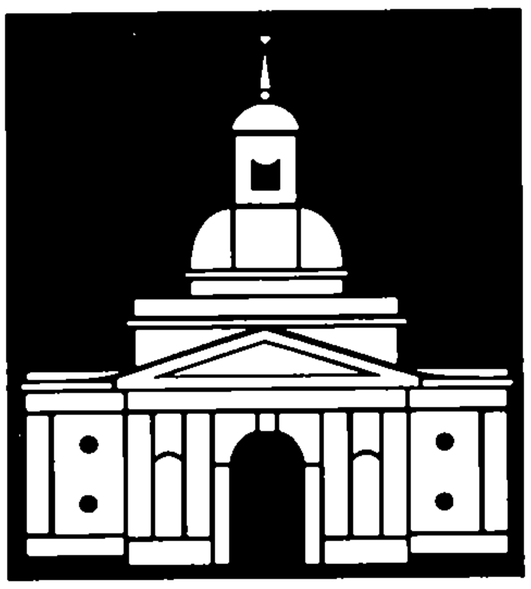

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CONTENTS

VOL. 47 NO. 1 **JANUARY 1993**

INTERNATIONAL:
WHAT KIND OF CORPORATION TAX? — 3 *Sijbren Cnossen*

This article surveys and evaluates the various forms of tax that are imposed on corporate profits. The following is discussed: the role of the corporation tax in OECD countries, the classical system and the imputation system, schemes for integration at both the corporate level and the shareholder level, comparison of various systems and an evaluation of various systems.

RUSSIA:
TAX ASPECTS OF IMPROVING THE INVESTMENT CLIMATE IN RUSSIA — 17 *James Riordan and Charles E. McLure, Jr.*

In July 1992 a mission organized by the US Tax Foundation met with officials of the Russian government to convey their perceptions of problems with the Russian tax system that impede foreign investment in Russia. This report summarizes the views presented by the Foundation to the Russian government.

INTERNATIONAL:
THE US PROPOSED REGULATIONS DEALING WITH TAX ASPECTS OF TRANSFER PRICING WITHIN MULTINATIONAL ENTERPRISES — 21 *A Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC*

This Report, prepared by a special Task Force established by the Committee on Fiscal Affairs of the OECD, aims to provide the US administration with the collective views of the OECD Member countries on the proposed Section 482 Regulations. The Report summarizes the main problems which arise with the proposed Regulations and then sets out the recommendations of the Task Force.

MALAYSIA:
THE 1993 BUDGET AND RECENT DEVELOPMENTS — 26 *Veerinderjeet Singh*

The budget strategy aimed at ensuring fiscal prudence, controlling inflation, and increasing efficiency and competitiveness of the private sector is considered appropriate both in the context of the encouraging growth of the Malaysian economy and the international economic situation. This article examines the various measures affecting direct and indirect taxation.

HONG KONG:
THE PRIVY COUNCIL WANDERS IN THE WILDERNESS — 33 *Jefferson P. VanderWolk*

Hong Kong imposes a 17.5 percent tax on corporations that carry on business in Hong Kong and earn profits that arise in or derive from Hong Kong – profits arising outside the territory are not subject to tax. This article takes a close look at recent case law which deals with questions regarding the distinction between onshore and offshore profits for Hong Kong tax purposes.

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A Guide to the Sixth VAT Directive

Europees Vennootschapsbelastingrecht
(available in the Dutch language only)

INDIA:
RECENT COURT DECISION
AFFECTING NON-RESIDENTS — 37 *Har Govind*

A recent decision of the Calcutta High Court rejected the Revenue's attempt to apply an extended definition to the term "royalty" as it appears in domestic law. Mr. Govind reports on this case which involved application of the India/UK tax treaty.

NIGERIA:
1992 REFORMS IN TAX
STRUCTURE AND POLICY — 40 *Professor A.C. Ezejelue*

The Nigerian government has built in certain basic reforms in the tax system and administration for the 1992 fiscal year, and this article reviews these measures.

BIBLIOGRAPHY 49

– Books 49
– Loose-leaf services 51

CONFERENCE DIARY 39

IFA NEWS 44
Some highlights from the Secretary General's 1991/92 Annual Report & Other IFA news

LIST OF ADDRESSES 53
of the major publishing houses appearing in the Bibliography

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INTERNATIONAL:

WHAT KIND OF CORPORATION TAX?

Sijbren Cnossen

Sijbren Cnossen is Professor in the Economics Faculty of Erasmus University Rotterdam. *This paper is an updated and expanded version of two earlier publications: "The Imputation System in the EEC," in Sijbren Cnossen, ed.,* Comparative Tax Studies: Essays in Honor of Richard Goode *(Amsterdam: North Holland, 1983) and "Corporation Taxes in OECD Member Countries," in 38* Bulletin for International Fiscal Documentation *(November 1984). The author is grateful to Lans Bovenberg for his comments on an earlier draft.*

Contents

I. Introduction
II. The Role of the Corporation Tax
A. Forms of corporation tax
B. Survey of corporation taxes
III. Classical System versus Full Integration
A. Classical system
B. Economic distortions
C. Full integration
IV. Dividend Relief at the Corporate Level
A. Dividend-deduction system
B. Split-rate system
V. Dividend Relief at the Shareholder Level
A. Imputation system
1. Workings
2. Technical aspects
B. Schedular methods
VI. Cross-Country Comparison
A. Degrees of dividend relief
B. Remaining discrimination
VII. Evaluation and Conclusion

I. INTRODUCTION

Corporation taxes are important because corporations are social and economic institutions of great impact. As separate legal entities, corporations have the power to contract, the right to hold and convey title to property, the capacity to sue and to be sued, and the authority to make rules and bylaws. Corporations have a life independent of the lives of their shareholders, they beget offspring, called subsidiaries, and, in principle, corporations are legally immortal. The power of a large transnational corporation approximates that of the government of a medium-sized country. Although no doubt there are exceptions, the total impact of a corporation is truly more than the sum of the influence of the constituent parts.

The social and economic importance of the "finding" of the corporate form of business organization has rightly been compared to the discovery of steam and electricity.[1] Corporations have reshaped the world in which we live. In most countries, a large part of the national product is generated in the corporate sector and its activities exercise a profound influence on the remainder of the economy. Modern industrial development is absolutely unthinkable without the corporate business form in which capital and labour are combined for mutually beneficial productive purposes. Without exaggeration, the corporation may be characterized as "the central economic institution of modern society".[2]

This paper surveys and evaluates the various forms of tax that are imposed on corporate profits. As a tax on the return on equity, the corporation tax interacts with the individual income tax of shareholders entitled to corporate profits. In tax law and theory, such interaction may be denied or explicitly recognized and reflected in the form of the tax. Section II, therefore, delineates the various forms of corporation tax and reviews their role in the countries that are members of the Organisation for Economic Co-operation and Development (OECD). Section III discusses the two poles of the corporation tax philosophy: the classical system that views the corporation as an entity distinct from its shareholders, and the conduit system that regards it as an extension of those shareholders. In practice, the corporation tax and the income tax are integrated only with respect to the taxation of distributed profits. Consequently, Sections IV and V examine the schemes for such integration at the corporate level and at the shareholder level. Section VI compares the various systems, noting the degrees of dividend relief and the remaining discrimination of payout decisions and methods of finance. Finally, Section VII evaluates the various systems.

II. THE ROLE OF THE CORPORATION TAX

The role of the corporation tax in various countries, particularly as regards its relationship to the income tax, is reflected in the forms of the tax. Forms differ as shown by a survey of corporation taxes in OECD member countries. Their revenue importance is also noted.

A. *Forms of corporation tax*

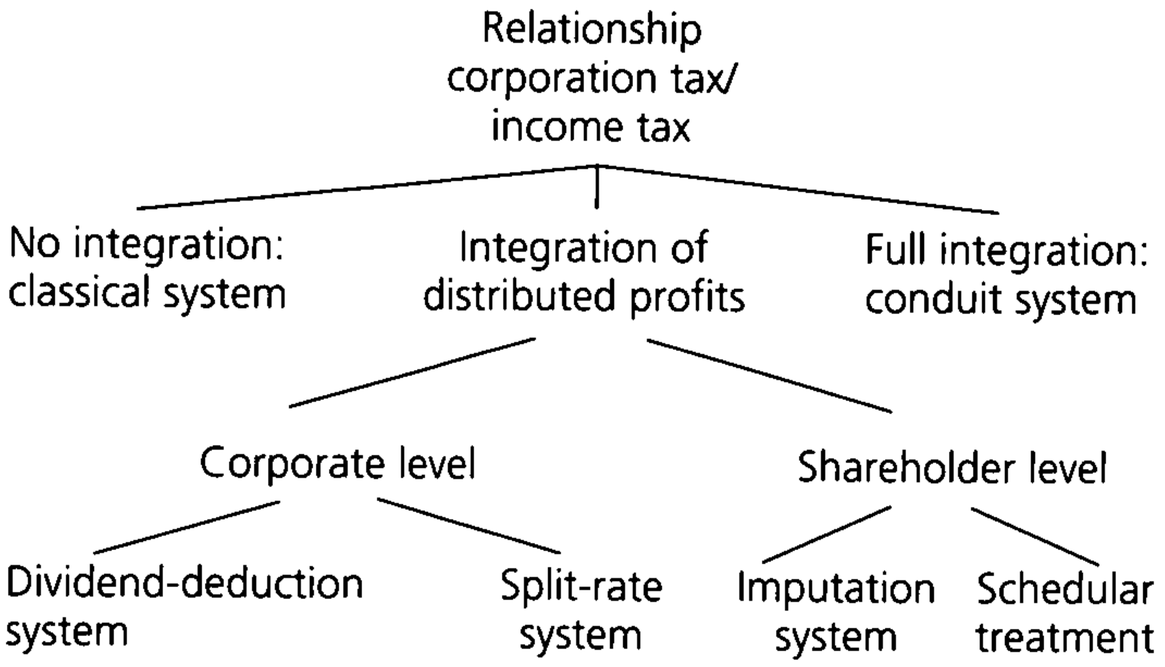
Figure 1 presents the various forms of corporation tax that can be distinguished depending on whether and to what extent they are integrated with the income tax of shareholders. At one extreme, the corporation is regarded as an entity entirely separate from its shareholders and taxed as such (classical system).[3] At the other extreme, the corporation is viewed as a pass-through, a conduit, of all corporate

1. For the reference, see Goode (1951), p. 11.
2. See Mason (1968), p. 396, in *International Encyclopedia of the Social Sciences.*
3. The label "classical system" was introduced by Van den Tempel (1970, p. 7). It should be noted, however, that, contrary to what the terminology suggests, the imputation system, discussed below, is of older date. In the 19th century, some German states already had some form of imputation and in 1922 it was incorporated as the withholding method in the Model Income Tax Ordinance of the United Kingdom, which was introduced in many colonies. For the classic treatment of the separate entity system, see Goode (1951).

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source income of shareholders – distributed as well as undistributed earnings. The corporation tax, if retained, serves solely as a prepayment for the income tax, just like a wage withholding scheme.

Figure 1



In practice, the integration of the corporation tax with the income tax of shareholders is limited to distributed profits (dividends). This form of partial integration, often referred to as dividend relief, can be achieved at either the corporate level or at the shareholder level. The most obvious method of dividend relief at the corporate level is to permit a deduction for dividends from taxable profits, as is commonly done for interest. This is called the dividend-deduction system. Another approach that can achieve the same result is the split-rate system, under which a lower rate of tax is levied on distributed profits. At the shareholder level, dividend relief may be achieved systematically under the imputation system, which permits shareholders a full or partial credit for the corporation tax that can be imputed to the dividends received by them. Alternatively, dividend relief may be provided by taxing dividend income on a schedular basis, e.g. by applying a separate flat tax to it or by allowing shareholders a tax credit against their income tax without regard to the underlying corporation tax. The workings of all of these systems will be discussed below.

The concern over the appropriate form of corporation tax arises because, under the classical system, corporate source income is taxed twice if it is distributed: once at corporate level and again at shareholder level. In the tax literature, this phenomenon is referred to as the "economic double taxation of dividends".[4] The existence of a separate corporation tax means that dividends will be `overtaxed' compared to other capital income, such as interest. The label is pejorative, however, in the sense that retained corporate source income may be `undertaxed' if the rate of corporation tax is lower than the rate of income tax at which dividends would be taxed at the shareholder level under full imputation. In the latter case, the separate corporation tax may be said to be biased in favour of retained profits. In a broader (and more correct) view, the real issue is not that dividend income is taxed twice or that the separate corporation tax exhibits a tax bias, but that corporate source income, distributed as well as retained earnings, is not taxed in accordance with the marginal income tax rates of shareholders.

B. *Survey of corporation taxes*

Table 1 shows the various corporation tax systems in OECD member countries, their rates (including the corporation tax, if any, levied by subordinate units of government) and contribution to revenue, and particulars about the way and the extent to which dividend relief is provided. Out of 24 countries, four countries levy the corporation tax in its pure classical garb: dividend income is subject to the twin yoke of the corporation tax and the personal income tax. In contrast, 20 countries permit some form of dividend relief either at the corporate level (3 countries) or at the shareholder level (17 countries). At the corporate level, the dividend-deduction system is found in three countries, while the split-rate system, as such, is not employed anymore. At the shareholder level, nine countries have a full or partial imputation system. Eight countries tax dividend income on a schedular basis. Germany has a mixed imputation/split-rate system: distributed profits are taxed at a lower rate than are retained profits, and the corporation tax attributable to distributed profits is fully eliminated at the shareholder level (at least if the local corporation tax is ignored). In contrast, France taxes distributed profits at a higher rate than retained profits. The domestic degree of integration or dividend relief can be made the same under the dividend-deduction system, the split-rate system, and the imputation system (but not the schedular methods), if it is assumed that the choice of the integration system does not affect the payout rate.[5]

As Table 1 indicates, most (total) corporation tax rates lie in the 35-45 percent range. The unweighted average rate (on retained profits, if differentiated) for all OECD countries is 39.7 percent. Since 1983, when the previous survey was undertaken, the average rate has fallen by some eight percentage points, reflecting the worldwide move of rate-lowering and base-broadening that occurred in the late 1980s.[6] Not surprisingly, the average corporation tax rate is somewhat higher in countries with some form of dividend relief than in countries with a pure classical system. Norway has the lowest overall tax rate of 28 percent.

