instal new directors who could simply decline to pay any dividends on the dividend-access shares. Alternatively, the new directors might choose to redeem the dividend-access shares, but this need not be required.

Because the beneficial ownership of the subsidiary could be transferred without a concurrent transfer of the dividend-access shares, the parent and the subsidiary would not be stapled entities.

This conclusion is consistent with the legislative history of Section 269B, which indicates that the statute was not intended to apply to shares of a parent corporation and a subsidiary corporation that are technically stapled interests under the statutory definition.[20]

D. Applicability of IRC Section 1059

Section 1059 of the IRC provides for (1) a reduction in the basis of stock held by a corporation for less than two years to the extent of the "non-taxed portion" of "extraordinary dividends" received in respect of such stock, and (2) recognition of gain upon disposition of such stock, in addition to the gain recognized under normal tax rules, in an amount equal to the reduction in basis below zero as a result of the basis-reduction rule above.[21] It appears that Section 1059 could apply in determining the amount of gain recognized on dispositions of dividend-access shares.

In the case of non-preferred stock, an "extraordinary dividend" is one that exceeds 10 percent of the taxpayer's adjusted basis in the stock on which the dividend is paid.[22] Thus, all dividends paid on the subsidiary's dividend-access shares in this scenario could be extraordinary dividends for purposes of Section 1059.[23]

The "non-taxed portion" of an extraordinary dividend is generally equal to the amount of the dividends-received deduction with respect to the dividend.[24] A U.S. corporation would be entitled to an 80 percent dividends-received deduction for dividends received from the U.S. subsidiary.[25]

Thus, a U.S. corporate shareholder would apparently be required to recognize, in the year in which the dividend-access shares were redeemed by the subsidiary, gain equal to the non-taxed portion of all dividends received from the U.S. subsidiary.[26]

The U.S. taxpayer could argue that Section 1059 was inapplicable in light of the legislative purpose underlying Section 1059. The legislative history makes it clear that Section 1059 was designed to prevent so-called "dividend stripping" in which a corporation would buy shares of another corporation that was about to pay a dividend, receive the tax-advantaged dividend income, and then sell off the shares at a loss.[27] Obviously no dividend stripping is involved in the use of dividend-access shares.

In addition, the statute contains an exemption for taxpayers who have held the shares during the entire existence of the corporation.[28] Although the holders of the dividend-access shares would not fall within the terms of the exemption, they could argue that in substance they had owned the U.S. subsidiary from the beginning.

Even if these arguments were not accepted and Section 1059 were applied, the use of dividend-access shares to pay dividends from the U.S. company to U.S. shareholders would still be beneficial from a tax viewpoint. The 30 percent U.S. withholding tax would be avoided, and the 80 percent dividends-received deduction would be obtained in the year of receipt. Not until such time as the dividend-access shares were disposed of (i.e. redeemed by the U.S. company) would a taxable gain be recognized to the extent of the aggregate dividends-received deductions taken by the taxpayer. In light of the current policy of the Bush administration with regard to tax rates on capital gains, the tax rate on the gain ultimately recognized under Section 1059 might be significantly lower than the current rate.

II. REORGANIZATION OF U.S.-BASED MULTINATIONALS

Dividend-access shares may be beneficial in the case of a U.S.-based multinational group that wished to reorganize so as to alleviate the burdens of U.S. income tax compliance with respect to the non-U.S. operations of the group. U.S. corporations with international operations or subsidiaries are subject to a competitive disadvantage vis-à-vis non-U.S.

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18. IRC Sec. 269B(e).
19. IRC Sec. 269B(c)(2).
20. See *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Staff of the Joint Committee on Taxation, 31 December 1984), at 458 (". . . Congress did not intend to treat stock of a parent corporation as stapled to the stock of a subsidiary corporation.").
21. IRC Sec. 1059(a).
22. IRC Sec. 1059(c).
23. See IRC Sec. 307 and regulations thereunder relating to the determination of the taxpayer's basis in stock received in a tax-free distribution.
24. IRC Sec. 1059(b).
25. IRC Sec. 243.
26. IRC Sec. 1059(a)(2).
27. See e.g. *General Explanation of the Tax Reform Act of 1986* (Staff of the Joint Committee on Taxation, 4 May 1987), at 280.
28. IRC Sec. 1059(d)(7).

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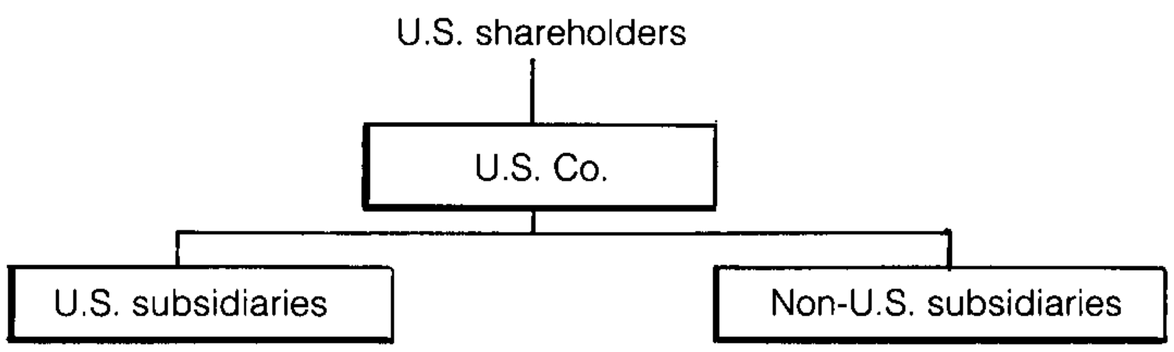
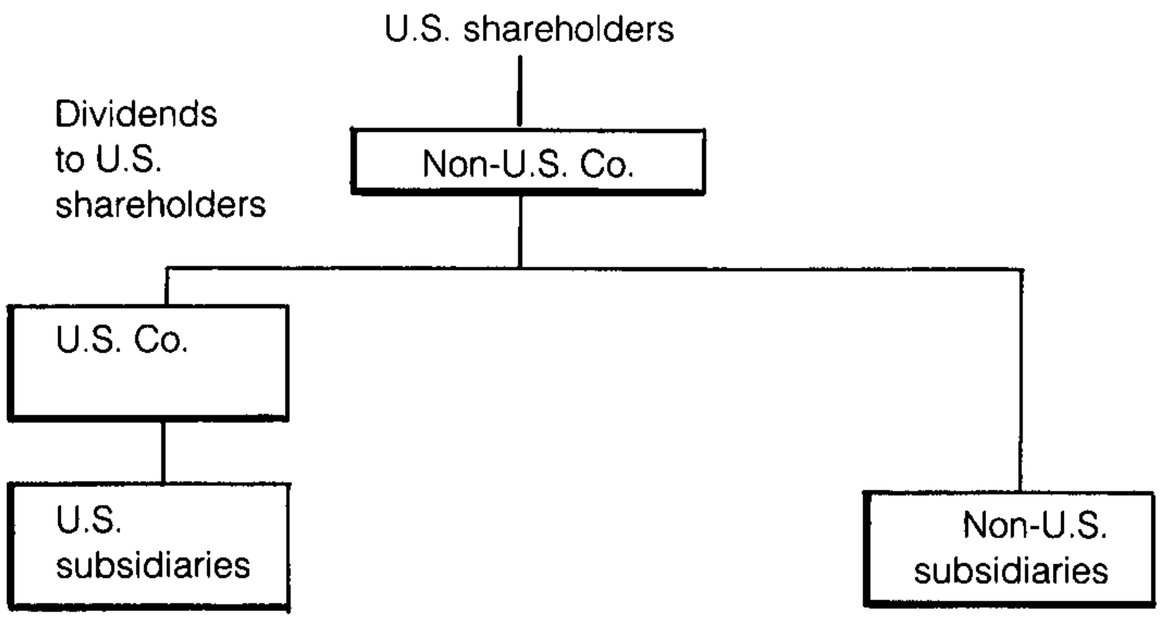
businesses, partly as a result of the U.S. tax rules applicable to their non-U.S. operations. Consequently, they have begun to look for ways to shift assets and subsidiaries outside the taxing jurisdiction of the United States.

One means of doing so is a reorganization, sometimes called a corporate inversion, in which the existing shareholders exchange their shares in the U.S. parent company for shares in a non-U.S. subsidiary that owns the group's non-U.S. operations and subsidiaries. After the share swap, the non-U.S. company will own the U.S. company as well, thereby becoming the parent company of the group. Thus, assuming there are more than a handful of shareholders, U.S. tax rules will apply only to the group's U.S. operations.

U.S.-based multinational group before reorganization



Multinational group after reorganization



By imposing a foreign company between U.S. shareholders and a U.S. subsidiary, the corporate inversion may create the same withholding tax and other problems described above in connection with tax-free acquisitions of U.S. targets by foreign acquirers.[29] Again, dividend-access shares can be a solution. Such shares could be issued by the U.S. company as the first step in the reorganization. Thereafter the shareholders would exchange their shares of the U.S. company for shares of a non-U.S. holding company that would hold all of the group's non-U.S. subsidiaries. The proposal is illustrated in column 1.

Such a reorganization would not be free of U.S. tax, but the U.S. tax cost might be limited to an acceptable amount. The shareholders would not be taxable on the exchange of their shares of the U.S. company for shares of the non-U.S. company, provided the transaction were properly structured.[30]

The U.S. company would, however, be subject to tax on a constructive dividend of the undistributed earnings of its non-U.S. subsidiaries.[31] This constructive dividend would carry with it indirect foreign tax credits which might substantially reduce the net U.S. tax cost of the transaction.[32] However, it is not clear whether the unrealized appreciation in the value of the non-U.S. subsidiaries could be taxed; this issue has never been directly addressed by the U.S. courts or the IRS.[33]

The distribution of dividend-access shares to U.S. shareholders prior to the reorganization would raise the same issues as those discussed earlier.[34] Undoubtedly, other issues might arise, depending on the particular circumstances of a given transaction. In principle, however, it appears that dividend-access shares can be used effectively in structuring tax-efficient acquisitions and reorganizations of U.S. companies with foreign shareholders or operations.

29. See text accompanying notes 2-4, supra.
30. See Dolan, K., "U.S. Tax Issues Related to Internal Restructuring of a Multinational Group", 2 *Intertax* (1990), at 59, 66. Dolan explains that the corporate inversion can be structured so as to be tax-free to shareholders under either IRC Sec. 351, Sec. 368(1)(B), or 368(a)(2)(E).
31. IRC Sec. 1248(i). See Dolan, supra note 30, at 67.
32. IRC Secs. 902, 1248(a).
33. See Dolan, supra note 30, at 67-68.
34. See text accompanying notes 6-28, supra.

In next issue:

The U.S.–Netherlands Income Tax Convention: Historical Evolution of Tax Treaty Policy Issues Including Limitation of Benefits – by *William P. Streng*

The U.S.–Netherlands Tax Treaty Negotiations: A U.S. Perspective – by *Mary C. Bennett*

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Direct Investment in the Netherlands: The U.S. Perspective – by *Erik J. Stapper*

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INTERNATIONAL:

TAX AVOIDANCE, TAX EVASION AND THE UNDERGROUND ECONOMY – THE CATA EXPERIENCE*

S.I. Chelvathurai

The topic of this article is so vast in scope that it is not possible to deal with it here in any depth. This article therefore merely overviews some of the measures adopted by CATA member countries to curb tax avoidance, tax evasion and the underground economy.

I. TAX AVOIDANCE

During the past two decades, tax avoidance schemes have proliferated in many CATA member countries as a means to reduce the overall tax burden. High taxation was a post-World War II phenomenon, with the highest marginal rate of income tax for individuals being pitched as high as 95 percent in some countries during the 1960s and 1970s. More affluent taxpayers were motivated to protect themselves from the ravages of an expropriating tax through carefully planned tax shelter schemes. A further breeding ground for tax avoidance schemes was the introduction of numerous tax incentives to promote social and economic policy objectives. Some countries discovered that every tax incentive provision required a battery of additional legislation to prevent abuse of the initial legislation. In certain cases, new anti-avoidance provisions were needed almost every year in an attempt to stave off the latest schemes for manipulation.

The term "tax avoidance" is used to denote the reduction of tax liability through legal means. In an extended or pejorative sense, however, the term is also used to describe tax reductions achieved through artificial arrangements of personal or business affairs by taking advantage of loopholes and anomalies in the law. Rules designed to plug these loopholes and to counter tax avoidance are termed "anti-avoidance provisions".

How should the tax administrator deal with tax avoidance? On one hand, the tax administrator must differentiate between simple tax planning, i.e. the taxpayer avails himself – in accordance with the law – of tax exemptions or privileges. It is the tax administrator's duty to interpret the tax laws equitably to ensure that all tax concessions are made available to the taxpayer; otherwise the policy objectives of the government would be frustrated. On the other hand, the tax administrator must exercise utmost vigilance with respect to artificial schemes devised by taxpayers. Tax codes should include proper guidelines, and sound judicial decisions should enable the tax administrator to prevent undue losses in revenue.

How do CATA member countries deal with tax shelters and artificial schemes which are designed solely to reduce tax liability? A brief look at some of the legal provisions and precedents of a few CATA member countries is useful in this respect. The starting point is the United Kingdom because the U.K. tax system is the foundation for the tax systems of most Commonwealth countries. The U.K. tax system contains no general anti-avoidance provision.[1] Until recently the basic approach of the United Kingdom was that laid down by Lord Tomlin in *IRC v. Duke of Westminster:*[2]

> Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.

Mr. Chelvathurai is the Executive Secretary of the Commonwealth Association of Tax Administrators. He was a Commissioner of Inland Revenue in Sri Lanka and served as Fiscal Officer at the Ministry of Finance and Planning, Sri Lanka, from 1980-1984.

The Commonwealth Association of Tax Administrators (CATA) was established in 1978 consequent to a decision taken at a Meeting of the Commonwealth Finance Ministers. The basic objective of the Association is to promote the improvement of tax administration in all its aspects within the Commonwealth with particular emphasis on developing countries, through the exchange of ideas and the dissemination of information and technical knowledge. Forty Commonwealth countries are now members of the Association.

* This paper was presented at the seminar on "Tax Avoidance, Tax Evasion and the Underground Economy" held in Seoul, South Korea on 2-3 April 1990.

1. For a discussion of the U.K. approach to tax avoidance, see S. Edge, "The United Kingdom Approach to Anti-tax Avoidance Provisions", 43 *Bulletin for International Fiscal Documentation* (February 1989), at 82.
2. (1936) 19 Tax Cases ("T.C.") 490.

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As a result of this judicial posture, which upheld the principle of "form" versus "substance", tax avoidance schemes were openly marketed in the United Kingdom in order to transform potentially taxable receipts into a non-taxable form or to create artificial losses. Although the government attempted to close loopholes as they were identified, new contrivances surfaced on a regular basis.

In *Ramsay (W.T.) Limited v. IRC,*[3] the House of Lords held that if a series of transactions all form part of a pre-ordained scheme, the courts could examine the entire scheme to determine whether it was legitimate for tax purposes. The conclusion reached in *Ramsay* was that there was no gain or loss because the transactions were circular or self-cancelling. This is now known as the "step transaction doctrine". The *Ramsay* approach was affirmed by the House of Lords in *Furniss v. Dawson,*[4] which involved an arm's length sale of shares through an offshore corporation established solely as the vehicle for the sale. The sale to the intermediary company was disregarded for tax purposes as it was an intermediate step inserted into a preordained series of transactions and it lacked any commercial purpose.