In addition to the national corporation tax, several countries, often with federal forms of government, have local corporation taxes (see Appendix) which, if differentially applied, are generally condemned in the professional literature because of their distorting effects on the location of investment. The case is also weak for levying lower rates of tax, as many countries do, on small amounts of profits that are not necessarily characteristic of small companies. Such rates do impart a slight degree of progressivity to the corporation tax but, except by coincidence, this does not have to reflect the tax burden distribution at the shareholder level. It should be noted that effective rates of tax, i.e. actual tax payments expressed as a percentage of "economic income", may vary widely, within countries as well as between countries, on account of differences in the way in which taxable profits are determined.[7]

4. The classic treatment of the double-taxation issue is McLure (1979).
5. For the formal proof, see the Appendix in Cnossen (1983).
6. For an overview, see Cnossen and Bird (1990), Table 1.1.
7. See OECD (1991) for an overview and analysis.

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Table 1. *Corporation Taxes in OECD Member Countries, 1992*

System and Countries Covered	Total CT-Rate[a]	Mitigation of Economic Double Taxation[b]	Revenue Contribution[c] As Percent of Total Tax Revenue	Revenue Contribution[c] As Percent of GDP
		I. *Classical Systems*		
Luxembourg	39.4	Relief for newly issued shares[d]	16.2	8.2
Netherlands	35	None.[e]	7.6	3.4
Switzerland	30.3	None.	6.5	2.1
United States	38.3	None.	7.3	2.2
		II A. *Dividend Relief at Corporate Level*		
1. *Dividend deduction*				
Greece	46(40)	Generally, 50% withholding tax is final.[f]	5.6	2.1
Iceland	45	Deductible and exempt from PT (up to maximum) up to 15% of share value.[d]	2.8	0.9
Sweden	30	Deductible up to 10% of share value.	3.1	1.8
2. *Split-rate* (None)				
		II B. *Dividend Relief at Shareholder Level*		
1. *Imputation*				
a. *Full*				
Australia	39	Gross-up and credit of 39/61 of net dividend.	13.9	4.3
Finland	40.2	Gross-up and credit for CT at 40%.	5.5	2.1
Germany	58.1/45.5	Gross-up and credit for CG-CT of 36%.	4.7	1.8
Italy	47.8	Gross-up and credit for CG-CT of 36%.	10.0	3.9
New Zealand	33	Gross-up and credit of 33/67 of net dividend.	6.5	2.5
Norway	28	Gross-up and credit of 7/18 of net dividend.	8.9	4.1
b. *Partial*				
France	34/42	Gross-up and credit of 50% of net dividend.[e]	5.4	2.3
Ireland	40(10)	Gross-up and credit of 1/3 (1/18) of net dividend.[e]	5.0	1.8
United Kingdom	33	Gross-up and credit of 1/3 of net dividend.	11.0	4.0
2. *Schedular treatment*				
a. *Separate Tax*				
Austria	39	Dividends taxed at one-half of PT-rate.[d,e]	3.3	1.4
Belgium	39	Generally, 25% withholding tax is final.[f]	6.4	2.9
Denmark	38	Dividends taxed at 45% (30% up to DKr 30,000).	3.3	1.6
Japan	51	Generally, 35% withholding tax is final.[f]	21.5	6.7
Portugal	39.6	Generally, 25% withholding tax is final.[f]	7.4	2.6
Turkey	49.2	Dividends exempt.	6.7	1.9
b. *Tax Credit*				
Canada	44.3(38.3)	Gross-up and tax credit of approximately 25%.	6.8	2.5
Spain	35.3	Tax credit of 10% of dividends received.	8.8	3.0

Source: See Appendix. Revenue figures are from OECD (1992).
Notes: a. See Appendix
b. CG = Central Government; SG = Subordinate Government; CT = Corporation Tax; PT = Personal Income Tax.
c. Revenue figures relate to fiscal years 1990 as reported in OECD (1992).
d. Subject to maximum, newly issued shares are deductible from taxable income.
e. Basic PT-exemption applies to dividend and interest income (usually doubled for married couples).
f. At the choice of the taxpayer. Credit for withholding tax if dividend included in taxable PT-income.

Several countries have changed their corporation tax system in the past decade. Australia and New Zealand moved away from the classical system to the full imputation system; Finland and Norway did so from the dividend-deduction system. The split-rate system was abandoned in Austria, Japan, and Portugal in favour of some form of relief at the shareholder level. Perhaps the most interesting development in the past years is the increasing schedular treatment of dividends under the personal income tax. Most changes reflect concern with the domestic effects of the corporation tax on payout and investment decisions rather than considerations pertaining to international neutrality.

With few exceptions, the corporation tax is not a major source of revenue. In 1990, the corporation tax, on average, contributed 7.7 percent of total tax revenue, or 2.9 percent of Gross Domestic Product (GDP), when total tax revenue, on average, was 38.8 percent of GDP. (Comparable figures for 1982 were 7.8, 2.8 and 36.2 percent, respectively). The yield of the corporation tax, of course, depends not only on the rate and the method and degree of dividend relief, but also on the extent of incorporation. Without further analysis, a comparison of inter-country yields, therefore, makes little sense. It should be noted that the yield of imputation systems includes the (creditable) `income tax' portion, whereas integration systems at the corporate level, of course, leave the income tax out of account. Although in most countries the corporation tax is not a negligible source of revenue, its yield seems disproportionately smaller than the attention, also in this paper, devoted to its form and structure. One reason may be that the corporation tax acts as a backstop to the income tax. Whatev-

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er the case, even corporations that pay little or no tax are still subjected to all its complexities, attendant compliance costs and excess burdens.

III. CLASSICAL SYSTEM VERSUS FULL INTEGRATION

The essence of the corporation tax debate can best be illustrated by contrasting the classical system with the conduit or full integration system. The case for full integration can be made on equity as well as efficiency grounds.

A. *Classical system*

Four OECD member countries have the separate entity system of corporation tax (Table 1), including a major economy such as the United States. (The Netherlands exempts a small amount of dividend income at the shareholder level, but this does not really affect the classical nature of the system.) In computing taxable profits, classical systems do not allow a deduction for profit distributions (dividends) to shareholders. Moreover, those distributions are taxed again in full in their hands at rates that differ from one shareholder to another – depending on the dividend amount and their other income – but that may range from the lowest to the highest marginal rate of the progressive income tax.

The workings of the classical system are illustrated in Example 1. It is assumed that the profits of a corporation before dividend distribution and corporation tax are £ 300, which are taxed at a rate of 40 percent. Remaining profits of £ 180 are distributed in full and taxed again at the shareholder level at individual income tax rates of, say, 30 percent or 50 percent, resulting in income tax liabilities of £ 54 and £ 90, respectively. Combined corporation and income tax payments are £ 174 or £ 210. When expressed as a percentage of original corporate source income, these payments translate into effective tax rates of 58 percent for the 30 percent bracket and 70 percent for the shareholder whose dividend falls in the 50 percent bracket. If these effective rates, in turn, are compared to the appropriate marginal tax rate of each shareholder, the dividend income of the 30 percent shareholder is `overtaxed' by 93 percent and that of the 50 percent shareholder by 40 percent.

Example 1
Classical system

		(£)	
A.	Corporate level		
	1. Profits before corporation tax	300	
	2. Corporation tax: 40% (1 x 2)	120	
B.	Shareholder level		
	3. Income tax rate	*30%*	*50%*
	4. Dividend income (1 – 2)	180	180
	5. Income tax (3 x 4)	54	90
C.	Combined tax burden		
	6. Total tax (2 + 5)	174	210
	7. Effective tax rate (6 ÷ 1)	58%	70%
	8. Overtaxation [(7 – 3) ÷ 3]	93%	40%

However, this is not the only possible outcome. As noted above, corporate source income, if retained, may also be undertaxed compared to the marginal tax rate of the shareholder. If, in Example 1, all profits would have been retained in the corporation, the effective tax rate for both shareholders would have been 40 percent. In other words, the 30 percent shareholder would still be overtaxed, namely 33 percent, but the 50 percent shareholder would be undertaxed by 25 percent. Furthermore, if half of profits after tax had been distributed (probably a more realistic situation than either no or full distribution), the 50 percent shareholder would be taxed roughly in accordance with his marginal income tax rate, but the 30 percent shareholder would still be overtaxed by 63 percent.

Proponents of the classical system deny the relevancy of the interaction between the two taxes. They point out that ownership and control functions have been completely divorced from each other in the large public corporation and that shareholders, except in rare instances, have no legal claim on earnings until dividends are declared by management. In their view, shareholders are little more than subordinate creditors. However, this argument does not provide an explanation for the difference in tax treatment of retained profits, dividends and interest.

B. *Economic distortions*

Whatever the argument that the separate personality of a corporation justifies a separate tax, the systematic overtaxation of distributed profits under the classical system brings a number of undesirable economic effects in its train, which deserve to be taken seriously.

The distortionary effect on investment of taxing profit distributions twice depends on the marginal source of equity finance, which may be retained profits or newly issued shares. If firms finance their investments through profit retention rather than new shares, they have to reduce dividends that would otherwise be available for distribution. Accordingly, the role of dividends is crucial. In this connection, the literature has developed two hypotheses, which are known as the `traditional view' and the `new view', respectively.[8]

The traditional view argues that dividend payouts offer non-fiscal benefits. Dividends may provide a signal to shareholders that all is well with the company, or they may limit financial discretion and, hence, potential misuse of funds by management. At the margin, therefore, companies equalize the tax advantages of profit retention and the non-fiscal disadvantages of reducing profit distributions. Accordingly, a new investment will in part be financed by issuing new shares, because dividends cannot be lowered without cost. This implies that the double tax on dividends discourages new investment and distorts the dividend-payout decision.

The new view denies the existence of non-fiscal advantages associated with profit distributions. Accordingly, the double tax on dividends should cause corporations to prefer profit retention over new share issues as the marginal source of

8. For a review and analysis, see Poterba and Summers (1985), Sinn (1985) and, more recently, Zodrow (1991).

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finance. Profit retention enables shareholders to enjoy the return on the new investment in the form of tax-preferred capital gains. Moreover, they save on the personal income tax on dividend income that they would have had to pay if profits had not been retained but distributed. The capitalized value of this tax saving is exactly equal to the discounted value of the tax on distributed profits that must be paid in the future. Therefore, the argument goes, the tax on dividends does not distort investment decisions – at least not as long as the company generates sufficient profits to finance marginal investments through retained profits and the tax rate on dividends is expected to remain constant over time.

Most empirical studies support the traditional view.[9] Companies clearly have alternative means of distributing funds other than taxable dividends. This weakens the new view. Furthermore, an important implication of the new view is that the market value of corporate assets exceeds existing share values. This does not seem to be the case. Whatever view is adopted, the double tax always harms investment by new businesses, which have to rely on new share issues to provide for their equity needs.[10] The discrimination of new equity under the classical system, therefore, contributes to the concentration of market power. The double tax is especially detrimental to small, growing firms that face difficulties in attracting debt, as they do not yet enjoy a high credit rating or generate sufficient taxable profits to be able to deduct interest. Consequently, these firms, which provide an important impetus to technological innovation, have to incur higher capital costs on account of taxation than do older, established firms with easier access to debt financing, or with sufficient retained profits to finance new investments.

C. *Full integration*

The economic distortions caused by the classical system should not occur in a fully transparent, competitive world in which the corporation tax would be integrated with the income tax of shareholders. The corporation would then serve only as a conduit, a pass-through, of corporate source income, which would be taxed fully at the appropriate marginal income tax rate in the hands of the shareholders. Example 2 illustrates the workings of full integration. For income tax purposes, it is irrelevant whether a corporation distributes profits and, if so, to what extent. Retained as well as distributed profits are fully taxed according to the partnership method; that is, they are allocated in proportion to each shareholder's holding in the corporation's equity. The corporation tax is simply a prepayment for the income tax. It follows, of course, that effective rates are equal to respective bracket rates; there is no overtaxation.

Full integration is one of the normative implications of the accretion concept of income, as formulated by Schanz, Haig and Simons (S-H-S concept). Its advocates point out that ability-to-pay, being an equity notion, can only be related to natural persons. It follows that if income is chosen as the best index of that ability, the equal treatment rule requires that income should be defined all-inclusive. For tax purposes there should be no difference between corporate profits and other capital income, such as interest and rents, or labour income, such as wages and salaries, which is solely subject to the individual income tax. There is no place, therefore, for an extra tax on distributed profits nor, it should be added, for the preferential treatment of profits retained by the corporation and taxed below the marginal income tax rate of shareholders.

Example 2
Full integration

		(£)	
A.	Corporate level		
	1. Profits before corporation tax	300	
	2. Corporation withholding tax: 40% (1 x 2)	120	
B.	Shareholder level		
	3. Income tax rate	*30%*	*50%*
	4. Attributed profits (1)	300	300
	5. Income tax (3 x 4)	90	150
	6. Corporation withholding tax (2)	120	120
	7. Net income tax (5 – 6)	– 30	30
C.	Combined tax burden		
	8. Total tax (5 or 2 + 7)	90	150
	9. Effective tax rate (8 ÷ 1)	30%	50%
	10. Overtaxation [(9 – 3) ÷ 3]	0%	0%
	11. Tax relief [(classical overtaxation – 10) ÷ classical overtaxation)]	100%	100%

Full integration of retained as well as distributed profits has been proposed by the Royal (Carter) Commission in Canada, the US Treasury (*Blueprints*) and the Campbell Committee in Australia. Under both the voluntary and mandatory plans, all corporate source income would be included in the income of shareholders, while a full credit would be permitted for the corporate tax paid on their behalf. To prevent double taxation of retentions, the basis for corporate shares would be written up by the amount of retained profits. These plans, however ingenious, have never left the drawing board, primarily because they are considered impractical. In particular, it has been pointed out that full integration would be costly to the treasury, that delays in completing corporation tax assessments would have repercussions on the filing of shareholders' income tax returns, that it would be difficult to deal with different types of equity, that an undesirable side-effect might be that preferential income items would be passed through to shareholders, and last but not least, that shareholders might have to pay additional income tax, although no cash had in fact been received.[11]

Full integration has been characterized as the search for a perfect solution in an imperfect world. Yet at the same time it has been considered important to eliminate or mitigate the economic distortions of the classical system. As a halfway house to the ideal, various dividend relief systems have been introduced under which at least distributed profits can be taxed in accordance with the shareholder's marginal income tax rate. These dividend relief systems are discussed in the following sections.[12]

9. See Zodrow (1991) for a review of empirical work.
10. It applies also to firms in which management is far removed from shareholders and a dividend reduction in any one year would thus be costly to management.
11. See, especially, McLure (1979), ch. 5.
12. A useful discussion of the nature and history of various dividend relief systems may be found in Norr (1982). For an up-to-date analysis, see also US Department of the Treasury (1992).