These decisions curtailed some tax avoidance schemes, and according to the U.K. Inland Revenue, it was possible to clear a large empire of tax avoidance activities known as the Rossminster schemes (about 4,000 cases were settled by agreement after the Ramsay case and the U.K. Revenue netted approximately £ 1.2 billion in tax). However, the *Ramsay* principle was somewhat diluted by the House of Lords decision in *Craven v. White.*[5] In *Craven,* the *Ramsay* principle was confined to circumstances in which there is a preordained series of transactions or one single composite transaction and where intermediate transactions are entered solely to avoid tax.

The position has been much the same in Australia, where in recent years, tax avoidance has been estimated as the fastest growing industry. Although the tax code contained an anti-avoidance provision,[6] Australian courts considered it too general in scope. The view was taken that the anti-avoidance provision, if construed literally, would extend to every transaction which had the effect of reducing the taxpayer's income. The Australian courts followed the English tradition of interpreting tax legislation strictly, and until recently upheld the principles enunciated in the Duke of Westminster case.[7] As a result of judicial interpretation, the anti-avoidance provision was rendered ineffective, and consequently tax avoidance became a widespread and serious problem in the 1970s. One particular scheme was devised as a means to avoid tax by disposing of shares in a company (as opposed to distributing the profits) so that the proceeds were received as capital. This developed into a wholesale dividend stripping operation, and led to the proliferation of what came to be known as the "Slutzkin schemes", which subsequently earned the sobriquet of "Bottom of the Harbour Schemes" (as there was said to be a new reef formed in Sydney harbour comprising the books of accounts of these companies!). This ultimately led to the 1982 enactment of retroactive legislation directed against blatant, contrived and artificial tax avoidance schemes.[8] In addition, some 22 pieces of legislation covering more than 50 tax avoidance schemes have been introduced since 1978 which reflects the changing attitude of the government. It is hoped that the new provisions will curb this alarming trend.

The Canadian experience is also analogous. Canadian courts had also followed the principle enunciated in the Duke of Westminster case, i.e. the tax liability of a taxpayer is determined by reference to the legal consequences of the taxpayer's actions, and not by the economic or financial results of the transaction.[9] Over the years, however, this approach was found to be too restrictive and Canadian courts tried to establish judicial limits on tax avoidance – the ineffective transaction doctrine (which deals with intentions that are not legally implemented) and the sham transaction doctrine (which deals with intentions that are different from the actual legal results that the documents or parties' actions appear to create).

In *Stubart Investments Limited,*[10] the Supreme Court considered the issue whether certain technical deficiencies in a transfer of assets between related corporations were sufficient to render the transfer ineffective for tax purposes. The Court concluded that in spite of the deficiencies, commercial reality was such that the transaction was not legally ineffective. Judicial rejection of the general business purpose test spurred a spate of transactions involving the utilization of accumulated losses, which culminated in a serious shortfall in corporate tax revenue. The White Paper on Tax Reform of June 1987 contained a proposed general anti-avoidance rule.[11] The effectiveness of this provision remains to be seen.

A similar pattern emerges in New Zealand, where the courts traditionally have interpreted tax legislation in a narrow and literal fashion, based on the example of the U.K. courts. The New Zealand tax code contains specific anti-avoidance provisions[12] as well as a broad general anti-avoidance rule.[13] The New Zealand courts have not formulated any guidelines based on the business purpose test, step transaction or substance over form principles because of the presence of the general anti-avoidance provision. However, in 1986 a case was decided by the Privy Council which renders void any arrangement entered into for the purpose of avoiding tax.[14] The facts of this case warrant mention. Challenge Corporation Ltd. purchased two non-trading companies with no assets but with substantial tax losses, which Challenge sought to group and offset against its own profits. The sole purpose of the transaction was to obtain the benefits. The Commissioner applied the general anti-avoidance provision Section 99. The Privy Council upheld the Commissioner's decision and applied a framework analysis which distinguished between tax mitigation (which is acceptable tax planning where real losses are suffered) and tax avoidance (where a taxpayer reduces his tax liability without subjecting

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3. (1981) 54 T.C. 101.
4. (1984) 55 T.C. 324.
5. (1988) Simon's Tax Cases ("S.T.C.") 476.
6. Income Tax Assessment Act, Sec. 260.
7. See *supra* note 2.
8. Income Tax Assessment Act, Pt. IVA, Secs. 177A-177G.
9. See *supra* note 2.
10. 84 Dominion Tax Cases ("D.T.C.") 6305 (SCC).
11. The new general anti-avoidance rule, Sec. 245, was enacted by the Canadian Parliament as part of Bill C-139, and became effective on 13 September 1988 when that Bill received royal assent. The purpose of the new rule is set out explicitly in the explanatory notes issued by the Department of Finance:

> New section 245 of the Act is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.

12. For example, Income Tax Act 1976, Sec. 191(7C) (to counter avoidance by means of loss offsets within groups) and Sec. 394ZF (aimed at "stapled stock" arrangements).
13. Income Tax Act 1976, Sec. 99.
14. *CIR v. Challenge Corporation Ltd.,* 8 New Zealand Tax Cases ("N.Z.T.C.") 5219(PC).

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himself to any real loss or expenditure). This decision implies that the courts will approach transactions with a view to their economic substance in preference to mere legal form. The Challenge Corporation decision confirms that Section 99 plays a vital role in the on-going battle against tax avoidance.

Since the inception of income tax in 1947, Hong Kong has had an anti-avoidance provision which permitted an assessor to disregard "any artificial or fictitious transaction".[15] However, these words begged the question, for what is artificial or fictitious is well nigh impossible to establish since any transaction contains an element of commercial reality.[16] Hong Kong went a step further in 1986 by introducing another anti-avoidance provision[17] because of the proliferation of tax avoidance schemes – primarily loss trafficking between companies, leveraged leasing and asset refinancing arrangements – which caused substantial revenue losses (as much as HK$ 1 billion in three years). The new provision applies to any transaction entered into for the sole or dominant purpose of enabling a person to obtain a tax benefit, and in such cases, an assessment may be made as though the transaction had not been carried out.

It is significant that the new judicial approach to tax avoidance schemes, based on the Ramsay and Furniss cases, is being followed in other countries as well. In *McDougall & Company Ltd. v. CTO,*[18] the Indian Supreme Court concerned itself not merely with the genuineness of a transaction but also with its intended effect on fiscal principles, emphasizing that artificial devices cannot be a legitimate aspect of tax planning. In Malta, the Court of Appeal decided as far back as 1963 that a transaction which did not make business sense was to be regarded as artificial.[19]

II. TAX EVASION

Tax evasion is usually defined as the reduction of tax by illegal means, including the omission of taxable income or transactions from tax declarations by fraudulent means. The most common forms of tax evasion are:

(a) omission of a particular source or sources of income;
(b) under-stating receipts or non-disclosure of cash or credit sales;
(c) over-stating expenses (including purchases) or improper claims for deductions through the use of fictitious expenses and purchases, or over-pricing the cost of raw materials;
(d) under-stating purchases and sales in order to maintain a fair rate of gross profit;
(e) falsification of the balance sheet (e.g. post-dating sales, under-valuing stock, secret or excessive reserves, etc.);
(f) under-reporting the market value of property;
(g) transactions through nominees;
(h) inflating profits of exempt undertakings (e.g. during a tax holiday);
(i) creating artificial losses.

Other forms of tax evasion having an international dimension or resorted to when entering into transactions with a foreign trading partner or enterprise include:

(a) over-invoicing imported goods (including machinery and equipment);
(b) under-invoicing exports;
(c) non-disclosure of income from foreign investments;
(d) non-disclosure of secret commissions accumulated abroad from the supply of goods;
(e) use of tax havens to reduce tax liability;
(f) fictitious deductions or foreign tax credits;
(g) changing tax status (residence) and arranging transactions when the taxpayer is outside a country's tax jurisdiction;
(h) creation of artificial loans;
(i) entering into contracts abroad so as to avoid a country's tax jurisdiction;
(j) excessive claims for head office expenses;
(k) non-arm's length transfer pricing arrangements.

It is generally accepted that one of the principal reasons for tax evasion is the high tax rates imposed in several countries in the 1970s and early 1980s. In other words, the higher the tax, the greater the propensity to evade. Prohibitively high rates of individual taxation operate as a disincentive for work and entrepreneurial effort and produce a plethora of tax shelter schemes and dodges. Some countries have acknowledged this consequence by introducing far-reaching tax reform measures which significantly lower the maximum marginal rates of taxation (at the individual and corporate level) and abolish most of the tax incentives which eroded the tax base and unnecessarily complicated the tax laws.

Other measures designed by some countries to tackle the problem of tax evasion are summarized below.

A. Australia

1. Audit programme

A new audit programme has been formulated to optimize use of the audit dollar and to create a greater degree of transparency. Audit has three main facets: (1) complex audit (for large and more complex businesses and those with international affiliations); (2) general audit (for self-employed and small businesses); and (3) desk audit (for wage earners, property income earners, etc.).

Under the case selection methodology (based on computer-assisted screening methods), auditors are able to assess cases which exhibit characteristics indicating possible evasion. For example, one system entitled "SCORE" ranks potential cases according to tests based on variations from industry standards and other indicators of evasion potential. Project-based audits are also being developed.

2. Penalties

The traditional approach of imposing penalties for omissions of income or failure to furnish returns are adhered to because of the deterrent effect. Penalties are severe with a maximum 200 percent of tax avoided being provided by law.

3. Legislative reform

Under new legislation (effective from 1990-91)[20] which provides for the taxation of foreign-source income, most income sheltered in low tax countries by Australian taxpayers – whether in foreign companies or trusts – will be subject to Australian income tax as it is earned.

4. Fringe benefits tax

Fringe benefits provided to employees are taxed in the

15. Inland Revenue Ordinance, Sec. 61.
16. In fact similar wording can be found in the tax codes of many countries.
17. Inland Revenue Ordinance, Sec. 61A.
18. (1985) 154 Income Tax Reports ("ITR") 148.
19. Unreported case.
20. Released in draft form on 29 June 1990 as Taxation Laws Amendment (Foreign Income) Bill 1990. The Bill was scheduled to be introduced into Parliament early in the 1990 Budget sessions.

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hands of the employer, thereby reducing the scope for manipulation.

5. Prescribed payments system

This is a form of withholding on payments to contractors, etc. to minimize non-reporting of income.

6. Tax file number system

More effective use is now being made of the tax file number system. Under this system, a person entering into a specified transaction or activity will be required to quote his or her file number. This requirement extends to bank accounts, the purchase of shares, wage earners, etc.

7. Public education programmes

Several programmes have been introduced in recent years to improve taxpayer education.

B. Bangladesh

Intensive surveys of urban areas have been undertaken. In 1986 a presumptive tax regime was introduced. It applies to owners of trucks, lorries and buses. A "shop tax" was also introduced.[21] A withholding tax is now imposed on several new sources of income.[22]

C. Barbados

Barbados has devised methods of establishing a taxpayer's roll so as to create a master file consisting of all persons who should file returns and pay tax. Principal sources of information are the National Insurance (Social Security) Department; registration of all professions, homeowners, etc. under Registration Acts; field audits; requiring firms to provide the names and addresses of persons to whom payments of more than $ 1,000 are made.

D. Canada

Compliance work in Canada focuses on five areas: audit, examination, delinquent action, source deductions and special investigations. Various techniques have been employed to improve compliance, i.e. computer-assisted audit selection (CAAS), audit report generator on-line (ARGO), specific audit programme, net worth method and an audit information management system (AIMS). More effective use has been made of the social insurance number (SIN) – with special reporting arrangements in respect of investment and interest income. A public education programme has been instituted, fines have been increased[23] and tax evaders prosecuted. In 1988 a general anti-avoidance rule was enacted.[24]

E. Cyprus

Field audits were initiated in 1987. Special criteria are utilized for detailed audit of particular accounts. Standard assessment guides (SAGs) are used for certain activities (e.g. farming). Capital statements must be submitted every five years, and a campaign to educate taxpayers was introduced in 1988.

F. Gambia

All businesses must register under the Business Registration Act. Shop-to-shop and house-to-house surveys are carried out on a regular basis.

G. Hong Kong

More prosecutions have been instituted against tax evaders, thereby creating a deterrent effect through publicity of successful prosecutions. Monetary penalties up to three times the under-charged tax are imposed for tax evasion. A net worth method was adopted, and anti-avoidance legislation was introduced in 1986.[25]

H. India

External surveys are carried out.[26] The Commissioner is authorized to search a taxpayer's business premises and residence and seize any relevant evidence. Tax clearance certificates are required for certain transactions. A presumptive tax is imposed for certain trades (liquor, timber). Preemptive purchase of property is used to prevent undervaluation.[27] Provisions have been introduced requiring payments above 10,000 Rs. to be made only by cheque, and loans/deposits exceeding 20,000 Rs. to be made only by account payee cheques; otherwise no deductions are allowed in computing the taxpayer's income. Harsher penalty provisions and automatic penalties for non-payment and delayed payment are imposed.

I. Jamaica

Jamaica has made extensive use of the Business Enterprise Number System (BENO). Business enterprises are required to obtain tax clearance certificates to clear imports or carry out certain contracts.

J. Kiribati

A tax reform programme was introduced in 1990, and specific provisions were introduced in new tax code to deal with transfer pricing, etc.

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21. The shop tax was enacted under the Finance Ordinance 1984. This tax, administered by the income tax authorities, is levied on the owners and occupiers of shops in urban areas who carry on a retail or wholesale business. The tax rate varies according to the size of the shop. Since all shops are required to pay the shop tax (there is no exemption), the assessing officers can easily cross-check whether there is an income tax file for each shop.
22. For example, a withholding tax of 5 percent on commissions derived by travel and shipping agencies; 3 percent on the sale price of property or goods sold by public auction; 7.5 percent by film producers on payments to actors and actresses if such payments exceed 36,000 TK per annum. In addition, the government, local authorities, statutory corporations, public companies and banks are required to deduct tax at source when making payments to contractors, suppliers or persons rendering services or when paying annual rent in excess of 48,000 TK (Finance Act 1988).
23. More than C$ 4.4 million in fines were levied by the courts in 1988 for tax evasion.
24. See *supra* note 11.
25. See *supra* note 17.
26. External surveys are the same as field audits, where tax officers visit the business premises and conduct an audit or examine the books of account, etc. on the spot.
27. In 1987, a provision was introduced to the effect that prior to the sale of any immovable property, the agreement of sale had to be submitted to the Income Tax Department after execution, and that the Department had to decide within two months whether it would purchase the property at the value agreed upon by the two parties. If the Department was of the opinion that the value was clearly under-stated, it could exercise the right to purchase the property at the value specified in the agreement, and the Department had a prior claim over the intended purchaser.

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K. Malawi

Eight-digit computer-generated taxpayer identification numbers were introduced in 1988. These numbers have been allocated to all persons in business and are to be used in all dealings with the Department of Taxes and Customs & Excise. A regular system of field audits is carried out. Withholding tax is imposed on the supply of goods and services.

L. Malaysia

Mobile units are used to identify new businesses, more tax investigations are initiated, and taxpayer information has been increasingly computerized. Programmes have been introduced to improve taxpayer education. Stiffer penalties are imposed for non-compliance, and rewards are offered to informers. Withholding tax coverage has been expanded.[28] Receipts must be issued for transactions where turnover exceeds M$ 18,000.

M. Malta

A computerized master file of taxpayers is maintained and a national identity card number system has been introduced to facilitate cross references and derive information from a number of sources.