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IV. DIVIDEND RELIEF AT THE CORPORATE LEVEL

The most obvious approach to the double-taxation issue is to permit dividends as a deduction from taxable profits, as is the case with interest. An alternative would be to tax distributed profits at a lower rate. The dividend-deduction system and the split-rate system are analysed in turn.

A. *Dividend-deduction system*

As shown in Table 1, the dividend-deduction system is found in Greece, Iceland and Sweden. Finland and Norway also had a dividend-deduction system before these countries moved to (full) imputation. Greece allows profit distributions to be deducted in full subject, however, to withholding rates (creditable against the personal income tax at the choice of the taxpayer) ranging from 42-50 percent (depending on the nature of the shares and on whether they are quoted on the Athens Stock Exchange), which exceed the usual corporation tax rate on large, open companies of 40 percent. Hence, the country's corporation tax is still biased in favour of retained profits.

Example 3 shows the workings of the dividend-deduction system. As in the previous examples, the illustration is based on profits before corporation tax of £ 300 and a corporation tax rate of 40 percent. It is assumed that the intention is to provide dividend relief for all shareholders at a rate of 50 percent measured against the overtaxation under the classical system (Example 1, line 8). To achieve this, one-half of profits marked for distribution should be made deductible in determining taxable profits. It is possible, of course, to vary the degree of dividend relief. A full deduction makes the system equivalent to an undistributed profits tax with which the United States briefly, and not altogether favourably, experimented in the late 1930s. A small deduction moves the system closer to the classical corporation tax.

Example 3
Dividend-deduction system

		(£)	
A.	Corporate level		
	1. Profits before corporation tax	300	
	2. Dividend deduction (1/2 x 1)	150	
	3. Profits after deduction (1 – 2)	150	
	4. Corporation tax: 40% (3 x 4)	60	
B.	Shareholder level		
	5. Income tax rate	*30%*	*50%*
	6. Dividend income (1 – 4)	240	240
	7. Income tax (5 x 6)	72	120
C.	Combined tax burden		
	8. Total tax (4 + 7)	132	180
	9. Effective tax rate (8 ÷ 1)	44%	60%
	10. Overtaxation [(9 – 5) ÷ 5]	47%	20%
	11. Tax relief [(classical overtaxation – 10) ÷ classical overtaxation)]	50%	50%

Iceland and Sweden limit the dividend deduction to what might be called a normal or primary dividend of 15 percent of the value of the shares or 10 percent of the paid-up capital, respectively.[13] The corporation tax becomes then akin to an excess profits tax. Conceptual difficulties arise in determining the base on which the relief must be computed. Equity capital placed and paid up, the Swedish criterion, has only historical significance. Certainly, it does not represent the amount that subsequent shareholders have paid for the acquisition of their holding. Another base, namely equity for tax (book) purposes (including retained profits and reserves), implies that the primary dividend is calculated by reference to an accounting item which may differ markedly from the market value of equity. The relief is then an arbitrary reduction of the corporation tax rate which varies with the (accounting) relationship between the business's equity and its total worth.

In Sweden, the relief is limited to dividends paid on newly issued shares for a maximum of 20 years (the total deduction cannot exceed the paid-in capital). In 1979, the American Law Institute (ALI) also suggested a limited deduction at the corporate level for dividends on new equity, as well as a corporate excise tax on redemption, in order to achieve a more even handed treatment of dividend and interest payments. An able lawyer, who compared the proposal to the imputation system, however, concluded that the latter was "preferable in theory and workable in practice".[14] Moreover, some arbitrary line must be drawn in deciding when shares stop being `newly issued.' Also, there is always the danger that old equity will be liquidated and converted into new issues. In 1992, in sharp contrast to its previous position, the ALI issued a study favouring the imputation system.

Unless the goal is to stimulate domestic investment, a drawback of the dividend-deduction system is that the relief is automatically extended to foreign shareholders (and exempt entities) who do not pay the (additional) national income tax incurred by domestic shareholders. To prevent this, the dividend withholding tax for profits transferred abroad might be increased, but experience in Germany has taught that it is nearly impossible to get such an increase incorporated in existing or new treaties for the prevention of double taxation. Another possibility is to disallow the deduction for dividends paid to (foreign) shareholders, who are not subject to the national dividend withholding tax. This does not require a renegotiation of treaties. It is the route followed by Sweden under the coupon tax. A final objection to the dividend-deduction system is that the corporation tax cannot serve as a means to verify the correct return of dividend income for the income tax. Its major advantage, of course, is that dividends are clearly treated at par with interest.

B. *Split-rate system*

The split-rate system used to be employed in Austria, Japan, and Portugal. Currently, under the German imputation system, distributed profits are taxed at a lower rate than are retained profits. Just as under the dividend-deduction system, it has been proposed in the literature in these countries to limit the lower rate to a so-called normal or primary dividend, or, more generally, to a specified part of distributed profits. Of course, if the rate differential is small, the split-rate system resembles the classical corporation tax, and if the differ-

13. For a description of the arrangements, see OECD (1991), pp. 351, 354-55, and 418. The primary dividend-deduction system receives a favourable review in a recent study of the Institute for Fiscal Studies (1991).
14. See Warren (1981), commenting on American Law Institute (1979).

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ential is large it again becomes an undistributed profits tax. In contrast to usual practice, France taxes distributed profits at a higher rate in order to stimulate retentions.

Example 4 gives an illustration of a split-rate system that taxes distributed profits at a lower rate of 20 percent (and retained profits at 40 percent). Following, profits after corporation tax are distributed. At the shareholder level, they fall in either the 30 percent income tax bracket: £ 72 tax, or the 50 percent bracket: £ 120 tax. The combined liability (line 6) is £ 132 or £ 180, and the corresponding effective rates are 44 percent and 60 percent. If the degree of overtaxation is now compared to the overtaxation inherent to the classical system, then a dividend relief of 50 percent has been extended, the same as under the dividend-deduction system.

Example 4
Split-rate system

		(£)	
A.	Corporate level		
	1. Profits before corporation tax	300	
	2. Corporation tax: 20% (1 x 2)	60	
B.	Shareholder level		
	3. Income tax rate	*30%*	*50%*
	4. Dividend income (1 – 2)	240	240
	5. Income tax (3 x 4)	72	120
C.	Combined tax burden		
	6. Total tax (2 + 5)	132	180
	7. Effective tax rate (6 ÷ 1)	44%	60%
	8. Overtaxation [(7 – 3) ÷ 3]	47%	20%
	9. Tax relief [(classical overtaxation – 8) ÷ classical overtaxation]	50%	50%

A disadvantage of the pre-1977 German split-rate system (without imputation) was that foreign parent companies with German subsidiaries could avoid the high split-rate on retained profits by first distributing the subsidiary's earnings and then channeling them back as equity for reinvestment purposes. The effect might have been considered less serious if other countries, such as the United States, levied corporation tax on profits transferred from Germany, while crediting the corporation tax paid in Germany. After all, the US Treasury would then recoup the difference between its tax and the German tax. But aside from the question whether this effect was intended by the German legislator, it could be avoided by placing a Dutch or Swiss holding between the subsidiary and the parent. As a remedy, Germany attempted to negotiate increases of dividend withholding taxes on earnings transferred abroad, but this required changes in treaties already agreed to – always a laborious exercise.

V. DIVIDEND RELIEF AT THE SHAREHOLDER LEVEL

As noted, there are two basic approaches to the integration of the corporation tax and the personal income tax at the shareholder level: the imputation system and various schedular methods of dividend relief.

A. *Imputation system*

The imputation system appears the most important form of dividend relief. It is, therefore, reviewed in somewhat greater detail than are the other systems.

1. Workings

The imputation system has long been dominant in the European Community (EC). The most important member states, namely, France, Germany, Italy and the United Kingdom (together accounting for 80 percent of the EC's GDP) all employ this system. In the EC, economic rather than equity considerations played an important role in the decision to adopt the imputation system. Foremost among these was the desire to promote profit distributions in order to stimulate stock markets and, to a lesser extent, to reduce the tax-induced preference for the corporate form of doing business. The fact that the relief was not automatically extended to foreign shareholders strengthened the grip of many countries on their international tax rights and obligations.[15] Since 1983, the imputation system has also been introduced in Australia, Finland, New Zealand and Norway.

As shown in Example 5, imputation is achieved by requiring the shareholder to partly gross up his net dividend of £ 180 (line 4) by one-third, representing the corporation tax attributable thereto. This achieves the same degree of dividend relief as under the dividend-deduction system and the split-rate-system. The grossed-up dividend of £ 240 is then added to his other income and subjected to the progressive income tax. Next, the gross tax: £ 72 or £ 120 (line 7), is credited with the corporation tax, with which the net dividend was grossed up in the first place. The balance represents the net tax payable (or refundable). Imputation, therefore, has the same gross-up and tax credit features as a dividend withholding tax. Moreover, it provides the tax administration with a similar means of checking the income tax return for the proper reporting of dividends. The withholding technique works as an anti-evasion device because nationals holding stock through nominee accounts do not benefit from the relief.

Example 5
Imputation system

		(£)	
A.	Corporate level		
	1. Profits before corporation tax	300	
	2. Corporation tax: 40% (1 x 2)	120	
B.	Shareholder level		
	3. Income tax rate	*30%*	*50%*
	4. Net dividend (1 – 2)	180	180
	5. Imputed corporation tax (1/3 x 4)	60	60
	6. Dividend income (4 + 5)	240	240
	7. Income tax (3 x 6)	72	120
	8. Tax credit (5)	60	60
	9. Net income tax (7 – 8)	12	60
C.	Combined tax burden		
	10. Total tax (2 + 9)	132	180
	11. Effective tax rate (10 ÷ 1)	44%	60%
	12. Overtaxation [(11 – 3) ÷ 3]	47%	20%
	13. Tax relief [(classical overtaxation – 12) ÷ classical overtaxation]	50%	50%

15. The interest in the imputation system was also stimulated by the 1975 draft directive of the European Commission on the most appropriate harmonized form of corporation tax for the Community. The directive proposed that the corporation tax rate should be harmonized between 45 percent and 55 percent and that member countries should agree on a tax credit of 45 percent to 55 percent of dividends paid. Source countries would bear the revenue cost of cross-border tax credits. The directive was withdrawn in 1990.

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The tax credit under an imputation system may be expressed as a percentage of the net dividend, indicating the usual legal form of the dividend relief, or as a percentage of the corporation tax, showing the extent to which the double tax is mitigated. The tax credit may also be calculated as a percentage of the grossed-up dividend, representing the comparable tax-inclusive income tax rate. In Ireland and the United Kingdom, the latter percentage equals the basic rate of income tax. A tax assessment is then not required if taxpayers' other income is also subject to the basic rate.

2. Technical aspects

Table 2 shows details of the various imputation systems. Because they do not want to provide a tax credit for profit distributions on which national corporation tax has not been collected, most countries levy a compensatory tax at the company level on dividends paid out of earnings that are wholly or partially exempt from corporation tax, such as profits remitted from abroad, earned under a tax incentive scheme, or arising in the form of lower taxed capital gains. Alternatively, as in Australia, the tax credit is reduced or denied at the shareholder level. In France, the compensatory tax applies also to profits retained longer than five years, even though corporation tax has already been paid thereon at the full rate. In Ireland and the United Kingdom, the withholding tax for the "mainstream" corporation tax, called advance corporation tax (ACT), has been assigned the role of compensatory tax, because the offset is limited to 25 percent of a corporation's taxable profits. Although the imputation system is meant to promote profit distributions, the compensatory tax, of course, forms an inducement to retain exempt profits in the corporation as a means to minimize the corporate tax liability. Also, to the extent exempt profits are distributed, the tax nullifies the intended effect of tax holidays and other tax incentives.

Countries with a compensatory tax must provide rules for the sequence in which profits are presumed to be distributed (Table 2). In order to mitigate the effect of the compensatory tax, profits that have been subject to the highest rate of corporation tax are generally deemed to be distributed first when dividends are paid. In addition, in France, current profits are presumed to be distributed before retained profits, and among retained profits, the latest profits are deemed to be paid out first. In Germany, profits are allocated to three accounts: profits to which the 50 percent rate has been applied, profits that have been subject to the 36 percent rate, and profits fully exempt from tax. Profits subject to an intermediate rate must be apportioned between a higher- and a lower-rated account.

In five countries, domestic corporate portfolio shareholders are treated the same as individual shareholders, i.e. they are permitted to deduct the tax credit attached to dividends received from other companies from their own corporate tax liability. In Germany, the lower rate on distributions implies that an additional 20 percent tax is charged on the receiving company if the dividend is not passed on to individual shareholders. In fact, the introduction of the imputation system made the old "affiliation privilege" for domestic companies obsolete. Ireland, New Zealand and the United Kingdom exempt all intercompany dividends in the hands of receiving companies. Under the legislation in Ireland and the United Kingdom, however, the tax credit on "franked investment income" slumbers and may be used to offset the compensatory tax payable upon redistribution of that income to individual shareholders. That arrangement applies also in other countries; France, for example, exempts dividends received from subsidiary companies under an affiliation privilege (Table 2). The use of such a privilege is necessary because if imputation is partial, deduction of the tax credit attached to a subsidiary's dividend from the parent's tax liability would result in a higher aggregate corporate tax liability than if the total profit had been wholly earned by the parent company.[16]

No country permits foreign shareholders to share automatically in the relief. France, Ireland and the United Kingdom, however, extend the tax credit on a bilateral basis to individual and corporate portfolio investors in a large number of countries (listed in Table 2). Thus, under its double taxation agreements, France provides an additional payment (which is generally subject to withholding tax) to foreign shareholders who, in turn, make the appropriate gross-up adjustment with respect to the individual or corporate income tax liability in their country of residence. As regards Germany, France makes a direct payment to the German government, and German shareholders in French companies apply the regular gross-up and credit procedure. Under other treaties, corporate portfolio shareholders receive a refund of the compensatory tax, if any, that has been paid by a French distributing company; in that case, however, shareholders are not entitled to the tax credit.

Generally, tax credits are not granted with respect to foreign direct investments. Only the United Kingdom has concluded a number of treaties under which profits on such investments, when remitted, are entitled to a tax credit at half the rate available to portfolio shareholders. The half rate is based on the argument that the credit should be extended only to non-resident direct investors to the extent earnings are redistributed to individual shareholders. Since it is estimated that approximately one-half of corporate profits are so distributed, the tax credit for direct investments has been set at one-half of the credit for portfolio shareholders.

Finally, most countries with an imputation system give a refund to individual shareholders if the tax credit exceeds the gross income tax liability. On the other hand, exempt entities, such as pension funds and educational and charitable institutions, are not entitled to a refund, except in Ireland and the United Kingdom.

B. *Schedular methods*

The separate tax on dividends received and the tax credit method (Table 1) are less structured forms of dividend relief. Under the separate tax, all corporate source income, including profit distributions, is taxed at the normal corporation tax rate, but dividend income is partially exempted from the shareholder's income tax by taxing it at a lower (flat) rate.

16. To illustrate, assume a rate of corporation tax of 40 percent, while half of dividends are grossed up and credited if profits are distributed. Then, if an affiliation privilege would not apply, a parent and its subsidiary would have to pay £ 46 tax on each £ 100 profits (before tax) earned by the subsidiary and paid out to the parent. Of course, this does not make sense.

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Table 2. *Imputation Systems in OECD Member Countries, 1992*

Country	Compensatory tax on exempt or partially taxed profits	Ordering rules for profit distribution	Tax credit for domestic corporate shareholders		Tax credit for foreign shareholders (under bilateral treaties)			Refund to domestic shareholder if tax credit exceeds income tax	
			Portfolio	Direct	Individual	— Corporate — Portfolio	Direct	Individual	Exempt entity
Australia	Yes, at shareholder level.	Dividends required to be franked to the maximum extent possible.	No.	No. But rebate of tax for domestic dividends received by resident companies (rebate equal to the tax on this income) except for unfranked dividends received by private companies.	No.	No. However, no dividend withholding tax is payable on fully franked dividends.	No.	No.	No.
Finland	Yes.	Highest-in-first-out.	Yes.	Yes.	No.	No.	No.	Yes.	No.
France	Yes, also on profits retained more than 5 years.	Current profit; previous four years profits; profits subject to compensatory tax.	Yes.	No, but dividends from 95% + holding exempt. Tax credit deductible from compensatory tax on redistribution.	Yes: Australia, Austria, Belgium, Finland, Germany, Japan, Luxemb., Netherlands, New Zealand, Norway, Spain Sweden, Switzerland, UK, US.[a]	Yes: Austria, Finland, Germany, Japan, Luxemb., Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, UK, US.	No.	Yes.	No.
Germany	Yes.	Highest-in-first-out.	Yes.	Yes.	No.	No.	No.	Yes.	No.
Ireland	Yes. Profits of manufacturing companies taxed at the special rate of 10% carry a reduced credit.	Proportional to corporate tax rates.	No, dividends exempt. Tax credit deductible from compensatory tax upon redistribution.	No, except UK.	Yes: Australia, Austria, New Zealand, Sweden, Switzerland, UK.	Yes: Australia, Austria, New Zealand, Sweden, Switzerland, UK.	No.	Yes.	Yes.
Italy	Yes, at 56.25%.	Highest-in-first-out.	Yes.	Yes.	No, except UK.	No, except UK.	Half credit: UK.	Yes.	No.
New Zealand	Yes.	Dividends to be franked to the maximum extent possible.	No, dividends exempt.	No, dividends exempt.	No.	No.	No.	No.	No.
Norway	No.	Not necessary.	Yes.	Yes.	No.	No.	No.	No.	No.
United Kingdom	Yes, through Advance Corporation Tax Act (ACT).	Not necessary.	No, dividends not liable to corporation tax, tax credit franks ACT on redistribution. No ACT on intra-group dividends.	No, dividends exempt. Tax credit deductible from ACT on redistribution. No ACT on intra-group dividends.	Yes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Ireland, Italy, Japan, Luxemb., Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, US.	Yes: Austria, Belgium, Canada, Denmark, Finland, France, Ireland, Italy, Japan, Luxemb., Netherl., Norway, Spain, Sweden, Switzerl., US.	Yes: Belgium Canada, Denmark, Finland, Italy, Luxemb., Netherl. Switzerl., US.	Yes.	Yes.

Source: Updated from S. Cnossen, "Imputation Systems in the EEC", Table 4.1, p. 90-92, in S. Cnossen, *ed., Comparative Tax Studies: Essays in Honor of Richard Goode* (Amsterdam: North-Holland, 1983).

Note: a. Refund of compensatory tax under all other treaties, and to all direct corporate shareholders under any treaty.

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Austria achieves this by taxing dividends at one-half of the shareholder's income tax rate, other countries by applying a final "withholding" tax. Turkey exempts dividends fully in the hands of shareholders. Alternatively, Canada and Spain permit shareholders a tax credit, specified as some fraction of dividends received, against their income tax. Unlike the imputation system, the tax credit is available regardless of whether or not corporation tax has been levied, usually the net dividend is not grossed-up before the income tax rate is applied, and no refund is given if the tax credit exceeds the gross income tax liability.

Example 6 shows the arithmetic of the tax credit method. Clearly, an objection to this form of dividend relief, as well as the separate tax approach, is that the benefit is distributed regressively with respect to income. As the example makes clear, a dividend relief from classical overtaxation of one-half for the shareholder in the 50 percent bracket corresponds to a relief of only 35 percent in the 30 percent income tax bracket. Essentially, the goal of dividend relief (the prevention of double taxation) interferes with the objective of progressivity (tax increases that rise proportionately faster than income). The effect would not occur if the income tax is levied at a proportional rate. Belgium, Japan and Portugal mitigate the resulting regressivity by permitting low-income shareholders to include the dividend in income with a credit for the withholding tax against the gross income tax liability.

Another, in some respects similar, concession permits a deduction from income of a specified net amount spent for the purchase of (new) shares. Austria, Iceland and Luxembourg have this kind of scheme to stimulate share ownership. However, a similar relief scheme in France in the 1980s, usually referred to as the *Monory*-deduction, appears hardly to have had any influence on the volume of new share issues or on the number of shareholders, particularly if it is considered that 75 percent of all new shareholders preferred investments in participation trusts, or so-called Sicav's-Monory. Moreover, small and medium-sized companies usually do not benefit from these kinds of measures.

Example 6
Tax credit method

		(£)	
A.	Corporate level		
	1. Profits before corporation tax	300	
	2. Corporation tax: 40% (1 x 2)	120	
B.	Shareholder level		
	3. Income tax rate	*30%*	50%
	4. Dividend income (1 – 2)	180	180
	5. Gross income tax (3 x 4)	54	90
	6. Tax credit (1/6 x 4)	30	30
	7. Net income tax (5 – 6)	24	60
C.	Combined tax burden		
	8. Total tax (2 + 7)	144	180
	9. Effective tax rate (8 ÷ 1)	48%	60%
	10. Overtaxation [(9 – 3) ÷ 3]	60%	20%
	11. Tax relief [(classical overtaxation - 10) ÷ classical overtaxation]	35%	50%

Note: The tax credit has been computed by assuming a total combined tax liability of £ 180 in the 50% bracket (line 8), equal to the liability in the other examples. The corresponding net income tax levied at the rate of 50% can then be calculated, as well as the tax credit itself. Next, the same amount of tax credit has been taken for the shareholder in the 30% bracket, which in turn forms the basis for computing the combined tax figures in this bracket.

VI. CROSS-COUNTRY COMPARISON[17]

This section assesses the degree of dividend relief under the various corporation tax systems on a comparative basis. Dividend relief is rarely provided in full. Also, income tax rates applicable to dividends received are seldom the same as corporation tax rates applied to profits. Hence, various non-neutralities remain.

A. *Degrees of dividend relief*

Table 3 shows the degree of dividend relief, or the absence thereof, under the various corporation tax systems. For the computations, the following simplifying assumptions were made:

- the corporation tax is fully borne by profits;
- all profits after corporation tax are distributed;
- distributed profits are taxed in the hands of individual shareholders who face the top marginal income tax rate; and
- the effective income tax rate on capital gains is nil.

As in the Examples in the previous sections, the degree of dividend relief is computed as the ratio of the difference between the classical overtaxation and the actual overtaxation over the classical overtaxation (all in percentage terms). Simplified, this can be expressed by the following formula:

$$\text{Degree of dividend relief} = \frac{\text{Total CT+PT if no relief} - \text{Actual CT+PT}}{\text{Total CT+PT if no relief} - \text{PT if full relief}}$$

Table 3 shows the data and the various degrees of dividend relief. For the calculation of the total tax burden under the no relief situation, i.e. the classical tax burden, the figures for "Total PT" in the Appendix are used rather than the reduced schedular rates shown in Table 3. Obviously, the same applies to the PT-figures in the above formula. As expected, the degree of dividend relief varies widely, from zero percent in countries with classical systems to 100 percent in Greece, Australia, Finland and New Zealand. In contrast to what the classification suggests, relief is not provided in full under the imputation systems in Germany and Italy, because non-creditable local taxes have to be taken into account. Full relief is considered provided if the total tax on dividends equals the top income tax rate. Judged against this benchmark, Norway, Belgium and Denmark provide more than full relief.

B. *Remaining discrimination*

As indicated above, the central issue in the debate over the most appropriate corporation tax system is the normative rule that corporate profits, whether retained or distributed, should be taxed like all other income at the marginal personal income tax rates of shareholders. In other words, dividends, interest and retained profits should bear the same total tax burden. If so, the choice between new share issues, debt and retentions to finance new investments would not be influ-

17. This section draws on OECD (1991), Annex 2.

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Table 3. *OECD: Dividend Relief and Potential Distortions of Corporation Tax Systems, 1992*
(In Percentages)

System and Countries Covered	CT on Retentions	CT + Top PT on Dividends	Top PT on Interest	Degree of Dividend Relief[a]	Degrees of Discrimination		
					Dividends/ Retentions[b]	Dividends/ Interest[c]	Interest/ Retentions[d]
I. *Classical Systems*							
Luxembourg	39.4	70.5	51.3	0	79	37	30
Netherlands	35	74	60	0	111	23	71
Switzerland	30.3	60.8	43.8	0	101	39	45
United States	38.3	60.5	36	0	58	68	-6
II A. *Dividend Relief at Corporate Level*							
1. *Dividend deduction*							
Greece	46(40)	50	25	100	9	100	-46
Ireland	45	Varies	0	-	-	-	-100
Sweden	30	Varies	30	-	-	-	0
2. *Split-rate* (None)							
II B. *Dividend Relief at Shareholder Level*							
1. *Imputation*							
a. *Full*							
Australia	39	48.3	48.3	100	24	0	24
Finland	40.2	56.2	10	100	40	462	-75
Germany	58.1/45.5	61.7	55	67	6	12	-5
Italy	47.8	58.1	30	66	22	94	-37
New Zealand	33	33	33	100	0	0	0
Norway	28	28	28	179	0	0	0
b. *Partial*							
France	34/42	63.4	18.1	69	86	250	-47
Ireland	40(10)	61.6	52	50	54	18	30
United Kingdom	33	46.4	40	68	41	16	21
2. *Schedular treatment*							
a. *Separate Tax*							
Austria	39	54.3	50	78	39	9	28
Belgium	39	54.3	10	129	39	443	-74
Denmark	38	65.9	57.8	117	73	14	52
Japan	51	68.2	20	82	34	241	-61
Portugal	39.6	54.7	25	38	38	119	-37
Turkey	49.2	49.2	10	93	0	392	-80
b. *Tax Credit*							
Canada	44.3(38.3)	64.5	49.1	31	46	31	11
Spain	35.3	65.1	56	42	84	16	59

Source: See Appendix. CT = Corporation Tax; PT = Personal Income Tax. Figures have been rounded to nearest decimal. Degrees of Discrimination are shown in full figures.

Notes:

a. Dividend Relief = $\frac{\text{CT + PT if no relief } \textit{minus}\ \text{CT + Top PT}}{\text{CT + PT if no relief } \textit{minus}\ \text{PT}}$

b. Dividends/Retentions Differential = $\frac{\text{CT +Top PT } \textit{minus}\ \text{CT on Retentions}}{\text{CT on Retentions}}$

c. Dividends/Interest Differential = $\frac{\text{CT + Top PT } \textit{minus}\ \text{Top PT on Interest}}{\text{Top PT on Interest}}$

d. Interest/Retentions Differential = $\frac{\text{Top PT on Interest } \textit{minus}\ \text{CT on Retentions}}{\text{CT on Retentions}}$

enced by the tax system. The corporation tax would be neutral regarding financing and payout decisions and, by extension, investment location decisions.

In the real world, corporation taxes, in conjunction with income taxes, discriminate against financing and payout decisions. Three measures of discrimination may be distinguished. First, the dividend/retention differential measures the percentage excess by which profit distributions are overtaxed compared with retentions. This measure is important for the choice between new shares and retained profits. Second, the dividend/interest differential measures the percentage excess by which profit distributions are overtaxed compared with interest. It is relevant for the choice between new shares and debt. Third, the retention/interest differential measures the percentage excess by which retentions are overtaxed (or, as often, undertaxed) compared with interest. This measure, which can readily be deduced from the preceding measures, affects the choice between retained profits and debt.

The calculations for the dividend/retention differential in Table 3 indicate that most corporation tax systems, particularly if classical in nature, discriminate heavily against profit distributions. Basically, the systems favour established firms

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that have sufficient profits to finance new investments and discriminate against starting firms that need new equity. Exceptions are the corporation taxes of New Zealand, Norway and Greece, where the differential is nil because dividends bear the same tax as retentions. Basically, the computations for the dividend/interest differential carry the same message. Some countries, such as Finland, France, Belgium, Japan and Turkey, discriminate heavily in favour of debt, however, because interest is taxed at a mere 10 or 20 percent under the personal income tax. The interest/retention differential varies most. The number of corporation taxes that is biased against debt is the same as the number that favours debt over retentions. Three countries (Sweden, New Zealand and Norway) are neutral as regards the choice between debt and retained profits.

The figures indicate that hardly any corporation tax system achieves neutrality in the taxation of the returns to current equity (retained profits), new shares (dividends) and debt (interest). For neutrality to occur (in other words, for all differentials to be zero), dividend relief should be given in full and the top rate of the income tax at which dividends and interest are taxed should equal the corporation tax rate. The corporation and personal income taxes in New Zealand and Norway meet these requirements, but only for the top marginal rate.

Although the figures form a useful indication of the remaining non-neutralities under the various corporation tax systems, it should be emphasized that they cannot explain why investors do not use opportunities for arbitrage. Thus, returns may not be taxed at shareholder or debtholder level because they are channeled through tax havens or received by tax-exempt entities, such as pension funds. Financial liberalization and innovation have greatly increased the opportunities for tax arbitrage. As a result, remaining non-neutralities may be accentuated or, more likely, mitigated in comparison with the figures shown in Table 3.

VII. EVALUATION AND CONCLUSION

The appropriate place of the corporation tax in an equitable and efficient tax system plays an important role in the tax debate in most OECD member countries. Should corporations be taxed as such or should their earnings be allocated to shareholders? If full integration is not feasible, is integration of the corporation tax on distributed profits a second-best alternative? If so, should dividend relief be provided at corporate or at shareholder level? How much weight should be given to the international repercussions of partial integration? And above all, even if some form of dividend relief appears desirable in theory, are the transition costs worth the trouble?