N. New Zealand

New Zealand has placed emphasis on improving voluntary compliance, i.e. improved taxpayer education programmes, etc. A post-assessment review was introduced in 1987, focusing on review of selected returns with less emphasis on salary and wage earner returns. This regime has resulted in a more cost-effective deployment of staff. The investigation unit has changed from a system of selecting cases according to local/regional criteria to a national programme of investigations defined by the head office. More resources are now devoted to detecting tax evaders. Another technique which has received considerable attention is matching – all information received is matched and where discrepancies are noted the taxpayer is questioned further. An elaborate corporate plan has been introduced.

O. Nigeria

Nigeria makes extensive use of tax clearance certificates and withholding tax.

P. Papua New Guinea

A strategic plan to ensure a more effective, dynamic and innovative tax administration has been implemented and penalties for non-compliance have been increased.

Q. Sierra Leone

Sierra Leone also uses tax clearance certificates. A withholding tax is imposed on all government contracts and rents by tenants.

R. Singapore

Singapore also uses computerized checking and matching of information, field audits and desk audits. Higher penalties and fines are imposed for tax evasion and informers are rewarded. The functions of the executive branch have been streamlined. Receipts must be issued where annual gross receipts exceed S$ 18,000 from the sale of goods or S$ 12,000 from the performance of services. International transactions are scrutinized carefully.

S. Sri Lanka

A computerized master index of taxpayers is maintained. As in India, the Commissioner has authority to search a taxpayer's business premises and residence and seize any relevant evidence. Following the trend of other countries, stiffer penalties and fines are imposed and rewards offered to informers. The coverage of withholding tax has been expanded.[29]

T. Swaziland

Tax clearance certificates are required and an information branch has been set up. The information branch has begun to collect and collate information relevant for taxpayer compliance. The information is derived from routine sources such as tax returns, government gazettes, etc., non-routine sources, such as newspaper articles and magazines, and field inspection.

U. Tanzania

A taxpayer education programme has been developed and a tax clearance certificate regime introduced.

V. Trinidad and Tobago

Persons doing business with any government department are required to furnish a tax file number with the application. A new self-employed registration unit was set up in 1985, and regular surveys are made.

W. United Kingdom

Increased use has been made of computer support. Communications between the taxpayer and staff have been improved. Enforcement has been made more effective and penalties for non-compliance have been increased.

X. Zimbabwe

Zimbabwe has undergone a recent tax reform. The investigative branch has been strengthened, combined with intensive training of staff.

III. THE UNDERGROUND ECONOMY

Numerous treatises have been published on the underground economy, focusing on its effect on a country's economic and social structure. It is now well known that the underground economy has been flourishing in several de-

28. Withholding tax is levied on royalties, management or technical fees, and entertainers' fees paid to non-residents. A 5 percent withholding tax is imposed on certain types of interest paid to residents which becomes a final levy.
29. A withholding tax of 20 percent is imposed on interest payable to both residents and non-residents.

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veloping and developed countries since World War II; it continues to grow and in some countries the underground economy sustains the economy to such an extent that it is often referred to as the parallel economy. Economists also refer to the underground economy as the shadow economy or black economy.

The underground economy can be said to consist of that part of legally earned income which is not declared for income tax purposes, illegal income (e.g. from drug trafficking, smuggling, bootlegging or prostitution) and any profits made by black marketeers or other unscrupulous dealers in countries which impose price control, exchange control or credit control.

Attempts have been made to quantify the income or money that is in circulation in the underground economy, but there is no way this can be done with any degree of accuracy. At best, the calculations made can only be guesstimates. However, it may be useful to refer to some estimates:[30]

U.S.A.	5% of GDP
U.K.	7% of GDP
France	7% of GDP
Sweden	13% of GDP
Belgium	21% of GDP
Spain	23% of GDP
Italy	30% of GDP

OECD studies estimate the underground economy in OECD countries to be approximately four percent of GDP, whilst according to Mr. Stephen Smith of London Institute of Fiscal Studies, the underground economy in Britain is not more than three to five percent of its GDP.[31]

In 1982, the Government of India entrusted the National Institute of Public Finance and Policy (NIPFP) with the task of reporting on the extent of unaccounted income in the country.[32] The Report, which was released in 1985, concluded that the quantum of black income was increasing and that tax-evaded income formed a significant proportion of the income that should have been taxed. The NIPFP estimated black income to be:

1975-76: 15-18% of GDP
1980-81: 15-18% of GDP
1983-84: 18-21% of GDP

The tax-evaded income had been worked out at 70-75 percent of the income that should have been taxed from 1975-76 and 74-75 percent for 1980-81.

The NIPFP identified several factors as contributing to the black economy: the current structure of taxation, economic controls, sharp increases in government and public sector spending, general deterioration in moral standards, inflation and ineffective measures to deter tax evasion.

Real estate transactions, large-scale manufacturing, the film industry, smuggling, the professions and construction activity were identified as the significant sectors where black money is generated. The Report concluded that complete or partial suppression of gross receipts, exaggeration of expenses and under-valuation of assets constituted the primary methods of black money generation. Black money, according to the Report, was generally spent on consumption except in the case of businessmen who reinvest it to generate more black income. Black wealth has found its way into real estate holdings, undisclosed or under-valued stock-in-trade, ornaments of gold and silver and precious stones and *benami* financial transactions.[33] According to the Report, a novel method of laundering black money is to exchange it for foreign exchange remittances in the form of gifts.

To discourage tax evasion the Report recommended a substantial reduction in tax rates, a reduction in the stamp duty on real estate transactions and a reduction in the excise and customs duties on commodities for which there is considerable demand within the country, a simpler tax structure, removal of price controls, relaxation of rent control laws, a system of reward and punishment and significantly higher remuneration for the senior officers of tax departments. A number of the recommendations made by the NIPFP have been implemented in India.

Other measures which have been adopted with a view to flushing out undeclared income include demonetization, under which currency notes of certain denominations are declared to be no longer legal tender and persons possessing these currency notes must account for possession when they exchange the notes for new notes;[34] amnesties[35] (amnesties, however, have certain undesirable features, e.g. discriminate against the honest taxpayer, and cannot therefore be recommended); and bearer bond schemes.[36] Most measures adopted by CATA member countries to tackle tax evasion (discussed above) are equally applicable to the underground economy.

IV. CONCLUSION

It is appropriate to conclude this overview with a quotation which perhaps creates the correct atmosphere in which this subject should be reviewed: "[T]axation is a game and tax evasion is a genuine sport in making a profit". One should not, however, look for winners in this game.

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30. These estimates were compiled by Friedrich Schneider and Markus Jofreither of the University of Linz and referred to in "The Shadow Economy", The Economist, 19 September 1987, at 21-24.
31. Stephen Smith, "Britain's Shadow Economy", referred to in The Economist, 19 September 1987, at 22.
32. K.N. Kabra and N.S. Jagannathan, eds., *Black Money,* IIC Monograph Series No. 8 (New Delhi: India International Centre, 1985).
33. A *benami* transaction is one carried out by a party as a nominee for a third unnamed party. The term *benami* is also used to refer to sham transactions. In a *benami* transaction, ownership vests only apparently in the *benamidar,* but sufficiently to lead others to believe that the *benamidar* is the real owner.
34. Experience both in Sri Lanka (in the early 1970s) and in India has demonstrated that demonetization did not have the desired effect.
35. India and Sri Lanka have had several voluntary disclosure schemes. Two of the Sri Lankan schemes were combined with an exchange control amnesty. These too have met with limited success. Australia offered an amnesty in 1988, which according to the Commissioner of Taxation was quite successful, resulting in more than 200,000 taxpayers lodging returns.
36. A bearer bond scheme has been tried in India and Sri Lanka, but again with limited success.

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MALAYSIA:

LABUAN: A NEW TAX HAVEN

Dr. Arjunan Subramaniam

The Malaysian Parliament recently passed legislation designed to transform the Island of Labuan into a tax haven. Labuan, an island off the coast of Sabah on the northwest coast of Borneo, is a Federal Territory currently enjoying freeport status. It has a population of 28,000 people, a land area of 77.69 square kilometers and possesses a deep natural harbour, good road and port facilities, a shipyard and a gas complex. The Malaysian government has plans to improve Labuan's infrastructure and to expand its airport in keeping with its position as an international offshore financial center.

OFFSHORE BUSINESS ACTIVITIES

The proposed Act will provide for the imposition, assessment and collection of taxes on offshore business activity carried on by offshore companies based in Labuan.

"Offshore business activity" is defined as an offshore trading or an offshore non-trading activity carried on in or from Labuan in a currency other than the Malaysian currency by an offshore company with non-residents or with another offshore company, but does not include shipping and petroleum operations. "Offshore trading activity" means banking, insurance, trading, management, licensing or any other activity which is not an offshore non-trading activity. The term "any other activity", however, does not encompass manufacturing.

Offshore companies will be subject to a three percent tax rate on income derived from offshore trading activities. As an alternative to the three percent tax rate, an offshore company engaged in offshore trading activity may elect to be charged a flat tax of M$ 20,000 for each assessment year provided the election is made within three months of the commencement of that year. The fixed tax is equivalent to a three percent tax on a taxable income of M$ 666,667 and so is clearly an advantage to an offshore company with a taxable income exceeding this amount. Offshore companies must file a statutory declaration of yearly profits. Payment of the tax is due at the time of filing the statutory declaration, with a ten percent penalty for failure to pay. The filing and declaration must be made within three months of the start of the year of assessment.

Offshore companies engaged in offshore non-trading activity will not be subject to tax. An "offshore non-trading activity" means an activity relating to the holding of investments in securities, stocks, shares, loans, deposits and immovable properties by an offshore company on its own behalf. Investment income, such as dividends, interest and rent are exempt from tax. An offshore company which conducts both trading and non-trading activities will be exempt from taxation only in respect of non-trading activities; the other portion, i.e. trading activities, will be taxed at the three percent rate.

To attract foreign investments to Labuan, the Malaysian authorities have proposed that expatriate management employees, legal, accounting, financial, secretarial or trust company service professionals, and persons engaged in infrastructure construction projects will have 50 percent of their adjusted income exempt from income tax for five years starting in the year of assessment 1992.

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He is consultant to the Malaysian Institute of Economic Research and Chairman of the Taxation Committee of the Malaysian Institute of Accountants. He lectures part-time in Revenue Law at the Faculty of Law, University of Malaysia. He is also an adjunct professor at the Northern University, Malaysia. He is the author of a number of books on taxation and writes frequently for taxation journals.

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No stamp duty will be imposed on transactions between offshore companies in relation to offshore business activities. There will be no withholding tax on interest, royalties and technical fees paid by offshore companies in Labuan. Dividends distributed by offshore companies are not subject to withholding tax nor does it appear that such dividends will be taxed as income to the shareholder. Where an offshore company receives Malaysian dividends from which tax has been withheld, the tax so deducted will not be available to set off against any income tax payable by the offshore company, nor will it be refundable to the offshore company.

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TRUST COMPANIES

Recognizing that the administration of trusts and the management of funds and investments are common offshore business activities, the Malaysian authorities introduced legislation to provide for the registration of companies to carry on business as trust companies in Labuan. The Act prohibits any company from carrying on business as a trust company in Labuan unless it is registered to do so. The term "carrying on business" is defined as engaging in any economic activity as a trustee, agent or administrator. Any domestic company or foreign company that is incorporated or registered under the Companies Act 1965 may apply to be registered as a Labuan Trust Company. A domestic company must meet several requirements for registration. The company's authorized capital must be more than M$ 500,000 divided into shares of at least M$ 10 each. At least half the amount of the nominal value of each share must remain unpaid. The company must have a paid up capital of at least M$ 150,000 and deposit with the Accountant General securities valued at M$ 100,000. The company must be able to meet its obligations to its shareholders without taking the deposited sum into account. It must maintain an office in Labuan. A foreign company registered as a trust company would be required to maintain such minimum levels of capital and reserves in Labuan as may be prescribed by regulations.

A trust company and each of its officers, servants or agents are bound by the secrecy provisions of the Labuan Trust Companies Act which prohibit the disclosure of the existence of any trust or estate or the identity of any executor, settlor or beneficiary of any trust or estate. There are no restrictions regarding the object of trust companies, borrowing powers and investments, except that all services must be provided to non-residents. Foreign offshore companies are required to appoint a trust company in Labuan as its authorized agent in Labuan. The trust company's office will be the registered office of the foreign offshore company authorised to accept service of process and other notices. Trust companies, however, may also act to obtain probate of a will or letters of administration or act as a trustee under any settlement.

OFFSHORE BANKING BUSINESS

Malaysian banks and foreign banks are eligible to apply to the Central Bank for a license to carry on offshore banking business. A Malaysian bank, however, does not qualify for tax haven status unless it has a subsidiary incorporated in Labuan specifically to conduct offshore banking business.

Offshore banks are required to maintain a minimum of capital funds unimpaired by losses of not less than M$ 10 million. An offshore bank cannot accept any money on deposit or loan which is repayable upon demand. Transactions must be in foreign currency, although transactions in Malaysian currency are permitted when buying or selling foreign currencies against Malaysian currency or in swap transactions involving Malaysian currency. Offshore banks may do business with residents as long as the transaction is in foreign currency. Absolute secrecy is maintained on information relating to the affairs of offshore bank customers.

OFFSHORE INSURANCE COMPANIES

An offshore insurance company can only engage in business which is not domestic; that is, where the subject matter of the contract is properly situated in Malaysia, a Malaysian-registered ship or aircraft, or where the risk is related to a Malaysian resident. All business must be transacted in foreign currency except the reinsurance of domestic insurance which may be transacted in Malaysian currency. Offshore insurance companies must hold a valid license before commencing operations in Labuan and may transact business with residents. Various working fund requirements, determined by type of insurance business, must be met before a license is issued. Offshore insurance companies must also maintain a specified margin of solvency and pay annual fees ranging from M$ 5,000-30,000, depending on the type of insurance the company issues.

CONCLUSION

Labuan will be Southeast Asia's only international offshore financial center when this legislation takes effect. The designation of Labuan as a tax haven by the Malaysian government comes at a time of political changes in the region with regard to Hong Kong after 1997. As an offshore financial center, Labuan is expected to be popular with Malaysian banks and insurance companies. Foreign banks and companies are expected to follow suit.

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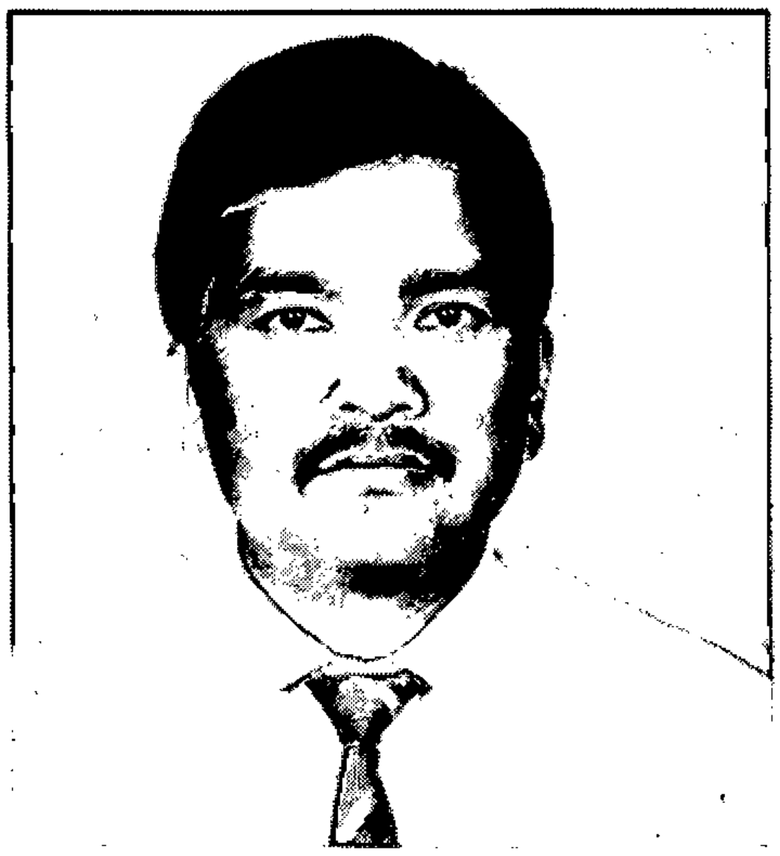
NEPAL:

AN OUTLINE OF THE 1990-91 BUDGET

Dr. Rup Bahadur Khadka

In April 1990 a multi-party system of government was reintroduced in Nepal.[1] An interim government has been formed to formulate a constitution and to conduct a general election. Economic reforms have never been more imperative. Although Nepal has implemented planned development regimes since the mid-fifties, the Nepalese economy remains backward: the infrastructure for development is inadequate, the level of economic development low, and basic amenities lacking.[2] The 15-month trade and transit stalemate with India also adversely affected economic activities in Nepal – one of the consequences of this stalemate has been astronomical increases in prices.[3]

Formidable challenges now face the new government. The most critical task is to pull the country out of decades of economic mismanagement and accelerate the pace of economic development in order to alleviate poverty and establish a democratic, equitable and prosperous society. Now is time to amend existing programmes and adopt new ones which will further the needs of the Nepali people. Political commitment to the effective implementation of the development programmes and laws is the need of the day. The 1990-91 Budget may be viewed in this perspective.



Dr. Rup Bahadur Khadka received a Master's Degree in Economics with "Merit" from Tribhuvan University, Nepal in 1980, and earned a Master's of Philosophy and a Doctor of Philosophy Degrees from Gokhale Institute of Politics and Economics, Poona University, India in 1984 and 1989, respectively. Dr. Khadka has written seven books, several research reports and many articles which have appeared in national and international journals. He was a member of the Task Force on Local Taxation appointed by His Majesty's Government of Nepal in 1988, a member of the Task Force constituted by the National Planning Commission of Nepal in 1989 for the formulation of Tax Policy for the 8th Five-Year Plan and a Fellow at the International Bureau of Fiscal Documentation, Amsterdam, from September 1988 to February 1989. Dr. Khadka, a Research and Curriculum Development Officer in the Revenue Administration Training Centre, Ministry of Finance, is currently a Research Fellow at the Seijo University in Tokyo under the Japan Foundation Long-Term Professional Fellowship programme.

BUDGET HIGHLIGHTS

The Honourable Finance Minister of the interim government, Dr. Devendra Raj Panday, presented the Cabinet Budget Speech of fiscal year 1990-91 on 14 July 1990.[4] Although it was not possible for the three month old government to formulate "detailed and concrete policies and programmes", the budget clearly indicates the approach and priorities of the new government. Several budgetary measures have been introduced to alleviate some of the most pressing problems. The issue of inflation has been taken up seriously and a series of decisive measures has been adopted to curb it.

1. A multi-party democratic system was introduced in 1951 when the 104 year old *Rana* regime was dismantled. In 1961, however, the partyless Panchayat system was introduced – this system remained in power until April 1990.
2. The government during the Panchayat regime introduced several programmes designed to accelerate the pace of economic development and raise the standard of living. However, implementation of the programmes was unsuccessful.
3. Landlocked Nepal depends on India for transit routes. Bilateral trade had been conducted under the 1950 special trade and transit treaty. Under this treaty Nepalese imports entering the port of Calcutta (India) by sea could pass through to Nepal at any one of the 15 points along the Nepalese-Indian border free from Indian taxes. Similarly, bilateral trade could be carried out at any one of the 21 points along the common border. Bilateral trade was subjected to preferential tariffs.
The special trade relation between Nepal and India, however, was severed when the trade and transit treaty expired on 23 March 1989. Trade over surface routes with India was restricted to two border points and bilateral trade was brought under the most favoured nation regime. Consequently, the price of Indian goods increased considerably in the Nepalese market and Nepal's exports to India declined sharply.
As a result of changes in both governments, new and encouraging efforts have been made to resolve the impasse and since July 1990 bilateral trade has returned to the pre-23 March 1989 status.
4. When the Panchayat system was abolished, the Legislative Assembly (Rastriya Panchayat) formed under this system was also dissolved. The King has granted legislative power to the newly-formed Cabinet until a general election is held and a new National Assembly is formed – thus the 1990-91 budget was presented to the Cabinet.

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TAX PROPOSALS

Income tax

The exemption limit has not been changed for the last six years, thus eroding real income of the fixed income group. The exemption limit for unmarried individuals has been increased from 15,000 Rs. to 20,000 Rs. and for married couples and families from 20,000 Rs. to 30,000 Rs. No personal allowances are granted to partnerships, private limited companies, other firms, or non-residents. After deducting provident fund contributions, salaried taxpayers may deduct 15 percent of the remaining amount, or 5,000 Rs., whichever is less, as other expenses when computing net income.[5]

Minor revisions have been made in income tax rates. However, as in 1989-90, a maximum rate of 40 percent will be levied on the income of salaried taxpayers and a corporate tax rate of 40 percent will be levied on government corporations and companies listed with the Security Exchange Centre. Non-resident taxpayers remain subject to a surcharge of 12 percent of income tax.

Until 1989-90, an advance income withholding tax of five percent was payable by importers of commercial goods. This tax increased the burden on the importers, and although it was creditable against the taxpayer's final income tax assessment, it was believed that the tax had been passed on by importers to consumers through higher prices. The five percent advance income tax has now been abolished.

Dividends distributed by public companies listed with the Sécurity Exchange Centre are completely exempt from income tax in order to attract investment in shares. Previously, only 85 percent of such dividends was exempt from income tax.

Until 1989-90, the rate of tax for the organized sector which has its shares and securities listed with the Security Exchange Centre was five percent lower than the corporate income tax rate. This sector is allowed an additional five percent deduction of income tax, provided a minimum of 30 percent of the shares are owned by shareholders with 100 or less shares. This provision is expected to encourage the organized sector to distribute ownership to small investors.

Small taxpayers who earn less than 40,000 Rs. per year are assessed by a separate assessment committee on the basis of best of judgement.[6] The ceiling has been increased to 60,000 Rs.

In order to improve income tax administration, tax clearance certificates will be required before travelling abroad and to complete contracts for rental values above 25,000 Rs. The certificates must be submitted to the tax office concerned within 15 days of the contract. Annual rentals exceeding 50,000 Rs. may now only be paid by drawing an account payee cheque.

Wealth tax

A wealth tax has been introduced. All income taxpayers must file a tax return listing all assets other than certain specified assets; net wealth will be assessed on the basis of these returns. The rate of wealth tax is between 0.25% and 1%.[7]

There are several policy factors underlying introduction of the wealth tax. Wealth tax can help minimize black marketeering and corruption and destroy the mentality of "getting rich quick", leading to a more even distribution of income and social reform. It will also ease income tax administration thereby strengthening the revenue system. Effective implementation of the wealth tax by this administration, however, is doubtful. The tax was introduced with little consideration of its revenue yield and operational effects – evidence enough that vestiges of the Panchayat system remain intact.

Customs duties

The Finance Minister has appealed to businessmen to channel imports from India under the "Duty Refundable Procedure", because Indian central excise duties levied on items imported under the "Duty Refundable Procedure" are refunded by the Indian government to the Nepalese government according to an agreement concluded between Nepal and India in the early 1950s. These imports are not subject to any tax except central excise duty in India and are free from the profit mark-ups of Indian traders. Further, the imports are either exempt or subject to nominal customs duties in Nepal. Logically, the prices of such imports should be lower than other imports.[8]

Excise duties

Excise duties on bricks, cement, iron rod, metal containers, sugar, etc. have been lowered while those on alcohol and cigarettes have been increased.

Registration fee on the transfer of land

Hitherto, the fee for transfer deeds in urban areas was five percent for the buyer and seven percent for the seller. The rate is now increased by one percent for both parties, i.e. six percent and eight percent, respectively.

Air flight tax

The air flight tax on passengers on international flights has been increased from 300 Rs. to 450 Rs.

Entertainment tax

Entertainment tax has been levied on a per ticket basis with the levy graduated according to the class of ticket. However, tax evasion under this system has been on the increase, so a new system of assessing entertainment tax based on the total seat capacity of each cinema hall has been introduced. An income tax of seven percent of the assessed entertainment tax has also been proposed.

Octroi

Octroi is a local tax levied on goods brought into a local area for commercial, professional or industrial use in commercial quantities. The tax is collected at the city gates under the contract system. Contractors who were not concerned with the burden and inconvenience to industrialists, traders and passengers collected the tax haphazardly which explains the octroi's nickname, the "harassment tax".[9] The contract sys-

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5. Until 1989-90, the corresponding figure was 15 percent of the amount left after deducting provident fund contributions, or 3,000 Rs., whichever was less.
6. This procedure is followed so as to relieve small taxpayers from the burden of keeping books of accounts for the purpose of income tax and to ease tax administration.
7. Procedural law is expected to be announced in the near future.
8. For details, see Rup Bahadur Khadka, "A Note on Duty Refundable Procedure", *Rajaswa,* Year 7, Vol. 2 (October- November 1987), at 16-23.
9. For details, see Rup Bahadur Khadka, *A Study Of Local Taxation In Nepal* Management Support for Urban Development UNDP/WB Project NEP/88/046, Unit A (Kathmandu: February 1990).

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tem of collecting octroi has been abolished and local entities will collect this tax directly.

CONCLUSION

Since restoration of democracy in Nepal in April 1990, political philosophy has changed as have government policies and priorities. The 1990-91 Budget has been prepared under a different political setting. Although it was not possible for the three month old interim government to formulate detailed and concrete policies and programmes, the budget proposes some measures to provide some relief. Inflation has been dealt with carefully and several monetary and fiscal weapons have been adopted to curb inflation. In this connection, measures such as reduction in the volume of public borrowing, changes in the composition of internal borrowing, exemption or reduction in the rates of commodity taxes on certain essential items, an attempt to divert Indian imports under the "Duty Refundable Procedure" abolition of the five percent advance income tax on imports, and the contract system of collecting octroi are appreciated. Introduction of the wealth tax is important from a long-term perspective. Budgetary proposals, however, are not complete in themselves; they need to be implemented effectively. Now is the time for the government to handle economic problems carefully, thereby initiating a process of development for the better future of the Nepali people.

Conference Diary

DECEMBER 1990

Trusts 1990 – An Up-to-date Review of the Tax Planning Benefits and Implications. London, 3 December (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: 071-637 4383. Fax: 071-323 4298.

German Double Taxation Treaties and Treaty Negotiation. London, 10 December (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071 936 3000.

Trusts, Companies and High Net Worth Individuals – A World in Transition – The Use of Atlantic, Caribbean and other Offshore Centres in International Tax and Financial Planning. London, 13-14 December (English):
Legal Studies & Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: 071-236-4080.

Taxation of Branches and Subsidiaries, Brussels, 13-14 December (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Planificación y Auditoría Fiscal. Madrid, 13-14 December (Spanish):
Carta Tributaria, Orense, 39, 28020 Madrid, Spain. Tel.: (91) 556 64 11. Fax: (91) 555 41 18.

Die Neuen Beschlüsse des Grossen Senats des BFH – Praktikerseminar. München, 15 December (German):
Dr. Peter Deubner Verlag GmbH, Postfach 41 02 68, 5000 Köln 41, Germany. Tel.: (02 21) 40 30 28/29. Fax: (02 21) 40 30 20.

De Praktijk van Fusies en Overname. Rotterdam, 18-19 December (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

De Brede Herwaardering Nu Definitief. Arnhem, 19 December (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608811; Fax: 040-44 98 95.

JANUARY 1991

Fundamental Elements of U.S. Federal Taxation. Lenham, 7-8 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

U.S. Taxation of International Joint Ventures, Partnerships Trusts. Lenham, 7-8 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

U.S. International Taxation: Tax Strategies for Cross Border Activities. Lenham, 9-11 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

U.S. International Reorganizations. Lenham, 9-11 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

Steuerplanung und Steuerpraxis Europa – U.S.A. 28. Tagung des Internationalen Steuerseminars in St. Moritz/Schweiz. St. Moritz, 14-18 January (German):
Internationales Steuerseminar, c/o Bank Leu AG, STER-KEW, Postfach, CH-8022 Zürich, Switzerland.

Beginners Course on the Principles of International Taxation and the Tax Systems of Selected Countries from an International Perspective. Amsterdam, 14-25 January (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

Fiscale Concernstructuren. Garderen, 15-16 January (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608811; Fax: 040 449895.

The Eighth Annual Waidring Conference – The Transnational Person / 1992. Waidring, 20-26 January (English):
University of the Pacific, McGeorge School of Law. Att. Mr. Stanley E. McCaffrey International Programs Center, Ferdinand-Porsche-strasse 6/II, A-5020 Salzburg, Austria. Tel.: (0662) 75 5 20; Fax: 662 75 5 23.

Tax Efficient Treasury Management. London, 21-22 January (English):
IIR Ltd., P.O. Box 293, 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1QL, United Kingdom. Tel.: (071) 412 0141; Fax: 071-412 0145.

U.S. Expatriate Taxation: Estate & Gift, Benefits/Retirement Plans & Financial Planning; U.S. Individual/Expatriate Taxation. London, 21-25 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel. (071) 935 7502; Fax: (071) 935 1308.

Efficient Management of VAT in Financial Institutions. London, 28 January (English):
IIR Ltd., P.O. Box 293, 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1QL, United Kingdom. Tel.: (071) 412 0141; Fax: 071-412 0145.

Supervised Study Programme on Double Taxation Treaties. Amsterdam, 28 January-22 February (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

Grensoverschrijdende Arbeid. Rotterdam, 29 January (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608811; Fax: 040-449895.

FEBRUARY 1991

Änderungen des Steuerrechts 1990. Badgastein, 4-8 February (German):
Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41, Germany. Tel.: (0221) 40 30 28/29; Fax: (0221) 40 30 20.

MARCH 1991

Beginners Course on the Principles of International Taxation and the Tax Systems of Selected Countries from an International Perspective. Amsterdam, 4-15 March (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

Advanced International Tax Course on Controlled Foreign Corporations, Transfer Pricing, International Joint Ventures, the Use of Tax Treaties, Treaty Shopping. Amsterdam, 18-21 March (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

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SALES TAX EVASION IN INDIA: SOME ISSUES

Tapas Kumar Sen

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Traditionally, a clear distinction has been drawn between tax avoidance and tax evasion. While both terms refer to certain practices by the taxpayer to reduce or cancel tax liability, these practices can be legal or illegal. Reducing tax liability through legal means is called tax avoidance, while a similar action carried out illegally is called tax evasion. The former is not punishable, the latter is.

The distinction between tax avoidance and tax evasion, however, appears to be gradually disappearing. The issue has been extensively debated in legal circles because it is primarily a question of law. The social and economic consequences of tax avoidance and tax evasion are the same and both cause a loss of revenue. Legal opinion, as expressed in a relatively recent court judgement, has also narrowed the gap between evasion and avoidance.[1] Nevertheless, the gap remains, and while tax administrators are alert to tax avoidance strategies, they are powerless to initiate measures to curb avoidance without substantial legislative amendments to plug the loopholes.