In an equitable tax system, the case for a separate corporation tax (classical system) is somewhat uneasy. Surely, corporations have an independent legal existence, as well as the capacity to pay tax in the sense that the corporation tax does not force them into bankruptcy. But the conclusion that they also have ability-to-pay is a *non sequitur*. The incidence of all taxes, whatever their name and form, is always on natural persons. The search for the answer to the question of who bears the tax burden must start and end with individuals of flesh and blood. The more nearly tax burdens are imposed on them in line with the ability-to-pay principle and government's redistributive objectives, the better the tax system is.

Also, the classical corporation tax does not appear a particularly efficient tax. There are indications that the tax distorts the optimal allocation of resources because it (a) stimulates the retention of profits, thus interfering with competitive conditions and hampering the entry of new firms; and (b) discriminates against new shares by treating interest favourably compared to dividends, thereby imposing relatively higher capital costs on starting firms that have difficulty attracting debt. In short, financing and payout decisions are distorted.

The equity shortcomings and economic distortions of the classical system, therefore, appear to point the way to integration. Full integration and retention of the corporation tax as a withholding device – to protect the workings of the income tax and to levy tax on foreign companies whose shareholders do not fall under the national income tax – does not appear feasible. Partial integration or dividend relief seems a viable alternative, however, as evidenced by the experience of 20 OECD member countries. Moreover, it has been pointed out that full integration might then, in practice, be achieved if the top marginal rate of the income tax would be set at the same level as the corporation tax rate, as in New Zealand and Norway. Shareholders in low-income tax brackets would then push for profit distribution, while high-income shareholders would not benefit from profit retention.[18]

If payout rates would not be influenced by the choice of the integration system, the degree of dividend relief can be made the same under a dividend-deduction system, a split-rate system and an imputation system. Any one of these systems distributes the tax on distributed corporate source income more systematically in line with marginal individual income tax rates than does the classical system. If the objective is to stimulate the stock market, relief at the shareholder level would seem most appropriate. If the goal is to increase the liquidity position of corporations (as an indirect investment incentive), a dividend-deduction or split-rate system might be called for. An advantage of the imputation system is that it functions as a withholding device, which should further taxpayer compliance with the income tax.

It should be noted that the case for or against dividend relief is not contingent upon the assumption made with respect to the incidence of the corporation tax.[19] If, as some argue, the tax is borne by consumers (in the form of higher prices) or workers (in the form of lower wages either immediately or, more likely, in the long run through the reduced availability of capital), it should be considered an inferior sales tax or payroll tax: inferior because its burden distribution varies arbitrarily from one corporation to another depending on the ratio between profits and sales or between profits and payrolls. Of course, there is no rationale for such taxes in an equitable tax system. Similarly, the efficiency case for integration does not depend on incidence assumptions.[20]

18. See McLure (1979), pp. 219-23.
19. For a review of the literature on the incidence of the corporation tax, see Ballentine (1980).
20. For the equity argument, see Musgrave and Musgrave (1980), p. 401, and for the irrelevancy of the incidence issue for efficiency, Mieszkowski (1972).

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Dividend relief, like other tax changes, cannot be imposed on a *de novo* basis. Changes in the existing tax burden distribution, transition costs and revenue effects must be accounted for. In classical countries, shareholders have long become accustomed to the system and it is likely that the tax, including its double levy, has been capitalized in earlier years in the form of reduced share prices. In other words, the tax has been borne by original shareholders who are not necessarily the same persons as present holders. Removal of the tax would then result in unwarranted windfall gains to existing shareholders. Nonetheless, this does not mean that change should not be contemplated, because distorting effects linger on. Dividend relief mitigates these effects.

Whatever the advantages of dividend relief in the domestic context, however, its international implications are a drawback.[21] Without corrections effected through double taxation treaties, the dividend-deduction or split-rate system unduly favours foreign investors, and the imputation system discriminates against them. This is not equitable and detrimentally affects cross-border ownership of equity. Indeed, the growing internationalization and liberalization of capital markets, which increases opportunities for tax arbitrage and tax evasion, may force the focus of attention on schedular systems under which corporate profits would be taxed in full in the source country, while distributed profits (and interest) would be subject to a final flat low-rate income tax (deducted at source), which might be reduced on a bilateral basis.[22]

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21. For a good treatment, see Doernberg (1992).

22. For a further analysis in the US context, see the excellent study of the US Treasury (1992). For reflections on the place of the corporation tax in the EC, see also Cnossen and Bovenberg (forthcoming).

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Appendix. *OECD: Corporation Tax Rates and Income Tax Rates in 1992*

Country	Rates of Corporation Tax (CT)			Top Rates of Personal Income Tax (PT)				
	Central Gov. (CG)[a,b]	Subord. Gov.(SG)[c,d]	Total CT	Central Gov.(CG)	Subord. Gov(SG)[c]	Total PT	Top PT on Dividends	Top PT on Interest
Australia	39	-	39	48.3[e]	-	48.3	48.3	48.3
Austria	30	14.8	39	50	-	50	25	50
Belgium	39	-	39	55	7	58.9	25	10
Canada[f]	28.8 (23.8)[g]	15.5 (14.5)[g]	44.3 (38.3)	34	63	49.1	49.1	49.1
Denmark	38	-	38	40	28	68	45	57.8
Finland	23	17.2[h]	40.2	39	17.2[h]	56.2	56.2	10
France	34/42[i]	-	34/42	57.g[j]	-	57.9	57.9	18.1
Germany	51.9/37.4[k]	15	58.1/45.5	55	-	55	55	55
Greece	46(40)[g]	-	46(40)	50	-	50	50	25
Iceland	45	-	45	32.8	7	39.8	39.8	0
Ireland	40(10)[g]	-	40(10)	52	-	52	52	52
Italy	36	16.2	47.8	50	-	50	50	30
Japan	38.5[i]	12+6.5	51	50	15	65	35	20
Luxembourg	33.3[m]	10	39.4	51.3[n]	-	51.3	51.3	51.3
Netherlands	35	-	35	60	-	60	60	60
New Zealand	33	-	33	33	-	33	33	33
Norway	-	28	28	13	28	41	28	28
Portugal	36	3.6	39.6	40	-	40	25	25
Spain	35.3[o]	-	35.3	56	-	56	56	56
Sweden	30	-	30	20	31	51	30	30
Switzerland[p]	8	24.2	30.3	11.5	32.3	43.8	43.8	43.8
Turkey	49.2[q]	-	49.2	47.5[r]	-	47.5	0	10
United Kingdom	33	-	33	40	-	40	40	40
United States	34	6.5	38.3	31	5	36	36	36

Source: International Bureau of Fiscal Documentation, *Taxation of Private Income*, Guides to European Taxation, Vol. III (Amsterdam: Loose-leaf). Updated from *Tax News Service*. Percentages have been rounded to nearest decimal.

Notes:
a. Corporations are also liable to net wealth or capital tax in Austria, Canada, Germany, Iceland, Luxembourg, Norway, Switzerland, and Turkey.
b. Lower or graduated CT-rates are applied to lower amounts of profits or to small businesses in Belgium, Canada, Finland, Japan, Luxembourg, Portugal, Switzerland, the United Kingdom, and the United States. The Netherlands levies a higher rate.
c. Taxes, surcharges or surtaxes differ between subordinate units of government. Therefore, an average or representative rate has been chosen. Italy has a uniform SG-CT rate and Iceland has a uniform SG-PT rate.
d. In Austria, Germany, Japan (12%), and Luxembourg, the SG-CT is formulated on a tax-exclusive basis. In these countries, as well as in Italy (¾), Switzerland, and the United States, the SG-CT is deductible in ascertaining profits for the CG-CT.
e. CG-PT includes 1.25% surtax.
f. SG-rates are for Ontario. Rates include 5% CG-PT surcharge and 10% SG-PT surcharge. SG-PT applied to basic CG-PT of 29%.
g. Rates between brackets apply to manufacturing corporations.
h. SG-rates include church tax of 1.2%.
i. Higher rate applies to distributed profits.
j. CG-PT includes CSG-surtax of 1.1%.
k. Lower rate applies to distributed profits. CG-rates include 3.75% surcharge.
l. CG-CT includes 2.75% surcharge.
m. Rate includes 1% CG-CT surcharge.
n. Rate includes 2.5% CG-PT surcharge.
o. CG-CT includes 1.5% deductible surcharge.
p. All typical rates. SG-rates are for Zürich.
q. Rate includes CG-CT surcharge of 7%.
r. Rate allows for CG-PT rebate of 5%.

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RUSSIA:

TAX ASPECTS OF IMPROVING THE INVESTMENT CLIMATE IN RUSSIA

James Riordan and Charles E. McLure, Jr.

Initiated by Russia's State Committee on Taxation and the Ministry of the Economy to assemble a delegation of tax experts which could guide the new Russian government in the most efficient, reasonable way to tax foreign investment the Tax Foundation agreed and submitted this statement on 7 July 1992, in Moscow to Vice President Aleksandr V. Rutskoi and I.A. Lazarev, chairman of the Russian State Tax Committee.

Mr. Riordan is former Vice Chairman, Mobil Oil, and current Co-Chairman of the Tax Foundation.

Mr. McLure is a Senior Fellow at the Hoover Institution, and a Foreign Advisor to the Supreme Economic Council of the Supreme Soviet of Russia.

I. PREFACE

The Tax Foundation delegation wishes to see the Russian transition to a free market succeed. Successful transition is important for many reasons, most notably the improvement in the living standard of the Russian people and enhancement of prospects for world peace.

The delegation wants American companies, by investing in Russia, to be partners in the success of transition. For this to be achieved, the Russian tax system must satisfy the objectives of both taxpayers and the government.

Economic progress in Russia requires that the tax system not discourage the saving and investment that are necessary for economic progress.

In the delegation's meetings with representatives of the Government, the Parliament and the State Tax Service it has shared its views in three areas: (1) the long-term goals for a tax system that is appropriate for a market economy, especially one that does not discourage investment; (2) aspects of the existing tax system that are of immediate concern to foreign investors; and (3) policies that would facilitate foreign investment during the interim period when the Russian tax system is in flux as a system suitable to the long term is being developed. In all cases these views are consistent with the Tax Foundation's long-established "Principles of Taxation". These principles include stability, reliability, simplicity, clarity, economic neutrality, the need for open discussions of policy, free and fair taxation of international transactions, moderate tax rates and the importance of applying these principles to the taxes of subnational as well as national governments. For over 50 years they have guided the Tax Foundation in its similar consultations with the government of the United States.

II. LONG-TERM POLICY GOALS

A. *Stability*

Stability is a critical feature of a tax system that will encourage investment. An unstable system creates uncertainty that discourages investment.

B. *Reliability*

Investors should be able to rely on continued application of the tax laws in existence at the time they make their investments. New and heavier burdens should not be imposed after an investment is made. Taxpayers must be able to rely on, published laws, decrees, regulations and rulings. Laws must be administered fairly and consistently, with only limited administrative discretion. Procedures for resolving tax disputes should include administrative hearings and court proceedings. Taxpayers should be protected from unreasonable and capricious interpretations of the law. Changes in laws should only be applied prospectively; changes in laws should not be applied retroactively. Subnational governments must not be allowed to deviate from (or unilaterally modify) legislation adopted by the federal government.

C. *Certainty*

Laws and regulations interpreting them must state precisely the tax consequences of various actions. This contributes to economic transparency (to be defined in E

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below). Adoption of Western accounting conventions and their incorporation into the tax system will increase clarity. Legally binding advance rulings interpreting new provisions of the tax system that might otherwise be unclear must be readily available.

D. *Simplicity*

Russia should avoid the complexity found in the tax systems of many Western countries. Such complexity is extremely troublesome even in advanced Western countries with substantial experience in tax administration and compliance. It would be far worse in Russia, which does not yet have the tax administration and experience in taxpayer compliance required to cope with a complex system.

E. *Economic transparency*

Under current Russian law the economic consequences of certain actions are not immediately clear either to taxpayers or the government. Because the tax base differs from economic income, as measured by Western accounting principles, the effective rate of taxation can depart radically from the statutory rate. Examples that increase the effective rate substantially (to be discussed in greater detail below) include the unrealistically long useful lives of depreciable assets, the use of historical cost in the calculation of depreciation allowances, and the disallowance of deduction of some ordinary and reasonable business expenses, such as interest expense and labour payments in excess of four times minimum wages.

F. *Satisfactory definition of taxable profits/income*

The measurement of profits (income) for tax purposes should be based on standard Western accounting principles. All reasonable and necessary expenses should be deductible. This is necessary to facilitate economic transparency, to avoid disincentives for investment and to assure foreign tax credits in the United States and perhaps elsewhere.

G. *Moderate tax rates*

Tax rates (both statutory and effective rates) should be moderate, so as not to discourage investment. (The top individual income tax rate of 60 percent[1] and the VAT rate of 28 percent[2] are high by international standards.)

The delegation appreciates the need to control deficits and the difficulty of reducing public expenditures (including subsidies to state enterprises) under current circumstances. It is equally important, however, to remember that in the long run only a growing private sector can provide productive employment, a rising standard of living and the tax revenue needed to finance essential government services. An overburdened private sector will not experience the investment needed for dynamic growth.

III. AREAS OF IMMEDIATE CONCERN

A. *High tax rates*

The Tax Foundation delegation believes the 60 percent[3] top statutory tax rate applied to individual income to be much too high. The combined effective rate paid by enterprises and their employees, including the effect of the disallowance of deductions for labour payments in excess of four times minimum wages, is even higher, approximately 73 percent. Attention should also be paid to the marginal effective tax rates on income from capital invested in Russia resulting from the low rates of depreciation allowed under Russian law and the failure to take account of inflation in calculating taxable profits (income).

B. *Foreign tax credits*

Ratification of the double taxation treaty with the United States will alleviate some concerns about the creditability of the current Russian profits tax, but does not assure creditability under all circumstances. Moreover, some foreign investors wish to use organizational structures for which issues of creditability will remain. The only satisfactory way to deal with the issue of creditability is to allow deductions for all reasonable and necessary expenses of earning income.

C. *Labour payments*

Wages and salaries are generally deductible, without limit, in advanced Western countries. Placing limits on the deductibility of labour payments is not a satisfactory means of dealing with the tendency for the management of state enterprises to grant unjustified and inflationary wage increases. At best such a policy is only appropriate for state enterprises and then only if reforms of managerial compensation policy are not adequate to provide incentives for cost control. This policy distorts the tax base, raises enterprises' cost of managers and skilled workers, discourages foreign economic activity in Russia and thereby the process of technological transfer, and raises questions of creditability. In the case of service industries the disallowance of deductions for labour payments is particularly problematical, since it can produce a definition of the tax base that approaches gross income.