I. THE THEORY OF TAX EVASION

In economic analysis, tax evasion results from four factors. Generally speaking, a taxpayer evades tax so long as the expected gains from evasion (a function of the probability of escaping detection, the tax rate and the tax base) are higher than the expected loss from evasion (a function of the probability of detection, the tax rate and the penalty rate). Of course, this analysis ignores all non-economic factors. Certain psychological and social factors are also relevant, making evasion less attractive. Most individuals have an innate aversion to illegal activities, which, if detected, could lead to a loss of social status. However, if the economic advantage is strong enough (which it is in many cases because of the low probability of detection and inadequate penalties), the pecuniary advantage can easily outweigh the costs of evasion.

Other things being equal, a reduction in the tax rate lowers the expected gains from evasion (although the decrease in the gain depends upon the extent of the reduction and the tax base), and hence reduces the likelihood of evasion. In practice, however, revenue constraints must be met, and so once evasion reduces the tax base, the tax rates are increased to compensate for lost revenue, which further encourages evasion. In this way, once tax evasion begins, it gives rise to a vicious circle of rising tax rates and increasing evasion. Combatting evasion by lowering tax rates is thus unattractive to the government; it is also opposed by some on moral grounds on the basis that it is perceived as capitulating to evaders. However, under certain circumstances, lowering the rates may be a legitimate measure in the battle against tax evasion.

The two policy instruments used to combat evasion are detection machineries and penalties. Although both instruments appear feasible in practice (and morally defensible to most), the issue is not so clear-cut, particularly if evasion is widespread. Given usual tax rates and reasonable guesses about the probabilities of detection, the penalty rates required to effectively discourage evasion are astronomical (in the region of 2,000–4,000 percent of the tax evaded, or the equivalent thereof). There is no reason to sidestep high penalty rates when one looks at evasion in isolation, but larger considerations impose a constraint. Society has an implied ordering of offences against it in terms of seriousness and this is legally formalized in that specific punishments are provided for different types of offences. Given the position of tax evasion in this scheme, it may not be possible to increase penalties beyond a certain limit without increasing penalties for other offences as well.

There are also limits to raising the probability of detection, depending on the material resources available to the auditing machinery and the integrity of the personnel involved. Auditing costs cannot be allowed to rise too much or the net revenue raised will not be worth the effort.

If the preceding discussion appears pessimistic, it is not intended to be so. The point is that there are limits to each of the instruments available to the tax authorities to combat evasion. Hence, exclusive reliance on any one instrument is unlikely to be very successful. All tools available to the tax authorities must be employed so that, within their limitations, the combined effect achieves the objective, i.e. to combat evasion.

II. METHODS OF TAX EVASION

Essentially, sales tax is evaded in five ways: (1) suppressing the quantity of the sale or purchase; (2) under-stating the value of the sale or purchase; (3) abuse of concessions and exemptions; (4) deflecting the tax liability to other assessees; and (5) misclassifying the goods sold or purchased. There are numerous ways in which the above are achieved.

A. Quantity suppression

Quantity suppression is, by far, the most common method of evading taxes and the simplest conceptually. The methods employed to accomplish quantity suppression, however, are not always so simple.

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1. The Indian Supreme Court judgement in *McDowell & Company Ltd. vs. CTO* 154 *Income Tax Reports* 148 (1985) finally buried the *Westminster principle* in India, and the rule that deliberate avoidance of tax is not qualitatively different from evasion.

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The dealer records neither the purchase nor the sale of the relevant transactions, i.e. these transactions are entirely in the black market and, except by physical verification of stock, there is no way to prevent this type of evasion.[2] There are, of course, checks built into the system, particularly with a last point tax, as each dealer in the previous stage points to the next dealer in the chain to save himself from paying the tax. However, this check fails when all transactions in the chain are in the black market.

Quantity suppression is easier if the commodity is produced within the state, as imports from other states must pass checkposts at the state border. If the commodities are produced within the state, the dealer will not record the transactions in his books, and he will involve as few people as possible. These commodities are often not stored in the dealer's warehouse, but are sold shortly after acquisition.

With respect to commodities imported from other states, the key is to avoid border checkposts. One method is to bribe checkpost officials; other methods involve using alternative routes with no checkposts, passing checkposts by deceiving the barrier operator into believing that the formalities have been completed, submitting way-bills (a declaration of the value and quantity of the goods) with false information and properly completing all the formalities at the checkpost but denying import at the time of assessment.[3] All of these ruses are problably used to some extent, although the last method is unlikely to be exploited too often because it would draw the attention of the tax authorities to the dealer and disrupt the operation of his business if the tax authorities then initiate an examination of his activities.

B. Under-invoicing

Under-invoicing involves under-stating the price per unit of merchandise for tax purposes. In the case of quantity suppression, the government receives no revenue from the undeclared quantity, whereas in the case of under-invoicing revenue is received but is less than it should be.

While this mode of tax evasion may be practiced, it is unlikely to be quantitatively important. Substantial under-valuation is impossible because the market prices of most commodities are well-known, and a ridiculously low declared price is likely to prompt a thorough investigation.[4]

In the case of agricultural commodities, this method can be used effectively since prices fluctuate violently and are therefore more difficult to verify. This is particularly likely to affect revenue from purchase taxes, generally levied on purchases of agricultural commodities in order to reduce the number of assessees.

C. Abuse of exemptions and concessions

Abuse of exemptions and concessions is one method of evasion which is believed to be widespread and is one which warrants careful examination. The sales tax acts grant exemptions and concessions on the basis of various criteria (e.g. the size of a producing dealer, the use of the commodity, the nature of the commodity). Exemptions and concessions are abused in two ways: dealers may claim an exemption or concession on the basis of false documents, or a registered dealer may use an eligible dealer as a *front* to obtain tax benefits he would otherwise not receive.

The tax benefits most susceptible to abuse are the exemptions for exports out of the country, exemptions for small-scale industry and concessions on the sale of raw materials for production purposes. Abuses of these benefits are difficult to check for several reasons.

Exports and pre-export sales (one stage prior to the actual export) are exempt from tax. Although the sales tax authorities can no doubt ascertain the veracity of actual export claims, it may not always be possible to check pre-export sale claims because the only way the authorities can determine the genuineness of the claim is by a declaration of the purchaser which is submitted by the assessee, i.e. the seller. If the purchaser is located in another state, the sales tax authorities have no jurisdiction over him; hence it is difficult to determine whether the goods sold were actually exported out of the country.

Small-scale industries, certified as such by an authorized government agency, can claim substantial tax benefits. These benefits are complemented by (it is said that they are rendered superfluous by) the preferential treatment given to small-scale industries in other matters. The availability of preferential treatment is exploited in two ways. First, the production process may be fragmented, i.e. either vertical or horizontal disintegration, or both. Essentially, several small-scale firms are established in place of one large firm. Second, large firms may make use of non-functional small-scale firms in order to obtain advantages not intended for the large firm. The first practice is legal and the tax authorities are powerless to halt it unless the law is amended. In the second situation, the tax authorities must prove that the small-scale firm claiming the benefit is non-functional. This is difficult to prove in general, and it pits the sales tax authorities against another government agency, i.e. the one which certified the firm to be a genuine small-scale firm.

Exempting (or treating concessionally) inputs has caused problems to indirect tax authorities in all countries with respect to goods which can be used as inputs as well as finished products. In the absence of any norms regarding the conversion of inputs into final products it is difficult to ascertain whether all the inputs on which concessional tax rates have been claimed are indeed used as inputs. Such norms, given the numerous factors involved in the production process (including varying technology), cannot be provided with any degree of fairness.

Another avenue of tax avoidance in India (*not* evasion, as it is still legal) is the consignment transfer or branch transfer mechanism. When a company producing in one state sells its product in another state, it is liable to pay central sales tax. However, if it opens a branch in the other state, the company can effect branch transfers to that state without incurring any tax liability. This lacuna in the Central Sales

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2. In some cases, quantity suppression is practiced with impunity because even stock verification fails to prove its occurrence. For example, a small unregistered rice miller, even when caught with a stock large enough to warrant registration, can claim that he was milling the paddy of others and that the entire stock is not his. Fortunately, this type of problem is not serious for the tax authorities as persistent efforts to unearth this type of evasion are likely to meet with success or cause the dealer to discontinue the practice.
3. This is possible because, given the present forms of way-bills, no connection between the dealer and the import can be proved beyond a doubt. Way-bills are generally not traceable to the dealer nor are they signed or in any way authenticated by the importer.
4. However, this method may be used by assessees dealing in occasional large consignments of commodities which are physically impossible to hide because once the tax on a consignment is evaded, the scrutiny of the tax authorities is no longer important to the tax evader. Also a small but steady amount of under-invoicing carries little risk of detection and may in the long run be more attractive for a shrewd evader.

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Tax Act is exploited by many large firms, including public sector companies in order to minimize tax liability.[5]

The *de facto* sale of a commodity in one state is sometimes recorded as a sale elsewhere for tax purposes. There are reportedly some dealers whose main business is of this type, taking advantage of substantial tax differences between states where they exist. This case is also one of tax *avoidance* rather than *evasion,* since it is not illegal *per se.*

D. Deflection of tax liability

This method essentially means that although the dealer does not falsify his accounts with respect to the quantity and value of a transaction, he either claims that tax has already been paid or that he is not the last seller in the chain (in the case of last point taxation). It should be obvious that this method relies on the inability of the tax authorities to cross-check inter-dealer transactions to determine whether tax has been paid. As far as a last point tax is concerned, a registered dealer can usually claim immunity from the tax only if he produces a declaration, duly filled in by the purchaser (who must be a registered dealer), certifying that the purchaser will resell the goods within the state. No such declaration is required in the case of a first point tax. An invoice showing that the dealer has actually paid a tax-inclusive price for purchases from the other registered dealer is sufficient for him to claim an exemption. The key issue here is the tax authorities' ability to verify transactions; the presence or absence of a form is irrelevant so long as invoices include sales tax registration numbers and details of the tax paid, if any. Without a fully computerized system, such verifications are not feasible – thus dealers take the risk of evasion through false declarations.[6]

E. Misclassification

Misclassification generally involves claiming that one commodity is another commodity with similar characteristics but bearing a lower (perhaps zero) tax rate.[7] Unclear or vague descriptions of goods in the rate schedule provide scope for this type of evasion, and can cause genuine confusion for the dealer and the tax authorities. Such ambiguities should be removed as and when they are brought to the attention of the government.

III. TAX AUDIT OR SCRUTINY OF TAX RETURNS

In what follows, some administrative measures to minimize evasion are suggested, keeping in view the particular methods of evading sales tax in use in India.[8]

As a general rule the sales tax authorities examine most tax returns. While more intense scrutiny is likely to produce greater revenue, examining only doubtful cases rather than examining minor or straightforward returns may perhaps yield dividends in terms of lower evasion and higher revenue.

The sales tax acts in several states provide for self-assessment; however, without an executive order to effectuate self-assessment, it is defunct for all practical purposes. No official wants to assume the blame for failing to examine a return in the event that an irregularity is later discovered in the return. The innate caution of the tax authorities thus results in almost 100 percent scrutiny. The time spent examining returns which are more or less acceptable as they are should be channelled in a different direction.

For example, more time could be devoted to cross-verification of purchases and sales. If not all, at least all relatively large transactions should be routinely cross-checked. One might consider this inconsistent with the argument that examination of all returns is unnecessary, because full cross-checking would require 100 percent scrutiny. Taxpayers not in need of examination, however, are public sector enterprises and small retailers. These taxpayers fall at one end or the other of the production-sale chain. Using the figures stated in their returns, the chain can be traced forward or back.

Closer scrutiny of claims for exemption and applications for registration is another area for improvement. Close monitoring of exemptions granted and thorough checking of the antecedents of an applicant for registration should go a long way towards curbing tax evasion.

Random spot-checks of accounts should also be employed. Sales without cash-memos and maintaining two sets of cash-memos (one for the consumer and another for the tax authorities) are believed to be widespread practices. To check this, occasional purchases by outstation tax officials and the random collection of cash-memos given to consumers for later checking against the books may be attempted.

Greater emphasis should be placed on physical stock verification. Legislation should mandate that taxpayers keep the books of account at the place of business – this would facilitate discovery of evasion through stock verification.[9]

IV. PENALTIES

Although penalties are generally understood to refer to monetary amounts, they are used here in a broader sense, i.e. encompassing non-monetary penalties as well.

The maximum penalties in India for various offences under the sales tax act are generally double the tax due and/or three years imprisonment. In practice, prosecution with a view to imprisonment is rare; the tax authorities are satisfied with the 200 percent penalty. Most tax authorities reason that their function is to maximize revenue collection and not to imprison offenders – imprisonment does not yield revenue but is costly in terms of legal fees. Although understandable, this point of view is narrow. As stated above, tax evasion must be tackled using all tools available, and penalties are only one such tool. The 200 percent penalty is inadequate to deter habitual evaders; so long as they achieve two out of three evasions (of equal magnitude), the net gain is the same whether or not they practise evasion. In practice, the probability of detection is far less than 33 percent. Hence – in order to serve as examples to would-be offenders – at least a few habitual offenders should be prosecuted to the full extent of the law, even if the costs of prosecution are

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5. Recently, the process of modifying the existing provisions to allow a levy on consignment transfers has been initiated. It is likely to take some time to complete.
6. Sometimes bogus dealers are registered only to act as the first seller (for a first point tax) for a temporary period to provide a smoke screen for tax evasion undertaken by a more established dealer. Only strict application of the rules for registration can prevent use of this strategy.
7. Misclassification probably does not constitute a significant method of tax evasion in all states. Some cases do occur, but from all accounts the quantitative importance of this method of tax evasion is minor.
8. There is no uniform sales tax system in India and hence all the measures suggested in the text may not be applicable to all states in India.
9. Stock verifications should be carried out discreetly to prevent unnecessary loss of face for the taxpayer. Verification should also be carried out without any prejudice on the part of the tax officials.

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high. Given the weight attached by society to even a brief imprisonment, it is time that the tax authorities made full use of the penalties available.

V. OPERATION OF BORDER CHECKPOSTS

Sales tax is within the competence of the individual states in India, and each state is free to have its own sales tax act. The tax administration differs among states in various respects, the presence of border checkposts being one such difference. Although the majority of states depend on border checkposts to monitor inter-state transactions, some have dispensed with checkposts, relying entirely on mobile surprise checks. Where mobile checks are used, the department has authority to set up checkgates anywhere within the state and its mobile staff have the necessary authority to examine consignments anywhere within the state. Regular checking is sometimes carried out by departmental staff at key points for specific periods. Mobile checking has thus far played a complementary but subsidiary role in this set-up.

States which rely on checkposts could improve their operation. One area for improvement is checkpost security. Where there is a unified checkpost, i.e. checkposts of various departments are consolidated under the supervision of one officer, the problem of security is not important. However, the lack of checkpost security in outlying areas can make the job of the checkpost staff a harrowing one.[10]

Generally, commercial traffic has definite peak hours and lean hours. During peak hours, the time available to examine each set of transit documents is about one minute if a traffic bottleneck is to be avoided. Staff should be increased during peak hours. A register of incoming and outgoing vehicles could provide sufficient information on which to base a rational plan, which would ultimately facilitate better examination of transit documents.

Finally, it is imperative to rationalize the sales tax documentation of the movement of goods. A method must be devised to make way-bills, the major sales tax document related to inter-state movements of goods, formally traceable to the purchasing dealer. One such method could be to print way-bills under security, number them and only issue the bills to dealers who want to purchase goods from other states after keeping account of the numbers of way-bills issued to each dealer. Another method would be to require the purchasing dealer to authenticate the way-bill.