D. *Capital recovery*

It is appropriate to allow tax-free recovery of the cost of capital investments. The generally accepted method of doing this throughout the world is the deduction of depreciation allowances (in the case of investment in tangible assets) and amortization (for intangible assets). The useful lives assumed in calculating depreciation allowances under Russian tax law are much too long (and the implied depreciation rates much too low) to allow timely recovery of capital, especially since inflation reduces the real value of such allowances. It is necessary to have more rapid depreciation and to prevent the loss of real value of allowances caused by inflation. The conceptually correct way of achieving the second of these objectives, indexation of the cost basis of assets, is extremely complicated. An alternative approach that deals with both problems simultaneously in a relatively simple manner is to allow immediate write-off (expensing) of investment.

1. Changed to 40% on 15 July 1992.
2. Changed to 14% on most products on 15 July 1992.
3. See *supra* note 1.

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E. *Discrimination against "middlemen"*

Many foreign multinational corporations may operate in Russia through organizations that would be defined as middlemen, subjecting them to the 45 percent profits tax rate. This will place them at a competitive disadvantage relative to organizations that can avoid such characterization. This discriminatory provision, which reflects a continuation of the socialist mentality under that commerce is unproductive, should be eliminated.

F. *Loss carryforward*

In order to avoid disincentives for investment, losses incurred in one year should be available to offset income earned in subsequent years. It is especially important that it be possible to carry losses incurred during the typically unprofitable start-up period forward to offset taxable profit/income once the enterprise becomes profitable. Most other countries allow net operating losses to be carried forward for extended periods. It would also be desirable to prevent inflation-induced declines in the real value of deductions for past losses, perhaps by indexing such losses (or paying market interest rates on them) or by denominating them in hard currency.

G. *Uniform treatment*

The tax law should treat all forms of enterprise in the same way.

H. *Export taxes*

Russia must export in order to earn the foreign exchange needed to import capital and technology. Export taxes discourage exports and should be eliminated. Since the world market price of most goods and services is beyond the control of one country, export taxes cause an involuntary reduction in net selling prices and thus the profits of exporters. They can discourage potential investors from investing in Russia. Russia can design other mechanisms to prevent windfalls from the export of subsidized raw materials.

I. *Mandatory conversion of hard currency earnings*

The requirement for mandatory conversion of hard currency earnings is a troublesome policy that resembles a discriminatory tax on the exports and other hard currency earnings of foreign investors. All investors considering projects in Russia must be concerned with risks of exchange rate fluctuations. Mandatory conversion aggravates such risks for those contemplating investments in export industries in Russia. Mandatory currency conversion is essentially an involuntary loan made in a currency other than that in which the foreign investor calculates and reports his profits. As such it subjects the investor to additional unwanted risk of fluctuations in the exchange rate. The delegation hopes that the exchange rate can be stabilized, that such risk will be reduced and that foreigners will find investing in rubles will become attractive. This is currently not the case; moreover, ruble investments cannot be hedged. It is important that this onerous requirement for mandatory conversion be eliminated, thereby removing a troublesome source of inconsistency with the Law on Foreign Investment.

J. *Import duties*

It is important that any import duties be levied at a single rate and that the rate of import duty be kept low, in order to avoid uneconomic and unfair protection of selected industries resulting from high rates of effective protection. Russia has not followed this policy in the recent past.

K. *Value added tax*

Most countries that levy value added taxes (VATs) employ consumption-based VATs. As a result, the aggregate base of the VAT is limited essentially to the value of final products sold to consumers. This is achieved by allowing businesses to offset (credit) all taxes paid on purchases – including taxes on capital goods (such as machinery and equipment) – against tax due on sales. Russia should follow standard international practice in this regard.

L. *VAT on financial services*

The application of VAT to financial services and credit card services involves extremely complex issues. This problem should be discussed with the representatives of these industries, especially those actively considering doing business in Russia.

M. *Actions of subnational governments*

Subnational governments have been engaging in actions that are extremely troublesome to potential investors; it appears that some of these may be inconsistent with current federal law. For example, they have been imposing taxes not allowed under federal law, they have required that potential investors engage in joint ventures with them or with state enterprises under their jurisdiction, and they have refused to allow local banks to remit tax revenues to the central government. This type of behaviour is extremely inimical to investment.

N. *Risk of confiscatory taxation*

Almost all companies doing business in Russia are subject to several forms of taxation (or tax-like provisions), including not only the profits tax and the value added tax, but also excises, export taxes and mandatory conversion of hard currency. In some cases the combination of taxes is confiscatory, or nearly so. It is important to analyse the consequences of policy to be sure that in total taxes and similar measures do not absorb all of the profits – or even almost all of them – and do not impinge so heavily on the markets for the products of some industries as effectively to destroy them.

IV. INTERIM SUGGESTIONS

Based on the delegation's meetings it understands that establishment of the type of system suggested above will be politically difficult. Thus it offers several suggestions for an inter-

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im policy that will facilitate the process of foreign investment while the permanent system is being developed.

A. *Review of proposed legislation*

Views of foreign investors should be sought as new legislative proposals are being developed. Written drafts of proposals should be readily available for analysis, discussion and comment. It is especially important that such drafts be widely distributed to interested foreign investors (actual or potential). Adequate time should be allowed for translation, analysis and the submission of comments. Ideally one Russian agency would be responsible for this activity, in order to simplify communication and increase efficiency and consistency. The Tax Foundation would be pleased to facilitate this process in the case of American investors.

B. *Advanced interpretive rulings*

It should be possible for investors to obtain legally binding rulings interpreting existing laws. It is especially important to reduce uncertainty during the next few years when investment is badly needed and there is a high risk that legislation will be unclear.

C. *Guarantees against adverse fiscal changes*

A procedure should be instituted that would provide investors with guarantees that tax rules (including maximum rates) will apply for specified periods of time.

D. *Uniformity and consistency*

Ruling letters (B above) and guarantees (C above) should treat similarly situated taxpayers in a similar manner. All ruling letters and the terms of all guarantees should be published promptly and have general applicability.

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INTERNATIONAL:

THE US PROPOSED REGULATIONS DEALING WITH TAX ASPECTS OF TRANSFER PRICING WITHIN MULTINATIONAL ENTERPRISES[1]

A Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC

EXECUTIVE SUMMARY

A. *Introduction*

1. The spread of the activities of Multinational Enterprises (MNEs) poses particularly difficult problems for all tax authorities in that it is not easy to determine the allocation of taxable profits in highly integrated groups. Whenever goods and services cross national boundaries within a multinational group, a transfer price is required in order to determine the division of the tax base between the countries in which the MNE is operating. Because that transfer price may be manipulated in order to affect the division of the tax base between the different countries involved, it is generally agreed that, for tax purposes, it may be appropriate to correct the allocation of profits between members of a corporate group to eliminate the effect of such manipulations. However, determining a proper allocation of profits is – both for the taxpayers and tax administration – particularly difficult for intangible property and it is primarily this problem which the United States has sought to address in its proposed income tax regulations relating to intercompany transfer pricing and cost-sharing arrangements under Section 482 of the US Internal Revenue Code.

2. The problems currently being encountered in the transfer pricing area by the United States are not new and are similar to those encountered by the other Member countries of the OECD. These difficulties, which are inherently global in nature, cannot be resolved unilaterally. A multilateral approach is required which builds upon widely accepted principles of international taxation. The recent discussions in the United States regarding the proposed Regulations provide a perspective to the determination of transfer prices which is useful and interesting in many ways. Nevertheless, the implementation of the proposed 482 Regulations in their present form could risk undermining the consensus that has been built up over a number of years on the application of the arm's length principle and thereby increase the risk of economic double taxation.

3. The purpose of the present report, which has been prepared by a special Task Force established by the Committee on Fiscal Affairs of the OECD, is to provide the US administration with the collective views of the OECD Member countries on the proposed Regulations.

4. The following paragraphs provide a brief summary of the main problems which arise with the proposed Regulations and set out the recommendations of the Task Force. The Member governments of the OECD stress that they are prepared to work further with the United States, both bilaterally and in such international fora as the OECD, to address the problems to which the Regulations are directed.

B. *The Existing International Rules*

5. Since 1956 the OECD has sought to build up a set of internationally accepted "rules of the game" which govern the ways in which Member countries tax profits arising from international transactions. The main instrument used to achieve an internationally consistent approach to the taxation relating to such international transactions has been the development of an OECD Model Tax Convention, the latest version of which was published in 1992.[2]

6. The purpose of the OECD Model Tax Convention is the avoidance of international double taxation and to assist tax authorities in counteracting tax evasion and avoidance. Article 9 (Associated Enterprises) of that Convention recognizes that Member countries can correct the allocation of taxable profits between associated enterprises. This Article, and Article 25 dealing with the Mutual Agreement Procedure, aim at ensuring that such corrections are made on the basis of the generally agreed arm's length principle.

7. The provisions set out in the OECD Model Tax Convention were supplemented in 1979 by guidelines for the practical application of the arm's length principle in respect of different types of cross-border transactions within a multinational group.[3] That report sets out the methods that OECD Member governments should use in applying the arm's length principle, namely:

a) The comparable uncontrolled price method.
b) The cost plus method.
c) The resale price method.
d) Other reasonable methods which produce an acceptable figure.

1. The full report was published by the OECD on 10 January 1993.
2. Published under the title, "Model Tax Convention on Income and on Capital", OECD, Paris (September 1992).
3. The 1979 Report was entitled "Transfer Pricing and Multinational Enterprises".

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The principles set out in the 1979 Report have been widely followed by Member countries, including the United States, and are strongly endorsed by the business community and tax practitioners.

C. *The Importance of Maintaining an International Consensus*

8. OECD Member countries wish to stress the importance of maintaining the international consensus that has been reached on how to deal with transfer pricing issues. The adoption by one country of rules which are inconsistent with this accepted standard and which were not generally accepted by other Member countries, would raise a very high risk of economic double taxation which could lead to increased uncertainty for the business community with a consequent disruption of international trade.

9. The proposed Regulations raise two fundamental issues as regards this international consensus. The first issue is whether the methodology put forward in the proposed Regulations is consistent with the arm's length principle which underlies the Article on Associated Enterprises. The second is that of the application of the Regulations in the context of a tax convention's mutual agreement procedure and arbitration mechanism.

(i) Relationship between the proposed Regulations and the arm's length standard

10. The arm's length standard is recognized in Article 9 of the OECD Model Tax Convention and allows for the re-allocation of profits which would be earned by one enterprise within a group of associated companies but for any special conditions that would not apply as between independent persons. The OECD 1979 Report emphasized that for this purpose arm's length profits are those that would be earned if transactions between associated enterprises were undertaken at their fair market values and sets out acceptable methods of determining the arm's length or fair market value of transfers of property and services. Matching or comparable transactions with unrelated parties will generally govern and, where these are not available, the cost plus, or the resale price method or other methods are used depending on the circumstances. The 1979 Report recognized the "many conceptual and practical difficulties" which arise in applying transaction-based methods and noted that it may be acceptable in certain cases to have regard to profits in determining whether transactions between associated enterprises were in fact based on the arm's length standard. The profits examined may be those of the various enterprises within the group of associated companies (subsequently referred to in this Report as the "profit split" approach) or the profits of independent entities carrying out the same or similar activities (the comparable profits approach). It is this latter approach which has been given a central role in the proposed Regulations along with periodic adjustments as a means of implementing the concept of commensurate with income introduced in Section 482 by the 1986 Tax Reform Act.

11. An examination of the current profit experience may often be useful as part of the evidence as to whether a transaction was made on arm's length terms. However, it may not be in accordance with arm's length standards to make an adjustment to tax liability in every case based on the overall current income earned. A major difficulty with the comparable profits approach is that the incomes of taxpayers engaged in the same or similar activities do not vary only because of differences in price, but are highly dependent upon other factors such as differences in cost structures, locational differences, the cost of capital, the degree of business experience, the quality of the management, the objectives of the firm, etc. Unless these differences are taken into account, there may be a fundamental inconsistency between the outcome under the arm's length standard and a methodology based on comparable profits.

12. To the extent that a commensurate with income approach involves the application of hindsight, there is a danger of a fundamental contraction between the arm's length standard which depends on evaluating bargains at the time they take place and the commensurate with income concept to the extent that it involves a year by year retrospective reappraisal based on profits. The question that needs to be asked is what profits could have been reasonably foreseen? As long as the objective is to exclude from consideration all events which were not known and could not reasonably have been predicted by the parties at the time the transfer was made, the Task Force would not regard the arm's length standard as having been necessarily breached.

13. Whilst it may be appropriate to use comparable profits to arrive at an arm's length price and to cross-check other methods, the 1979 Report stresses that comparisons of this sort should be made with care and that "exceptional profits or losses" may not necessarily indicate that income was being shifted by artificial transfer prices. The Task Force endorses strongly this warning since profit comparisons are valid only if the comparable is a true one and if they accord with commercial reality.

14. The Task Force believes, however, that an approach that considers the totality of profit with respect to the transactions made by the related enterprises under consideration (the profit split approach) could mitigate – at least insofar as it is not based on some arbitrary division of profits – some of the problems associated with the comparable profit method. The main advantages of the profit split are that it is based on the commercial activity of the entity itself and therefore less likely to penalize the commercially unsuccessful (through comparisons with more successful rivals) and it reduces the number of uncontrolled factors such as poor management and locational differences affecting the entity. Revenue authorities may therefore find it easier to agree on a profit split than reconciling the various comparable profit interval (CPI) calculations for entities in each country. For those reasons, profit splits have sometimes been used in preference to the comparable profit method where a transaction-based approach is not feasible. It should be stressed that this approach is based on an analysis of the economic activities of particular groups of companies and thus should not be confused with unitary methods which are based on pre-determined formulae and

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which the Task Force would regard as being contrary to the arm's length principle. However, the Task Force also recognizes a number of limitations to this approach and that substantially more work is required to evaluate the widespread application of the profit split approach. The Committee on Fiscal Affairs intends to examine this issue as part of its review of the OECD 1979 Report.

15. In conclusion, the Task Force considers that even if in theory the comparable profit method underlying the proposed Regulations could reflect an arm's length profit analogous to the way that a comparable price can reflect an arm's length price, there are serious difficulties in putting the theory into practice. The considerable weight given in the proposed Regulations to the comparable profits approach increases the danger of arriving at a result that would not comply with the arm's length principle.