As far as internal checkposts within a state are concerned, the primary objective seems to be double checking inter-state trade. However, this goal cannot be stretched too far – improved administration of the border checkposts would, to some extent, reduce the need for double checking. Another objective of internal checkposts seems to be monitoring intra-state movement of consignments, and as a solution to that problem, the existence of checkposts is even less convincing. The utility of these checkposts to the tax authorities must be weighed against the cost to the economy in general (higher transport charges, fuel wastage, impeding the smooth flow of traffic and waste of time). Internal checkposts are not desirable when viewed from this perspective. The numerous alternative routes available within a state make these checkposts much less effective than border checkposts. Internal checkposts should be dismantled and the resources thus freed should be used to improve border checkposts and the mobile squads.

Other checkposts include those set up at railway station areas to monitor commercial goods traffic on the railways. However, this system has been much less effective than it could be, primarily due to the less than full cooperation extended by the railways. However, within its limitations, the system has been working as well as can be expected and cannot be improved without the cooperation of the railways, over which state administrations have no control.

VI. TRADE DIVERSION AND TAX EVASION

Trade diversion and tax evasion are conceptually different issues and one does not necessarily imply the other. However, they are not mutually exclusive, and to the extent they overlap in actual practice, some comments are in order.

Trade diversion refers to a reduction in trade in one state and a compensatory rise in trade in one or more other states purely as a result of tax factors. Trade diversion leads to tax evasion when a dealer discovers that he can easily evade taxes in another state if he makes his purchases there (which he does and he then has to evade taxes in his own state as well because he lacks the necessary transit documents), or when the tax rate is much lower in another state or when the dealer is able to smuggle in merchandise without fear of detection.[11]

In the first case, the tax authorities cannot do much except tighten the checking of inter-state movements of goods. As for the second case, identifying the commodities concerned and introducing some parity in the tax rates of contiguous states would be a more practical approach to the problem than trying to stop the smuggling, which is likely to be a frustrating experience.

VII. CONCLUSION

The problem of sales tax evasion in India cannot be tackled by any one measure alone; the solution requires fundamental policy changes. However, even without changing the fundamental structure of sales taxation in India, it may be possible to reduce evasion through some of the administrative measures suggested above, each of which is aimed at a particular method of evasion.

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10. Communication is also a problem in these checkposts, i.e. some posts even lack telephones.
11. Smuggling generally occurs with respect to high value, small bulk commodities such as pharmaceuticals, gems and jewellery, watches, etc.

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ISRAEL:

THE 1990 ISRAELI TAX REFORM

Professor Arye Lapidoth

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The 1990 tax reform, which follows the 1987 reform,[1] primarily aims to further reduce the individual and corporate income tax rates and broaden the tax base by limiting or abolishing certain tax exemptions and benefits. The reform is effective for both corporations and individuals from 1 July 1990. Because the amendments are generally not thought to be extensive enough, the reform has been popularly termed the *mini tax reform*.

One reason for the limited scope of the 1990 changes is the difference of opinion between the Treasury and the Workers Union (the "Histadrut") – the reform being based on an agreement reached by the two parties in early 1989.[2] The manner in which the reform was legislated also spawned controversy. Two laws were published on 6 April 1990: an amendment which mainly relates to the reduction of corporation tax;[3] and a special law, which aims at "limiting the expenses of the State, as well as increasing its revenues, in a manner that will make possible the achievement of the objectives of the 1990 budget and the economic policy".[4] The special law (in Sections 15 and 16), relates to income tax and includes amendments to the Income Tax Ordinance.

CORPORATE TAX RATES

Prior to the 1990 tax reform, the effective rate of tax imposed on undistributed profits of corporations was 45 percent (40 percent corporation tax plus 8⅓ percent income tax payable on the amount of the undistributed profit, after 40 percent corporation tax, i.e. 8⅓ of (100–40), which equals 5 percent).[5] The 1990 reform abolishes the income tax payable by corporations, so corporations will only pay 40 percent corporation tax on their undistributed profits. This change, however, will not be immediate but will be phased in gradually. During the period 1 July 1990 to 31 December 1990, the income tax rate for corporations will be 3⅓ percent.[6] For the tax year 1991 (ending 31 December 1991), the rate will be 1⅔ percent.[7] The income tax on corporations will be eliminated from 1 January 1992, i.e. as of 1992 a corporation will only pay corporation tax at the rate of 40 percent on its undistributed profits.

The rate of income tax imposed on dividends received by individual shareholders remains unchanged at 25 percent.

If a corporation distributes all of its profits to its individual shareholders, the aggregate rate of tax paid by the corporation and the individual shareholder will remain at 55 percent.[8]

INDIVIDUAL INCOME TAX RATES

Top marginal tax rate of 48 percent retained

The top marginal tax rate payable by individuals was reduced from 60 percent to 48 percent under the 1987 tax reform. However, in effect the maximum marginal rate was higher, because for the period ending 31 December 1989, a provisional surtax was imposed. The 1990 reform has retained the 48 percent rate but no surtax has been imposed for 1990, so the maximum marginal rate is now 48 percent.

Alleviating the tax burden of middle income taxpayers

The main feature of the 1990 reform relating to individuals is a slight mitigation of the steep progression of tax rate structures and the lowering of the tax threshold. Previously the individual taxpayer paid tax on an extremely low income and higher tax brackets cut in abruptly. A fairly complicated tax relief formula has been introduced to alleviate this burden.[9]

1. For an overview of the 1987 tax reform, see A. Lapidoth, "The 1987 Tax Reform", 41 *Bulletin for International Fiscal Documentation* (December 1987), at 561.
2. The Workers Union strongly objected to the taxation of certain fringe benefits which were tax-free. The Union maintained that taxation of the benefits would impair the vested rights of workers. The agreement represents a compromise between the two positions.
3. Income Tax Ordinance (Amendment No. 82) Law 5750-1990, *Sefer-HaChukkin* No. 1314 of 6 April 1990, at 137.
4. Arrangements in the State Economy (Amendments of Legislation) Law, 5750-1990, *Sefer-HaChukkin* No. 1314 of 6 April 1990 [hereinafter referred to as the "Law of Arrangements 1990"].
5. For more details of the corporate tax system before and after 1987, see supra note 1.
6. Consequently, the average effective tax rate imposed on corporations for the 1990 tax year will be 43.5 percent, as follows:
effective rate for 1 January 1990 – 30 June 1990 = 45 percent
effective rate for 1 July 1990 – 31 December 1990 = 42 percent
i.e. an average of (45+2) = 43.5 percent
7. The effective tax rate for 1991 will be 41 percent [40 percent + 1⅔ percent (100–40)].
8. For example:

Corporation tax payable on 100 undistributed profits	40
(Remaining amount of profits for distribution after corporation tax 100–40 = 60)	
Income tax payable by the individual shareholders receiving 60 dividend: 25 percent of 60	15
	55

No income tax would be paid by the corporation because for purposes of computing the amount of income subject to income tax, both the corporation tax (amounting to 40) and the dividend distributed (amounting to 60) are deductible (100–(60+40) = 0). As of 1992, the corporation will not pay income tax in any event.
9. Income Tax Ordinance, new Sec. 121A, introduced by the Law of Arrangements 1990, Sec. 15(11).

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From 1 July 1990, an individual taxpayer is entitled to the following tax credit:[10]

(1) where his annual taxable income does not exceed NIS 18,121 (about US$ 9,000): 4.3 percent of the tax payable;
(2) where his annual taxable income is between NIS 18,121 and 29,880 (about US$ 15,000): 3.4 percent of the tax payable;
(3) where his annual taxable income is between NIS 29,880 and 42,481 (about US$ 21,250): 2.5 percent of the tax payable;
(4) where his annual taxable income is between NIS 42,481 and 88,880 (about US$ 44,400): 1.7 percent of the tax payable.

The law also provides for marginal relief and empowers the Minister of Finance to establish averaging rules and adjustment in respect of computation of the tax credit.

Abolition of tax exemptions and benefits

As is common in recent tax reforms, the reduction in tax rates has been accompanied by a limitation or abolition of certain tax exemptions and benefits, with a view to broadening the tax base. For example, the exemption of certain fringe benefits has been abolished. The fringe benefits exemption[11] related to the value (up to a ceiling established by law) of certain benefits enjoyed by employees, such as small gifts, free meals, free transportation and rebates on purchases of goods supplied by the employer. The exemptions for all these benefits have been abolished.[12]

An employee's right to a reduced rate of tax in respect of overtime has also been considerably limited.[13] The Minister of Finance has been empowered to limit the scope of tax incentives given in respect of an investment in oil exploration and research and development.[14]

The tax reliefs in respect of medical insurance and special medical expenses have been limited or abolished,[15] as has been the partial exemption of a student's earned income which is spent on his studies.[16] The right of a working mother to tax relief in respect of her minor children has been limited.[17]

CONCLUSION

The 1990 tax reform is a step in the right direction – it has reduced the tax rate imposed on corporate income, lowered the tax threshold, mitigated the steep progression of the individual income tax rates, retained the top income tax rate of 48 percent payable by individuals, thus far resisting pressure to extend the "provisional" surtax on higher income, and broadened the tax base by limiting or abolishing exemptions. However, it appears that the reform deserves the name *mini tax reform* – the reductions in rates are inadequate and the higher tax rates should apply to higher income brackets to relieve "middle income" taxpayers from their heavy tax burden.

With respect to broadening the tax base, it must be remembered that the numerous tax exemptions were adopted as a counterpart to the high tax rates. The section of the Income Tax Ordinance which deals with exemptions expanded with the increase in the tax rates and is the longest and most intricate section of the law. The tax base should be broadened further but that goal can only be achieved when the tax rates are further reduced.

The problem created by the 1987 tax reform regarding the taxation of corporate income has been accentuated rather than solved. The imposition of a top marginal rate of income tax on individual taxpayers which is higher than the effective corporate tax rate may tempt individual taxpayers to resort to the old practice of avoiding tax by incorporating as a closely-held company and refraining from distributing dividends. Under the 1987 tax reform the tax rate paid by corporations was less than the top individual tax rate, although the difference under the 1987 reform was still less than it was before 1975.

The difference between the corporate and top individual marginal rate has increased under the 1990 reform. Hence, the reduction of corporate tax to 40 percent, with the retention of the top marginal rate for individuals at 48 percent, may serve as a greater disincentive to distribute dividends, and a greater incentive to incorporate a company and avoid tax by not distributing dividends.

The Israeli experience has shown that the most effective way to counter tax avoidance by locking profits in a closely-held company is to fix a top marginal rate of income tax for individuals, which is either equivalent to or lower than the rate of corporate tax.

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10. These amounts are linked to the cost of living index.
11. Income Tax Ordinance, Sec. 9(20).
12. Under the Israeli tax system (and particularly since 1975) fringe benefits provided by employers to employees have been extensively taxed in the hands of employees. However, because of the resistence of the Workers Union, certain fringe benefits received by employees still remained tax-free even after 1975. Most of these benefits are now subject to tax.
13. Income Tax Ordinance, Sec. 10(c), introduced by the Law of Arrangements 1990, Sec. 15(3).
14. Income Tax Ordinance, Sec. 245(c) introduced by the Law of Arrangements 1990, Sec. 15(3).
15. The Law of Arrangements 1990, Sec. 15(5), replacing Income Tax Ordinance, Sec. 44.
16. The Law of Arrangements 1990, Sec. 15(6), replacing Income Tax Ordinance, Sec. 45B.
17. The Law of Arrangements, Sec. 15(9), replacing Income Tax Ordinance, Sec. 66(a)(3).

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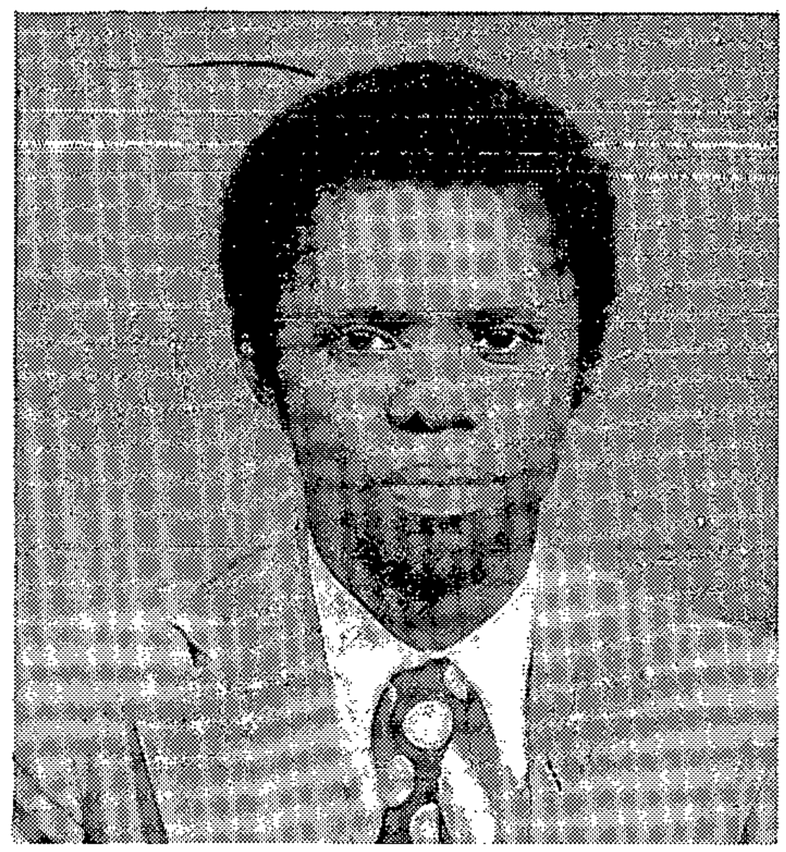
NIGERIA:

1990 CHANGES IN TAX LAW AND POLICY

Professor A.C. Ezejelue



I. INTRODUCTION

Two new growth and development plans have been implemented in Nigeria: the perspective plan and the rolling plan.[1]

The perspective plan is a broad, long-term (lasting 15-20 years) economic development projection.[2]

The rolling plan will cover three year time frames but will be subject to review on an annual basis.[3] The rolling plan is a bold attempt to break away from the five year development plans of recent years.[4] The primary objective of the plan is to consolidate the gains made by the Structural Adjustment Programme.[5]

The rolling plan will rely on market forces as its strategy to achieve allocation and distribution efficiency. Bureaucratic controls will be de-emphasized by means of state intervention. More use will be made of fiscal and monetary policy instruments to correct noticeable malfunctioning of the market in light of national objectives.

II. CHANGES IN TAX LAW AND POLICY

The overall tax policy in 1990 is designed to further reduce the tax burden on individuals and corporations, provide more incentives for productive activities, improve the collection machinery and provide sanctions for tax evasion.[6] To this end changes have been introduced in the following areas: minimum tax on individuals, personal allowances, remuneration and fringe benefits in the private sector, interest on deposit accounts of non-residents, income from abroad, tax clearance certificates, investigative powers of the tax authorities, employment income and the residence test, tax identification numbers, capital allowances, collection of tax at source, pre-operation levy and minimum tax payable by companies.[7]

A. Minimum tax on individuals

Hitherto a minimum tax on individuals of one percent of total income has been imposed. The minimum tax has been reduced to 0.5 percent of total income. An individual who earns ₦ 3,000 or less will not be required to file an income tax return but he must pay the reduced minimum tax of 0.5 percent. In effect, no individual with earned income (except for statutorily exempted income under the Third Schedule to the Income Tax Management Act (ITMA) 1961 is exempt from personal income tax. The reduction of minimum tax for low income earners is a step in the right direction towards introducing the concepts of progressivity and wealth redistribution into the tax system.