(ii) The mutual agreement procedure and arbitration process

16. The proposed Regulations as presently drafted are likely to result in adjustments that will not be accepted by other countries, which would lead to economic double taxation and a consequent disruption of international trade. These concerns could be somewhat alleviated in the case of direct transactions with associated enterprises resident in countries with which the United States has a tax convention if the United States expressly confirms that an agreement reached under the mutual agreement procedure provided for by these conventions would take precedence over the application of the proposed Regulations and that when concluding such mutual agreements, the IRS would not have to comply with the proposed Regulations. Similar remarks apply in the case of the arbitration process which is increasingly being advocated as a way of solving disagreements between countries on issues of transfer pricing. However, it is necessary that decisions under the mutual agreement procedure and under arbitration be based on internationally agreed standards and that the countries involved be in a position to implement those decisions even where they depart from their internal rules.

D. *An Overall Assessment of the Proposed Regulations*

(i) The need for amendments

17. The Task force shares the stated objectives of the United States to counter abusive transfer pricing practices, to reduce the scope and the number of controversies between taxpayers and the IRS and to implement the commensurate with income requirement in a manner that is consistent with the internationally accepted arm's length standard. Any regime for preventing abuses of transfer pricing should, however, operate fairly and should not lead to international double taxation or impose excessive compliance or administrative burdens. The Task Force believes that the proposed Regulations make some progress towards reconciling the stated objectives but, in their present form, do not meet these objectives and may in fact frustrate them. Accordingly, substantial amendments are required.

(ii) The need to concentrate on abusive cases

18. One of the goals of the proposed Regulations is to reduce the scope for disputes with taxpayers, thereby enabling resources to be concentrated on truly abusive cases. Therefore the proposed Regulations should be explicitly directed towards such cases and confine as far as possible the applications of the comparable profits methodology and of periodic adjustments to these cases.

(iii) The need for flexibility

19. The Task Force believes that some of the difficulties that are identified in this Report could be alleviated if the Regulations were drawn up and implemented in a more flexible manner than is presently the case.

(iv) The need for a short-term review following the implementation of the proposed Regulations

20. Whilst it is acknowledged that profit comparisons have a legitimate role in reviewing transfer pricing cases and that the comparable profit methodology suggested in the proposed Regulations is far more sophisticated than anything previously attempted, the work in this area remains at the experimental stage and requires further testing before its precise impact in the transfer pricing area can be determined. Therefore, the Task Force considers that the importance of these concerns requires that the proposed Regulations, amended as suggested in this Report, should ideally be implemented on a temporary basis and, in any event, be subject to a review after a short period of time. The Task Force also believes that treaty partners of the United States should be invited to collaborate in this review process through the work of the OECD's Committee on Fiscal Affairs.

(v) Encouraging a more intensive use of existing international instruments

21. The Task Force considers that at least some of the problems addressed by the proposed Regulations and the risks of economic double taxation could be alleviated by making more intensive use of existing instruments for international cooperation. These would include:

- Intensifying the use of existing bilateral and multilateral instruments for the exchange of information. The Task Force has recommended to the Committee on Fiscal Affairs that its Working Party on Tax evasion and Avoidance should speed up and intensify its work in this area.
- Considering more closely the use of simultaneous examinations of related enterprises operating in different countries since this can be an effective means of obtaining information on the activities of MNEs and of countering abusive transfer pricing practices. The OECD has recently adopted a standard working agreement for such examinations and hopes that his will encourage the more frequent use of this technique by those Members countries which are in a position to carry out such examinations.
- Considering further the use of advance transfer pricing agreements, which could avoid some of the problems for MNEs addressed by the proposed Regulations. These

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agreements can be an effective way of introducing greater certainty into the transfer pricing area, especially if they continue for a relatively long period of time. It is, however, recognized that these agreements are time-consuming to conclude for both the taxpayer and the tax authority.

E. *Specific Recommendations*

22. The following paragraphs set out the specific recommendations that are proposed by the Task Force and these should be read as a whole. In making these recommendations, the Task Force emphasizes once again that all Member countries share many if not all of the concerns of the United States and that they are prepared to work closely with the IRS and the Treasury to address the problem of abusive transfer pricing practices. The Task Force believes that the suggestions set out below are constructive and, if adopted, would enable the international consensus on the approach to transfer pricing problems to be maintained and developed.

a) *Recommendations dealing with the application of the proposed Regulations in the context of a mutual agreement procedure or arbitration process:*
It is recommended that the United States confirm that it will not be bound by the proposed Regulations in the mutual agreement procedure or any arbitration process under an arbitration clause provided for in its tax conventions.

b) *Recommendation dealing with the application of the proposed Regulations to abusive cases:*
Whilst the comparable profit method must remain a method of last resort, it is recommended that its application be explicitly directed towards abusive cases and that the IRS examiners be instructed to exercise care and discretion in the selection of transfer pricing cases and in their subsequent application of the method set down in the Regulations so as to focus on abusive situations. It is further recommended that general information on these instructions be published.

c) *Recommendation on priority of methods*
It is recommended that the Regulations should allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments. In the view of the Task Force, the role of comparable profits should be primarily to complement or to cross-check other methods of determining transfer prices and as a useful tool for selecting cases for audit. Therefore, to the extent that the comparable profit method is used to determine the amount of the adjustment to be made in a particular case, it should be regarded as a method of last resort and it should not take priority over transaction-based methods or other methods including the profit split approach, in those cases where these methods can reasonably be applied on the basis of the available information.

It is also recommended that the Regulations should not in practice compel IRS examiners to go too quickly to a comparable profit method.

d) *Recommendation that the results of the comparable profit method be rebuttable*:
It is recommended that, to the extent that the comparable profit method is used to determine the amount of the adjustment to be made in a particular case, the results of applying that method should be regarded as a presumption that the taxpayer would have the right to rebut and that, for that purpose, the taxpayer should be entitled to present evidence to demonstrate either that the price charged is an arm's length price, or can be accepted as such, and results in an arm's length allocation of profit between the two parties to the transaction, or, in the absence of a comparable price or transaction, that the allocation of profits between the two entities is reasonable having regard to the arm's length standard.

e) *Recommendations on the availability of data required for the application of the CPI method*:

The Task Force recommends that the data used to construct a comparable profit interval range should be data drawn from information that is available to the public or to which the taxpayer could reasonably be considered to have access or from other information which is available to the tax authorities and which could be shared with the taxpayer. All such data used by an examiner in constructing the CPI should be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and the exchange of information.

It is also recommended that where the controlled party is a foreign entity, the CPI should be determined from data on similar independent entities which carry on business in the same or similar markets.

It is further recommended that the Regulations should not force the application of the comparable profit method in those cases where sufficient data are not available to permit valid profit comparisons.

f) *Recommendation dealing with difficulties in the application of the CPI*:

Whilst the Task Force considers that safe-harbours would provide certainty to taxpayers and therefore overcome the difficulties in the comparable profit method, it believes, as stated in the OECD 1979 Report on Transfer Pricing, that designing effective safe-harbours involves a number of difficulties. The Task Force is recommending that the Committee on Fiscal Affairs undertake further work in this area in the context of its review of the 1979 Report. The Task Force believes, however, that the United States should develop some mechanism to enable small businesses to avoid the compliance burden, including computational complications, arising out of the comparable profit method.

Where a comparable profit method is used and to the extent that the result produced conflicts with the result obtained under other methods, it is also recommended that, rather than move immediately to determining a fixed point in the comparable profit interval, an explicit obligation be placed on the examiner to check that the methods have been applied correctly and in particular that the right comparables have been selected and the appropriate adjustments made and, as already stated, to share the results, plus the underlying data, with the taxpayer.

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g) *Recommendation on the concept of sound business judgement*:
The Task Force recommends that the sound business judgement concept used in the proposed Regulations should be refined to include only the facts which were known to the taxpayer (for example a trade secret) and also any other facts which were in existence at the time and which could reasonably be expected to be known by a taxpayer, even if he maintains to the contrary. In assessing the exercise of this judgement, account should be taken of the nature and the size of the enterprise, what type of information would normally be available to an unrelated party to the transaction or what type of information could be ascertained by the taxpayer with reasonable effort and care or could be estimated by him, either through the use of financial forecasting or other normal business planning methods, including the use of external data such as market reports. The Task Force does not consider that it is realistic to postulate that all taxpayers should have full knowledge of all relevant facts.

h) *Recommendations on periodic adjustments*:
While it is recognized that retrospective adjustments are in some cases justified, it is recommended that they be confined to truly abusive cases and in order to do so the scope of the exceptions to the requirement to make periodic adjustments should be broadened. In particular, it is recommended:

- that the ten-year period used as a test for the second exception be reduced to five years;
- that the limitation to changes in economic conditions be broadened to cover all factors which were neither anticipated nor reasonably foreseeable and that clearer guidance be provided as to what is meant by the expression "beyond the control of any member of the group";
- that the criterion of the method by which an arm's length amount is determined be removed from the test applicable to the consideration in the second and third exceptions.

i) *Recommendation on the treatment of tangibles*:
It is recommended that the extension of the proposed Regulations to the transfer of tangible property be limited to cases where the property derives its value primarily from its intangible component.

It is also recommended that tangibles should not be subject to less generous treatment than intangibles. Thus, for example, the discretion to limit adjustments in the case of intangible transfers where the reported operating income of the tested party is not significantly outside the comparable profit interval should be extended to tangible transfers.

j) *Recommendation dealing with the allocation of costs in cost-sharing arrangements*:
It is recommended that reasonable methods of allocating costs under a cost-sharing arrangement that are applied consistently should not be disturbed simply on the basis that they fail the application of the cost/income test.

It is further recommended that any changes to a reasonable cost-allocation formula should be made prospectively only and not retroactively as suggested in the proposed Regulations except in those circumstances where the formula adopted is clearly deficient.

k) *Recommendation dealing with buy-in/buy-out rules*:
It is recommended that the requirement for "buy-in" or "buy-out" payments should be decided on a case by case basis, at the moment of entry to or departure from the cost-sharing arrangement, taking into account all relevant circumstances.

l) *Recommendation on application of deemed intangible transfer rule*:
It is recommended that any adjustments regarding bona fide cost-sharing arrangements should generally be limited to a re-allocation of costs amongst the participants and that the use of a deemed intangible transfer rule should normally be directed towards abusive cases.

m) *Recommendation dealing with eligible participants*:
It is recommended that the definition of an eligible participant should be clarified and made more flexible to recognize the many different arrangements that are in common use in cost-sharing arrangements.

n) *Recommendation on ownership of intangibles under cost-sharing arrangements*:
It is recommended that the rules relating to cost-sharing arrangements be clarified to ensure that they apply only to allocate income and deductions for tax purposes and not for the purposes of assigning legal title to the intangibles.

o) *General recommendation dealing with cost-sharing arrangements*:
Further consultation with OECD Member countries in the context of the Committee on Fiscal Affairs are recommended before final changes are made to the rules relating to cost-sharing arrangements.

It is also recommended that a longer transitional period be provided to permit multinational companies to adapt their existing arrangements to any new rules that may be introduced and that the United States work with its treaty partners to develop appropriate transitional arrangements, including the possibility of grandfathering, particularly for bona fide existing cost-sharing arrangements.

p) *Overall recommendation:*
It is recommended that the proposed Regulations should be substantially amended according to the suggestions set out in this Report and, even after such amendments, that they should ideally be implemented on a temporary basis. In any event, their application should be reviewed, after a short period of time, in collaboration with the OECD Committee on Fiscal Affairs.

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MALAYSIA:

THE 1993 BUDGET AND RECENT DEVELOPMENTS

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Contents

I. Introduction

II. Business Taxation
- A. Corporate tax rate
- B. Tax rates for cooperative societies
- C. Franking of dividends
- D. Deduction for expenses incurred on translation or publishing of books
- E. Double deduction for research expenditure
- F. Operational headquarters company (OHQ)
- G. Investment holding company
- H. Contribution to employees provident fund (EPF)

III. Personal Taxation
- A. Income tax rates
- B. Contribution to EPF
- C. Exemption of interest on bonds
- D. Exemption for scientists, writers and artists
- E. Cash award in lieu of leave for public servants

IV. Indirect Taxation
- A. Reduction/abolition of import duties
- B. Increase in import duties/excise duties
- C. Expansion of scope of service tax
- D. Sales and service tax
- E. Stamp duty

V. Other Changes
- A. Export rebate scheme on agricultural products
- B. Fund for food production
- C. Shipping Fund
- D. Housing loan facilities
- E. Human Resource Development Fund
- F. Corporatizatio of the Inland Revenue Department
- G. Zakat

VI. Recent Developments
- A. Reinvestment allowance
- B. Venture capital companies
- C. Research incentives
- D. Overseas investment in approved projects
- E. Double tax treaties
- F. Promotion of investments (amendment) bill

VIII. Conclusion

I. INTRODUCTION

The Honourable Minister of Finance, Datuk Seri Anwar Ibrahim presented the 1993 Budget on 30 October 1992. The budget was presented at a time when the growth of the Malaysian economy is very encouraging and increasingly resilient having registered strong growth for five consecutive years.

The economy grew at the rate of 8.5 percent in 1992. The current account deficit in the balance of payments is expected to decline to M$ 7.9 billion in 1992 as compared to M$ 12.5 billion in 1991. This reduction is due to the continued strength of merchandise exports over imports which has resulted in a surplus in the merchandise account for 1992. Further, the growth of the tourism industry has contributed significantly to the moderation of the deficit in the services account. As a result, the overall balance of payments position has strengthened further. However, the rate of inflation is a cause of concern and measures were introduced to keep the rate below five percent.

The budget strategy aimed at ensuring fiscal prudence, controlling inflation, increasing efficiency and competitiveness of the private sector and enhancing the quality of life and national prestige is appropriate in the context of the current local and international economic scenario. It is also intended to accelerate efforts to achieve the objectives of 'Vision 2020' (under which Malaysia aims to achieve developed nation status) and to increase the resilience of the economy through internal discipline.

In the light of the international economic scene, it is expected that the Malaysian economy will grow at the rate of eight percent in 1993. Measures were introduced to curb inflation (both through tight control over government expenditure as well as monetary and fiscal measures to curtail aggregate demand) and to improve the savings-investment gap. What is also interesting is the continuing process of tax reform and the commitment to change the tax mix so as to place a greater reliance on indirect taxation in the future.

This article examines the various measures introduced in the Budget and the Finance (No. 2) Bill 1992 with regard to direct and indirect taxation as well as other recent tax developments.

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II. BUSINESS TAXATION

A. *Corporate tax rate*

Currently, the rate of income tax and development tax applicable to companies is 35 percent and two percent, respectively thus giving a corporate tax rate of 37 percent. With effect from the year of assessment 1993, the income tax rate will be lowered to 34 percent and the development tax (in line with the commitment made in the 1992 Budget) will be abolished. As such, the corporate tax rate would be 34 percent.