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1. The Rolling Plan is known as the Economic Consolidation and Expansion Programme (ECEP).
2. This plan is so comprehensive that its utility will depend on the availability of reliable information and data. Apart from the expected improvement in the Nigerian statistical system (which is expected as a result of the effort of the national data bank to undertake a major survey of the statistical base as from January 1990) Nigeria's statistical data have thus far been unreliable. The gaps in statistical data are such that meaningful planning and monitoring of the performance of the economy will be difficult and elusive.
3. The overall plan size for the three year period is approximately ₦ 144.2 billion, consisting of ₦ 94.2 billion (65 percent) for the public sector and ₦ 50 billion (35 percent) for the private sector. The macro-economic projections leave a savings-investment gap of about ₦ 28 billion over the period and a balance of payments gap of about the same amount primarily due to debt service obligations. It is hoped that the savings-investment gap will be closed by resources transferred into Nigeria by Nigerians living abroad and from foreign investment. Efforts will also be made to close the gap through substantial debt relief and debt forgiveness.
4. Between 1962 and 1985, the development programmes were based on fixed five year plans. Four such plans were implemented during this time frame.
5. The Structural Adjustment Programme (SAP) was first adopted in July 1986. Officially SAP was designed to last until June 1988, the SAP package became the base of Nigeria's economic structure.
6. See A.A. Alhaji, "1990 Budget Breakdown", Business Times, 8 January 1990, at 8-15; see also A.A. Alhaji, "Press Briefing on the National Rolling Plan 1990-92 and the 1990 Budget" (Lagos: Federal Government of Nigeria Press, 1990).
7. Unless otherwise noted all of these changes are effective as from 1 January 1990.

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B. Personal allowances

Every individual subject to tax is entitled to a personal allowance of ₦ 2,000 plus 15 percent of earned income. This contrasts sharply with the personal allowance of ₦ 1,000 plus 12.5 percent of earned income which was introduced in 1986. In addition to reducing the tax burden on individuals, the increase in personal allowances aims to achieve economic stability in this period of recession when there is a serious decline in the taxpayer's spending power.

C. Remuneration and fringe benefits in the private sector

Remuneration for employment and other fringe benefits of senior staff and executives in the private sector will be treated by the Federal Board of Inland Revenue within the context of the agreement reached with the Federal Ministry of Employment, Labour and Productivity, Prices and Income Board. This agreement deals with the method of assessing benefits in kind and taxable perquisites (e.g. rent free accommodation, employer-owned furniture, transportation, etc.).

D. Interest on deposit accounts of non-residents

Since the 1989 fiscal year, *all* banks have been required to make tax deductions at source at the rate of 15 percent on interest paid or credited by the bank to the accounts of all customers. This requirement has been amended with respect to interest on deposit accounts of non-resident companies (whether or not incorporated). Now interest accruing on deposit accounts of such companies will be tax exempt, provided that the deposits are made by a transfer of funds to Nigeria on or after 1 January 1990 and that the depositor does not become non-resident after making the deposit while in Nigeria. Interest on foreign currency domiciliary accounts will also be tax exempt. This new fiscal policy is designed to encourage non-resident companies to accumulate savings in Nigeria.

E. Income from abroad

According to Section 4(i) of the ITMA 1961, an individual is taxed on income brought into Nigeria. Until 1990 the only exception to this provision was investment income derived from abroad. However, henceforth all income derived by an individual from abroad will be tax exempt, if the income is brought into Nigeria through authorized channels. This fiscal policy is also designed to encourage capital accumulation from abroad to enhance productive capacity.

F. Tax clearance certificates (TCCs)

With effect from January 1985, both the ITMA 1961 and the Companies Income Tax Act 1979 (CITA) were amended to introduce the issuance of Tax Clearance Certificates (TCCs). A person or a company must present a TCC for the three years immediately preceding the current year of assessment before any transactions with a ministry, department or agency of the government can be entered into.

To facilitate the procurement of TCCs, the Federal Board of Inland Revenue (FBIR) and the Joint Tax Board (JTB) will appoint area ombudsmen to deal expeditiously with complaints while final recourse may be made to the Chairman of the FBIR. The 1990 amendment also provides that any person or company who obtains a TCC through misrepresentation, forgery or falsification will, in addition to penalties for offences under the tax laws, be liable to a fine equal to twice the tax avoided, or three years imprisonment, or both.

G. Investigative powers of tax authorities

To further arrest the wave of tax evasion, the investigative powers of revenue authorities will be strengthened so that tax investigations can be conducted more effectively.

H. Employment income and the residence test

Section 8(1) of ITMA 1961, which determines residence for tax purposes, provides in part that income from employment shall be deemed to be derived from Nigeria if the employment is wholly or partly carried out in Nigeria, unless the employee is not in Nigeria for 183 days or more in a year of assessment.

The 183-day test will now be calculated on a 12 month period, commencing in a calendar year and ending either in the calendar year concerned or in the following year. The test will no longer be limited to a stay for 183 days in a year of assessment. The effect of this change is to bring more non-residents into the Nigerian tax net by not restricting the 183 day test to a particular year of assessment, but to base it on a 12 month period within two calendar years.

I. Tax identification numbers

All companies must display their incorporation number, which will serve as its identification number, on all transactions and correspondence. However, in respect of returns and correspondence with revenue authorities, both the tax reference number and the identification number should be displayed. This provision is designed to improve tax administration, particularly in the areas of identification and enumeration of taxpayer companies and for the enforcement and collection of tax.

J. Capital allowances

The Finance (Miscellaneous Tax Provisions) Decree No. 4 of 1985 which provides, among other things, for computation of annual allowances on a straight-line basis at a specified rate, after deducting the initial allowance where applicable, also restricts the total capital allowances that may be claimed in any year of assessment to a maximum of 75 percent of the total profits in the case of manufacturing companies and 66⅔ percent in other cases. The provision restricting capital allowances to 75 percent of total profits in the case of manufacturing companies has been abolished. One hundred percent of the total profits is now available for claim by way of capital allowances; this will provide more incentives for productive activities and reduce the tax burden on companies.

An investment allowance of 10 percent on qualifying expenditure incurred on new production machinery is also granted. This allowance, however, is only deductible from profits made in the year of expenditure. If no profits are made in the year of expenditure, the investment allowance will lapse.

K. Collection of tax at source

The penalty for failure to deduct or failure to pay tax withheld to the relevant tax authorities within 30 days from the

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date the amount was deducted or the time the duty to deduct arose, is a ₦ 5,000 fine, in addition to the amount of tax deducted, plus interest at the prevailing commercial rate.[8] The penalty for failure to remit the amount due remains the same but the interest chargeable will now be based on the prevailing bank rate. The prevailing bank rate is higher than the commercial rate, and so the purpose of this amendment is to improve collection machinery and encourage prompt accountability of withholding tax deductions.

The withholding tax deductions on payments by companies to any person for all types of contracts, building and construction activities, commissions, professional and technical services which took effect from 1985, have been formally extended to all payments within or outside Nigeria by oil companies to any person, whether resident or not. The purpose of this amendment is to enlarge the withholding tax base and improve the tax collection system in circumstances where the willingness to pay tax is low and the rate of tax evasion is high.

L. Pre-operation levy and minimum tax payable by companies

1. Pre-operation levy

Since 1985, a company which does not commence business after six months of incorporation in any year of assessment but before submitting accounts for the first 12 or 18 months of operation, must pay a levy of ₦ 500 for each year of assessment or part thereof for which the company does not carry on any business. The pre-operation levy provisions have been amended so that, for purposes of obtaining a tax clearance certificate, ₦ 500 will be payable for the first year and ₦ 400 for every subsequent year.

2. Minimum tax payable by companies

A company which has commenced business but which has no profits, or total profits which result in a tax payable less than the minimum tax will be taxed as follows:

(1) if the turnover is ₦ 500,000 or less and the company has been in business for more than four years, the tax will be 0.5 percent of gross profits, or 0.5 percent of net assets, or 0.5 percent of acquired net assets, or 0.25 percent of paid-up capital, or 0.25 percent of turnover, of the company for the year, whichever is highest;
(2) if the turnover is more than ₦ 500,000, the minimum tax will be the tax payable on a turnover of ₦ 500,000, and any excess above ₦ 500,000 will be taxed at 50 percent of the rate first used;
(3) the minimum tax is not applicable to a company during the first four years of business;
(4) the minimum tax is not applicable to agricultural trade or businesses as defined in Section 9(8) of CITA 1979 or any company with at least 25 percent imported equity capital;
(5) the minimum tax will apply to partnerships and self-employed persons, but at a rate of 0.5 percent of total income.

The government's aim in imposing the pre-operation levy and the minimum tax is undoubtedly to curb tax evasion. However, the policy has been criticized as infringing on principles of equity, fairness, ability to pay and benefits received.[9] The tax is considered unacceptable, a disincentive to investment and inimical to capital formation and industrialization. It is also seen as violating the rationale of income and profits taxation. For instance, to impose a pre-operation levy on a company which has not commenced business may be tantamount to imposing a profits tax on a non-going concern that has no income. It is difficult to imagine the basis for this tax. In the same way, to make any other items in the balance sheet the tax base simply because a company's profits cannot produce the required minimum tax seems to violate the principle of basing income tax on anything other than income or profits.[10]

The pre-operation levy and the minimum tax are new methods for the government to deal with another *hard-to-tax* group. The withholding tax system was introduced in 1985 to enable the government to collect taxes before taxpayers had an opportunity to hide the income. For the group that cannot be subjected to a withholding system, the government wants to manage with an estimation system of assessing taxes on the basis of something more readily verifiable than income. This *presumed* income system is obviously a rough and rigorous method, and it is usually directed to the *hard-to-tax* group. This method is a coarse attempt to be vaguely right rather than precisely wrong, or as Professor Bird puts it, to pursue "the attainable 'good' as opposed to the unattainable 'perfect'".[11]

III. SUMMARY AND CONCLUSION

The Nigerian economy has suffered a major setback since 1980. This fact has been highlighted in various ways by the present administration since it came into power in 1984: e.g. under-development, low level of productivity, high rates of inflation, increasing unemployment, and dependence on foreign assistance. The administration has addressed these issues by means of various fiscal and monetary policies and an attempt to structurally adjust the economy. Some of these efforts have yielded positive signs, but the road has remained tortuous and has exacted painful endurance and patience from the populace.

The latest effort is the introduction of the perspective plan and the rolling plan in the 1990 budget. These plans, which constitute the framework and focus of the 1990 plan, will be fully backed by other fiscal and monetary policies, such as those embodied in the 1990 budget. Among the fiscal policies are the review of tax policy and amendments to the tax laws discussed above. These, among other measures, constitute the necessary ingredients in the course of accelerating economic recovery.

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8. ITMA Sec. 21F and CITA Sec. 59D.
9. See, for example, "Manufacturers' Association of Nigeria Review of 1990 Budget", Business Times, 5 and 12 February 1990. See also, Ibeabuchi Nwankwo, "A Review of the Minimum Tax Rule and Company Income Tax in the 1990 Budget", Business Times, 26 March 1990, at 7.
10. It is in the light of the foregoing that Ibeabuchi Nwankwo (supra note 10) observed that:
"... Government seems to have lost sight of the rationale for taxation. It is no wonder, therefore, that she has always handled the issue of tax badly; and this is largely responsible for the antipathy against tax in our society. Tax is not necessarily by fiat. It is more by moral suasion.... Tax worldwide is an appropriation of profit, not a charge on income. But the minimum tax rule seeks to impose tax on turnover, gross profit, net assets, acquired net assets, and paid-up capital, without due consideration for expenses of operation. It is most unfair. And what is more, this rule attacks all known growth indicators of a firm. It will not be surprising that businessmen will be discouraged from pursuing growth-oriented ventures in order to escape from government's tax dragnet."
11. Richard M. Bird, "Income Tax Reform in Developing Countries: The Administrative Dimension", 37 *Bulletin for International Fiscal Documentation* (January 1983), at 3.

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INTERNATIONAL FISCAL ASSOCIATION

NEWS

RESOLUTIONS

44th IFA CONGRESS, STOCKHOLM, 1990

SUBJECT I:
Taxation of Cross Border Leasing

Resolution (original version)

The 44th IFA Congress:

Taking note of 31 National Reports and the General Report as published in the *Cahiers de Droit Fiscal International,* Volume LXXVa, and

Taking further note of the discussions held during the Congress on 27 August 1990.

And considering that:

1. Leasing, both domestic and cross border, is a well established financing technique throughout the world. In many states it is a major source of finance for new capital equipment and has evolved, in some cases, despite changes in tax legislation which have reduced tax incentives.
2. An overriding feature of cross border leasing is the problem of the different tax treatment afforded by different states to lessors and lessees depending upon whether the lease is characterized as an "operating" lease or a "finance" lease. If a lease is characterized as an operating lease, the lessor is treated for tax purposes as the owner, and is generally entitled to depreciation and where applicable, investment credits. However, in certain circumstances, the lease may be characterized for tax purposes as a finance lease, and ownership may be attributed to the lessee, who may depreciate the asset, and where applicable, is entitled to investment credits, and is viewed as making payments of principal and interest to the lessor.
3. Some states do not have tax rules that distinguish between operating and finance leasing. In such states legal ownership is the only basis for depreciation. However, in those states it is reported that courts and tax authorities have sometimes considered leases in reality to be installment sales or hire-purchase agreements. Other states have distinguished between operating and finance leases, in the latter case attributing economic ownership of the asset to the lessee and allowing him to depreciate it.
4. This can lead to complications on the international level. If a cross border lease is treated as an operating lease in one state and as a finance lease in another state, the result may be a so-called "double dip", where an asset is depreciated in both states, or may lead to a situation where depreciation is denied in both states.
5. This difference in tax treatment is mostly a timing difference, and in the absence of other elements, does not result in tax avoidance. However, the complexity and lack of certainty which results from differing national tax treatments of leasing transactions is an obstacle to the free flow of capital between states.
6. In the General Report, it is suggested that all cross border leases be treated for tax purposes as operating leases, since it would be impossible to have all states agree on making a distinction between operating and finance leases and to do it in the same way. Furthermore, leases are generally dealt with as operating leases in a majority of the states for which National Reports were prepared.
7. However, in a number of major industrial states representing the major part of the volume of leasing business, finance leases are distinguished from operating leases, for the reason that under certain economic criteria, ownership of the leased property is attributed for tax purposes to the lessee.
8. The selection of economic rather than legal criteria as the basis for a harmonized approach to the characterization and taxation of cross border leases is supported by several considerations. States using legal criteria as the point of departure may in any event be influenced by other considerations such as abuse of law or substance over form doctrines leading to somewhat the same tax treatment of the lease as in states using economic criteria. It would seem to be easier to achieve uniformity in tax law and administration than to seek an international harmonization of the civil law of sale and lease. The use of economic criteria facilitates a greater similarity between the tax and the accounting treatment of cross border leases.
9. States have not generally followed the OECD recommendation of 13 September 1983, that lease payments be free of tax in the state of source in the absence of a permanent establishment. More often, and in sharp contrast with those recommendations, they have continued to levy withholding taxes on rentals of moveable property.
10. Withholding taxes are imposed on gross income and without usually taking into account related costs. Normally the profit margin of the lessor is small so that the tax burden in relation to net income is excessive, making leasing transactions impossible with some countries.
11. There are other problems connected with the tax treatment of leasing which are not dealt with in conformity with generally accepted principles of tax law and, in particular, the principle of non-discrimination against nationals of other states.

Recommends:

1. States should take steps to clarify the tax treatment of lease payments, and in so doing, should participate in the harmonization of the tax treatment of cross border leasing.
2. This harmonization can be achieved by multilateral agreement, bilateral agreement and unilateral action. The OECD should study the problem and make recommendations to its member states.
3. In making its recommendations, the OECD should bear in mind the tendency of states towards a greater utilization of economic criteria in elaborating rules regarding the tax treatment of cross border leases, whilst seeking to accommodate the concerns underlying arguments in favour of legal criteria, and in particular, the use of economic criteria should not disrupt or displace the

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application of legal criteria to define legal ownership for non-tax purposes.

4. States are encouraged to follow the recommendation of the OECD and adopt treaty provisions which would eliminate withholding tax on rental payments for industrial, commercial or scientific equipment made by resident lessees to non-resident lessors. In those states where this cannot be achieved, and in particular in non-OECD states, the rate of taxation should be limited to a low rate such that a full credit can normally be obtained in the state of residence. Alternatively, the state of source should allow the lessor to elect to be taxed at domestic rates of tax on its net income, after deduction of attributable expenses, including finance costs. In the event that the non-resident lessor has a permanent establishment in the source state, it should likewise be entitled to deduct all attributable expenses, including finance costs.
5. States should not discriminate against foreign lessors or lessees. In particular, they should allow the full deduction of rental payments for tax purposes regardless of the state of residence of the lessor. They should allow the same deprecation to a lessor regardless of the state of residence of the lessee or state of utilization of the asset. They should characterize payments under a cross border lease in the same manner for income tax and withholding tax purposes.

Review of the Resolution on Subject I by Mr. P. Cumyn (Canada), Chairman of the Resolutions Committee

The Resolution following closely the approach which was taken by the Panel under its Chairman, M. Jean-Pierre Le Gall, in its analysis of Subject I "Taxation of Cross Border Leasing".

The opening paragraphs of the Resolution reflect the different views which were expressed as to whether legal or economic considerations should serve as the point of departure in the characterization of payments under a cross border lease. No clear consensus emerged on this issue during the discussion. Accordingly, the third recommendation is perhaps only a timid endorsement of the economic school, and seeks to highlight what appeared to be the chief concern of those holding the opposite view, namely that there be no dilution of the use of legal criteria to define ownership for non-tax purposes.

The fourth recommendation seeks to accommodate the view which was strongly expressed by a number of members from Latin America, that rental payments under a cross border lease could be expected to suffer significant withholding taxes in their countries. However, the consensus among members from OECD countries who expressed their view on this issue was overwhelmingly that withholding taxes in the country of source should normally be eliminated or reduced to the greatest extent possible.

The fifth recommendation is inspired by certain specific rules or administrative positions which came to light during the Panel discussion. The three situations addressed are the limitation on deductibility of payments to non-residents under the German trade tax, the limit to depreciation allowed in the United States in respect of leased assets used abroad and the policy of the tax authorities in Canada to characterize all financial lease rental payments to non-residents of Canada as payments of rent, even where the contract is characterized as one sale for domestic tax purposes.

SUBJECT II: International Mutual Assistance through Exchange of Information

Précis (original version)

PRELIMINARY REMARKS

When a State, after due discussion in its appropriate legislative bodies, has enacted the introduction of, or changes in tax law, it is the Tax Administration* of that State which is authorized as the Governmental body to collect that tax.

The rights and obligations of the Tax Administration and of the Taxpayers are commonly also laid down in or are based upon legislation.

The duty of the Tax Administration to levy tax and the constitutional and procedural rights of the Taxpayer are to be reconciled so that the tax will be levied in a legal and fair way.

While it is recognized that there should be an exchange of information between the national tax authorities to the extent necessary for the correct application and for the prevention of fraud and abuses of Double Tax Conventions, many such Tax Conventions additionally provide for the carrying out, within some limitations, of provisions of domestic laws concerning taxes covered by the Convention.

Given the increasing internationalization and globalization of the world economy it can be expected that a greater official interest in an exchange of information be perceived, which requires that the rights and protection of the persons concerned by such exchange of information be reinforced and strictly observed.

NOTE OF DISCUSSION AT THE CONGRESS

1. Several participants expressed the view that persons affected by a request for information should be informed in advance of such a request; this should be the rule and exceptions should be defined by law. The right of appeal to an independent judicial or administrative body must be available comprehensively. Concern was expressed that advance notification could, in cases of fraud or serious evasion, prejudice the progression of an inquiry being carried out by fiscal authorities. This point was taken but it was considered that this aspect should not render it impossible to find a solution to devising satisfactory procedures.
2. The question was also addressed as to who should determine whether information requested constitutes an industrial, commercial or trade secret.
3. The relative merits of bilateral and multilateral conventions were discussed with a majority expressing a preference for bilateral Double Tax Conventions which can establish a proper balance between the prevention of double taxation on the one hand and increasing cooperation between the fiscal authorities on the other hand. These Conventions can also be specially drafted to take into account differences between the two countries' tax systems or economies. The different positions of developing and developed countries deserve special attention.
4. Moreover, interventions from the floor indicated that the 1977 EEC directive which provides for a multilateral approach had been little used in practice.
5. Attention was devoted to the issue of confidentiality

* National, State, Provincial, or Municipal.

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and to the delicacy of some of the problems arising from the different standards of confidentiality prevailing in the various countries. The importance of such issue will be thoroughly explored at the 45th IFA Congress in Barcelona in 1991.

6. While the topic of the Congress was restricted to International Mutual Assistance through Exchange of Information as provided for Tax Conventions, the Congress took note of the fact that information relevant for tax purposes may be the object of Conventions other than Tax Conventions and primarily designed for other purposes. In addition to the problem of confidentiality, this phenomenon entails the risk that information will be utilized for purposes other than those which are the actual subject matter of a particular convention (doctrine of specialty).
Concern was expressed about information being passed between governments in connection with "fiscal offenses" where there is no dual criminality. But the view was also expressed that agreements to exchange information about crime generally should not normally apply to fiscal offenses as such.

Review of the Précis on Subject II by Prof. Mr. A. Nooteboom (Netherlands), Chairman of the Resolutions Committee.

The text of the Précis, meant to reflect in a condensed way what was discussed during the sessions of the 1990 IFA Stockholm Congress about Subject II, "International Mutual Assistance through Exchange of Information", was accepted by a large majority of the Congress participants.

From the discussions conducted during the Congress it appeared – not unexpectedly – that the Subject was rather controversial. Strong emphasis was placed upon the vital necessity of protecting the rights of individuals and enterprises about who information is being requested and/or exchanged and of those who are being asked to supply information.

The right of the individual or enterprise to be informed by the Tax Administration prior to an exchange of data by that Administration – a right already existing in some countries – was clearly demanded, with a view to enabling the taxpayer to challenge the exchange of information before an independent Court. Only in this manner would it be possible to also enforce the strict observance of procedural rules, as well as the prevention of an exchange of secret information.

It was likewise clearly pointed out that the national Tax Administrations, which are charged by way of legislation with the levying of the tax by a national Parliament, must be enabled to fulfil that task with adequate means. These include the obtaining of sufficient means of verification, part of which is the acquisition of adequate information by the Tax Administration; also information that can be obtained through international exchange. It would be a token of one-sidedness, so it was further argued, to draw attention to the rights of individuals and enterprises and not to have an open eye for the right of Tax Administrations to dispose of sufficient means for the fulfilment of their task.

In particular the remark that separate multilateral Conventions to implement the international exchange of information can be concluded in a simpler and faster manner gave rise to many reactions. Many participants argued that the right of individuals and enterprises to adequate avoidance of double taxation is irremovably linked to providing the Tax Administration with the right to e.g. international exchange of information for the furtherance of an adequate levying of the tax.

It was pointed out that it took a very long time to decide, as yet only within the EEC, on the introduction of the long-awaited procedure of compulsory arbitration in the case of a dispute between Tax Administrations of different countries and that in contrast therewith it took only a relatively short time to arrive at the multilateral Convention of the Council of Europe.

Only in Conventions containing the general provisions for the avoidance of double taxation, so it was argued explicitly, may the rights of the Tax Administration concerning the levying of the tax be laid down (including international exchange of information), so as to ensure a balance between the rights of individuals and enterprises and the rights of Governments. As long as the provisions for the avoidance of double taxation are laid down in bilateral Conventions the exchange of data should likewise be provided for by such a bilateral Convention.

Within the context of international exchange of information the attention was drawn to the special position of less developed countries in relation to developed countries, in particular with regard to the lack of real reciprocity.

Finally, it was advocated that the principle should be that the national means should be exhausted before entering into the international exchange of information (doctrine of subsidiarity).

BRITISH BRANCH

A technical meeting of the Branch was held on Monday, 10 December 1990. Professor Wolfgang Ritter of BASF Aktiengesellschaft spoke on German Double Taxation Treaty Negotiations.

SWISS BRANCH

On 1 November 1990, the Swiss branch held a meeting to discuss the 1990 Stockholm IFA Congress and the subjects of the 1991 Congress.

U.S. BRANCH

1991 Annual Meeting

The 1991 Annual Meeting will be held in Chicago on 28 February and 1 March 1991 at the Ritz Carlton Hotel. The Mid-West Regional Group led by Art Gould is putting together an outstanding programme. About three hours will be devoted to "Europe – 1992". Tentatively, three European nationals will discuss the major changes and what they mean for the larger European businesses, a panelist from a major U.S. corporation discussing the possible U.S. corporate responses and a speaker from Treasury discussing the impact of "1992" on U.S. tax policy.

Pacific Basin Meeting

The Pacific Basin Meeting is to be held on 22 May through 24 May 1991, in Maui, Hawaii. Countries participating in the seminar include Australia, Canada, Hong Kong, Indonesia, Malaysia, Mexico, New Zealand and the United

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States. The programme is tentatively scheduled as follows:
1. Doing business in a country, including acquisitions
2. Cost sharing and transfer pricing
3. Enforcement
4. Taxation of inpatriates

These subjects will be presented by way of a panel discussion – the panel will consist of representatives from most of the countries.

Kevin Philips, a publisher, author and commentator, will be our keynote speaker. His most recent book, *The Politics of Rich and Poor: Wealth and the Electorate in the Reagan Aftermath,* is a best seller. *U.S. News and World Report* included Phillips in their 40-member "Who's Who" in U.S. politics.

Other speakers will include a senior representative from the Japanese Ministry of Finance and the Deputy Commissioner of Internal Revenue from Korea.

Joint Dutch-U.S. Meeting

The two branches held a two-day joint meeting in Amsterdam on 23 and 24 August 1990 just prior to the Stockholm Congress. The technical presentations were excellent and there was a lively discussion between the floor and the panelists. Joseph Westerburgen, Treasurer of Central IFA, gave a particularly informative talk on 1992.

Other Inter-branch meetings

The following meetings have been scheduled with other branches over the next several years:

U.K.	London	3-4 October 1991
Germany	Williamsburg	October 1992
Switzerland*	(in Switzerland)	Fall 1993
The Netherlands	Chicago	Fall 1994

* Preliminary conversations to this date.

U.S. Regions

The U.S. branch is organizing four new regions in the United States. The new regions and their vice presidents are:

Pacific Northwest	Jack Huston
Denver	Bob Rich
Boston	Dan Coughlin
Atlanta	Gerry Ball

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1990 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ERRATUM

Please accept our apologies. There is an error in pagination at pp. 517-521 (October 1990 issue). The correct order is 517, 519, 520, 518, 521.

AFRICA

LEGAL ASPECTS OF DOING BUSINESS in Africa.
Edited by Prof. Dennis Campbell.
Deventer, Kluwer Law and Taxation Publishers; St. Paul, West Publishing Co. (U.S.A.), 1986.
International Business Series, Volume 4 (including Pocket Supplement March 1989, 81 pp.), pp. 240, 226.- Dfl.

Guide for doing business in a few selected African countries each dealt with per chapter. Countries covered in the basic volume: Bophuthatswana, Ghana, Ivory Coast, Kenya, Nigeria, Senegal, South Africa, Tanzania and Zimbabwe. The Pocket Supplement updated the materials on Bophuthatswana, Ghana and Nigeria. New chapters include Liberia and Mauritania. Reference to taxation of foreign business and foreign employees are made.
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Washington, The World Bank, Publ. Dept. J2190, 1818 H Street, N.W. Washington, D.C., U.S.A., 1989, pp. 34, $ 5.95.
Report on tax policy which strengthens the role of the price mechanism in allocating resources, based on the existing tax structures of the countries of Sub-Saharan Africa.
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ASIA & THE PACIFIC

Australia

CLEARING TAX HURDLES IN THE YEAR of the horse.
Tax planning 1990.
Amsterdam, KPMG – Peat Marwick, 1990, pp. 53.
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Canberra, Australian Government Publishing Service, 1990, pp. 615.
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Sydney, Australian Tax Research Foundation,

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Level 2, 44 Hunter Street, Sydney NSW Australia, 1990.
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BHARGAVA, U.K.; BHARGAVA, B.P.
Direct taxes manual. Volumes 1, 2 and 3.
Delhi, Taxmann Publications Pvt. Ltd., 1990, pp. 3200.
Publication in three bound volumes. Each volume covers different fields of direct taxes. Volume 1 contains texts of direct tax acts (Income-tax Act, 1961; Companies (Profits) Surtax Act, 1964; Expenditure Tax Act, 1987; Interest-tax Act, 1974; Wealth-tax Act, 1957; Gift-tax Act, 1958; Special Bearer Bonds (Immunities and Exemptions) Act, 1981; Public Provident Fund Act, 1968 and Unit Trust of India Act, 1963). Volume 2 contains the texts of Direct Tax Rules. Volume 3 contains charts and tables explaining the entire gamut of direct tax laws, investment planner, direct tax rates, text of important tax saving schemes/rules, text of Finance Act, 1990 and Direct Tax Laws (Second Amendment) Act, 1989, etc.
(B. 57.517)

BUSINESS PROFILE SERIES: INDIA.
6th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Limited, 1990, pp. 56.
Revised edition of information guide on doing business in India with some reference to taxation.
(B. 57.485)

Japan

AN OUTLINE OF JAPANESE TAX administration 1989.
Tokyo, National Tax Administration, 3-1-1 Kasumigaseki, Chiyoda-ku Tokyo 100, 1989, pp. 112.
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(B. 57.477)

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Tokyo, Ministry of Finance, 1990, pp. 98.
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Editors: Catherine S. Bobbett and Juhani Kesti.
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Summaries of the taxation of corporations and individuals in 17 major European countries. Corporate tax summaries: include a description of all corporate income taxes, group treatment, social security contributions, turnover taxes, and net wealth taxes. A special feature is a per country treaty chart listing the withholding tax rates on dividends, interest and royalties from all treaties concluded by that country. Individual income tax summaries: include all relevant income taxes (including local taxes), inheritance and gift taxes, social security contributions and national net wealth taxes. Both the corporate and individual sections pay special attention to non-residents and relief from double taxation. The book will be published annually in the Spring, with an updating booklet towards the end of the year.
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Working papers of a study of Fenedex and the Chamber of Commerce of Belgium and Luxembourg held in Utrecht on 13 June 1990 on the Belgian income tax reform of 22 December 1989.
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Guernsey, KPMG – Peat Marwick, 10 Lefebvre Street, Guernsey, 1989, pp. 57.
Booklet providing an introduction to aspects of company law, taxation and other related matters in the Channel Islands for those considering business or investment activities in the islands.
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London, Euromoney Publications PLC, 1990, pp. 82.
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