Table I compares Malaysia's corporate tax rate with rates in the other ASEAN countries. With the proposed changes, Malaysia's corporate tax rate would be fairly competitive.

Corporate Tax Rates of ASEAN Countries

Country	*Rate (%)*
Brunei	30
Singapore	30
Thailand	30
Malaysia	34
Philippines	35
Indonesia	35

It is encouraging to note that the Minister has indicated further reductions in tax rates depending on circumstances and developments. It is felt that with the eventual withdrawal of investment incentives and the shift towards indirect taxation, the corporate tax rate may be in the region of 25 to 28 percent which would be very competitive.

B. *Tax rates for cooperative societies*

Currently, cooperative societies are subject to income tax on a graduated scale ranging from four to 35 percent. In line with the general lowering of tax rates, the rate of income tax will range from two to 34 percent with effect from the year of assessment 1993.

C. *Franking of dividends*

Malaysia adopts the imputation system whereby the income tax chargeable on a resident company is available to frank dividends paid, credited or distributed to its shareholders. In line with the proposed reduction in the corporate income tax rate from the year of assessment 1993, the rate of tax deductible from dividends will be 34 percent. This will apply to dividends paid, credited or distributed from 1 January 1992.[1]

D. *Deduction for expenses incurred on translation or publishing of books*

Currently, expenses incurred in translating into or publication in the national language of cultural, literary, professional, scientific or technical books are not tax deductible unless undertaken by businesses which are in the publishing industry. With effect from the year of assessment 1994, such expenses would be tax deductible so long as the translation or publication is approved by the Dewan Bahasa dan Pustaka.[2]

This proposal is intended to encourage the publication of more books in the national language. As such, it is likely that private sector companies would sponsor intellectual works, writings and translation into the national language.

E. *Double deduction for research expenditure*

Revenue expenditure incurred on research by way of cash contributions to an approved research institute or payments for the use of services of an approved research institute or an approved research company was to be eligible for double deduction with effect from the year of assessment 1991.
It is proposed to change the effective date of this incentive to the year of assessment 1992.

F. *Operational headquarters company (OHQ)*

Currently, Section 60E of the Income Tax Act, 1967 (hereinafter ITA) provides the following incentives to multinationals to locate their regional head offices or regional offices in Malaysia to service their affiliated companies in the region:

- a preferential income tax rate of ten percent on chargeable income from providing qualifying services;
- tax-free dividends can be paid put of the above income (after payment of the ten percent tax);
- dividend income received from foreign-related companies is tax exempt and tax-free dividends can be paid therefrom.

However, companies in the finance and service sectors are excluded from this incentive.

It is proposed that, with effect from 1 January 1993, the scope of OHQ incentives be extended to the services sector. The type of qualifying activities under the services sector will be determined later. Further, it was also announced that the Gov-

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1. As such, dividends paid before budget day on which tax at 35 percent has been deducted will be recalculated as shown in the illustration below:

(a) *Shareholder's position*	M$
Gross dividend	5,000
Less: Tax deducted at 35%	(1,750)
Net dividend received by shareholder	3,250
Re-grossing of net-dividend:	
100/66 x 3,250	4,924.24
Less: tax deemed deducted at 34%	(1,674.24)
Net dividend received by shareholder	3,250.00

With the proposed change, the tax deducted of M$ 1,674.24 would be allowed as a set-off (under section 110 of the Income Tax Act, 1967) against the tax chargeable on the shareholder.

(b) *Company's Section 108(6) account*

The company's Section 108(6) account with the distribution of a gross dividend of M$ 5,000 would be as follows:

	Existing M$	Proposed M$
Balance of tax credit b/f say	10,000.00	10,000.00
Less: Tax deducted/deemed deducted from dividend	(1,750.00)	(1,674.24)
Balance of tax credit c/f	8,250.00	8,325.76

2. A Government agency involved in promoting the use of the national language through publishing and translating books into the national language.

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ernment is considering relaxing the terms concerning expatriate employment as an added incentive to attract more multinationals to establish OHQ's in Malaysia.

G. *Investment holding company*

Currently, the deductibility of expenses incurred by an investment holding company is determined by the general deduction rule in ITA Section 33(1), i.e. expenses which are wholly and exclusively incurred in the production of income are deductible. The position of the Inland Revenue Department is that a pure investment holding company does not carry on a business for tax purposes. As such, the deductible expenses are normally restricted to interest incurred on loans obtained to finance income-producing investments and other direct expenses. As a concession, certain expenses incurred in complying with statutory requirements are granted a deduction, i.e. audit, accounting and secretarial fees.

With effect from the year of assessment 1993, it is proposed to introduce ITA Section 60F. Under this proposal, resident investment holding companies are allowed to deduct a certain portion of permitted expenses (which are normally not allowable for tax purposes). The deduction is to be made in arriving at the total income (before deduction of approved donations) of the company.

"Permitted expenses" means expenses incurred by an investment holding company in respect of:

- directors' fees;
- wages, salaries and allowances;
- management fees;
- secretarial, audit and accounting fees, telephone charges, printing and stationery costs and postage; and
- rent and other expenses incidental to the maintenance of an office.

The amount of permitted expenses allowable shall be determined in accordance with the following formula:

$$A \times \frac{B}{4C}$$

Where A is the total of the permitted expenses incurred for that basis period reduced by any receipt of a similar kind;

B is the gross income consisting of dividend, interest and rent chargeable to tax for that basis period; and

C is the aggregate of the gross income consisting of dividends (whether exempt or not), interest and rent, and gains made from the realization of investments for that basis period.

The amount of expenses allowable is further limited to a maximum of five percent of the gross income consisting of dividends, interest and rent for that basis period. It is not stated whether this includes tax-exempt income. The view is taken that tax-exempt income would be included in determining this limitation.

"Investment holding company" is defined as a company whose activity consists wholly in the making of investments and whose income is derived therefrom. As such, companies which have mixed activities, i.e. business source and investment holding, are not eligible for this deduction.

Where there is insufficient income to fully utilize the fraction of permitted expenses, the unabsorbed expenses are not available for carryforward to future years of assessment.

This proposed amendment removes the arbitrary determination of the deductibility of certain administrative expenses by the tax authorities. However, the maximum deduction would be 25 percent of permitted expenses. It will benefit an investment holding company with a high level of income.

H. *Contribution to the employees provident fund (EPF)*

Currently, the statutory contribution to the EPF is 11 percent by the employer and nine percent by the employee. With effect from 1 January 1993, the contribution is increased to 12 percent by the employer and ten percent by the employee.

The increase in contribution by the employer is an additional cost of doing business and would affect labour-intensive businesses more than capital-intensive businesses. The current tax deduction for contributions by an employer is limited to 15 percent of remuneration. No change has been proposed to this limit. This will affect companies who are currently contributing 11 percent to the EPF and four percent to an approved scheme for the benefit of their employees. Such companies would be required to contribute 12 percent to the EPF, thus pushing total contributions to 16 percent one percent above the limit of 15 percent in the ITA.

III. PERSONAL TAXATION

A. *Income tax rates*

Currently, resident individuals are subject to income tax on a graduated scale ranging from four to 35 percent. With effect from the year of assessment 1993, the income tax rates will be lowered. The rates will range from two to 34 percent. This is in line with the general reduction in tax rates. The reduction of the maximum tax rate to 34 percent is in line with the proposed corporate tax rate and will negate any advantage of sheltering personal income through a corporate body.

The rebate of M$ 60 for a resident individual and M$ 30 for a wife will continue to be given to those having chargeable income not exceeding M$ 10,000.

In line with the reduction in tax rates; the income tax rate will be lowered to 34 percent in respect of a non-resident individual, a trust body, an executor of an estate of a deceased individual who was domiciled outside Malaysia at the time of his death, and a receiver.

B. *Contribution to EPF*

As stated earlier, the contribution by an employee will be increased by one percent to ten percent with effect from 1 January 1993. This enforces compulsory savings and is intended to curb inflation. However, with the reduction in income tax rate, the net effect on disposable income is not significant. It would

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have been more equitable to have increased the personal relief in respect of contributions to EPF and insurance premiums.

C. *Exemption of interest on bonds*

Currently, interest income earned by individuals in respect of securities or bonds issued by the Government, and bonds (other than convertible loan stock) issued by public companies listed on the Kuala Lumpur Stock Exchange (KLSE) is exempt from income tax.

It is proposed that, with effect from the year of assessment 1993, interest earned by individuals from bonds (other than convertible loan stocks) issued by companies not listed on the KLSE but rated by Rating Agency Malaysia Berhad (an independent credit rating agency) will also be exempted from income tax. It is also proposed that, with effect from 30 October 1992, all such interest paid to non-resident individuals will not be subject to withholding tax.

The proposed change reflects the continuing effort by the Government to promote savings by individuals and to develop the corporate bond market. A developed bond market will lead to a financial system that is more flexible and diversified and will assist the private sector to raise capital for investment. The exemption of interest for non-resident individuals will attract capital inflow into Malaysia's bond market and develop the domestic capital market.

Furthermore, it is also proposed that savings bonds up to M$ 1 billion would be issued by Bank Negara Malaysia (the Central Bank of Malaysia) to individuals and institutions. This will further increase investment opportunities for such persons.

D. *Exemption for scientists, writers and artists*

Currently, cash awards received by scientists, writers and artists are subject to tax. It is proposed that, with effect from the year of assessment 1993, all official cash awards received by scientists, writers and artists be exempt from income tax. This exemption is intended to further motivate efforts to develop knowledge, culture and creativity so as to produce more original and quality works as well as new scientific and technological discoveries which will enrich our heritage.

E. *Cash award in lieu of leave for public servants*

Currently, sums received by way of gratuity paid out of public funds on retirement from an employment under any written law are exempt from income tax. Cash payments received by public servants on retirement on conversion of unutilized leave are subject to income tax. With effect from the year of assessment 1993, cash awards paid out of public funds (in lieu of leave) to such employees will be tax exempt. The above proposal applies only to employees in the public service.

IV. INDIRECT TAXATION

A. *Reduction/Abolition of import duties*

With effect from budget day, the import duties on about 600 items were either reduced or abolished. This is part of an ongoing process over the past four years to review the level of tariff protection and to focus on the efficiency and competitiveness of the manufacturing sector. With the reduction, it is hoped that the prices of imported consumer goods in the domestic market will be lowered. Besides combating inflation by lowering prices of consumer goods and increasing competitiveness of local manufacturers, the changes are also in line with the trade liberalization measures proposed under the GATT negotiations and the commitment towards implementing the Common Effective Protection Tariffs Scheme under the proposed ASEAN Free Trade Area arrangement.

The above changes will involve a revenue loss of about M$ 369 million to the Government.

B. *Increase in import duties/excise duties*

As part of the Government's continuing efforts to discourage smoking and consumption of alcohol, import duties and excise duties were increased as follows with effect from Budget day:

Item	Import duty increase	Excise duty increase
Cigarettes	M$27 per kg.	100%
Beer, stout and other alcoholic beverages	15%	30%

Through this increase, additional revenue of M$ 344 million is expected.

C. *Expansion of scope of service tax*

Currently, service tax of five percent is charged on and paid by any person who carries on the business of providing taxable services or selling or providing taxable goods either in any prescribed establishment or prescribed professional establishment. With effect from 1 January 1993, service tax will be extended to cover the additional prescribed professional establishments and prescribed services shown below:

(1) *Prescribed professional establishments*
- estate agents who are licensed or registered under the relevant laws in force for the time being, excluding estate agents having an annual sales turnover of less than M$ 300,000 of prescribed services;
- companies, firms and sole proprietors dealing in or providing telecommunication services;
- private agencies licensed under the Private Agency Act, 1971, excluding private agencies having an annual sales turnover of less than M$ 150,000 of prescribed services.

(2) *Prescribed services*
- provision of all types of surveying services normally provided by the surveyors, including valuation, appraisal, estate agency and professional consultancy services;
- provision of sports and recreational services by private clubs, including the entitlement to use such services by club members for which membership subscription fees are charged;

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- provision of telecommunication services in the form of telephone, facsimile, telemail, paging, cellular phone and telex by companies, firms and sole proprietors dealing in or providing telecommunication services;
- provision of guards and protection for the personal safety and security of another person or for the safety and security of the property or business of such other person by private agencies licensed under the Private Agency Act, 1971.

The above proposals are a continuation of the widening of the service tax base which commenced on 1 January 1992. This extension is estimated to bring in about M$ 180 million in revenue to the Government.

The proposals with regard to charging service tax on telecommunication services will affect most businesses and will be a significant source of revenue for the Government. The expanded service tax base is a prelude to the introduction of a comprehensive consumption tax through the intended integration and restructuring of the existing sales and service taxes into the Sales and Service Tax (discussed below).

D. *Sales and service tax*

In the 1989 Budget, the Government announced its intention to introduce value added tax (VAT) to overcome inherent weaknesses in the sales tax system as well as to expand the revenue base. Since then, service tax has been extended and the broadening of the scope of service tax was seen as laying the foundation for the eventual introduction of VAT. Among ASEAN countries, Indonesia (1985), Philippines (1988) and Thailand (1992) have introduced a VAT system. As a consumption tax, VAT provides a stable source of revenue which should be less sensitive to economic fluctuations than direct taxes.

In order to increase revenue commensurate with the growth in the economy and to overcome several weaknesses in the present structure of sales and service taxes, e.g. tax pyramiding, the narrow base of sales tax, multiple taxation of certain goods, transfer pricing, bias towards imports and other abuses, the Government announced the intention of integrating and restructuring the existing sales tax and service tax into a consolidated tax to be called the Sales and Service Tax (SST).

The proposed features of the SST are as follows:
- the SST will be imposed on the sales of a firm and a credit will be allowed for SST on inputs of production;
- the SST rate will not be more than ten percent;
- exports will be zero-rated (i.e. the exporter can claim a credit in respect of the inputs on which the SST has been imposed);
- in order to avoid burdening the lower income group, several essential goods and services will be exempted from SST;
- a threshold level will be set to exempt small enterprises from charging and accounting for SST;
- the invoice method will be used;
- it will be a multi-stage tax.

For all ends and purposes, the SST is a form of VAT despite the effort to make it look different. As a tax on consumption, it is also expected to stimulate greater savings and investments.

It is encouraging to note that the Ministry of Finance will consult all relevant parties before implementing the SST. Meanwhile, the Royal Customs and Excise Department will be strengthened. It is understood that the Department will complete its computerization programme in 1995. No indication was given about when SST would be implemented. Normally, a substantial lead-in time is needed before such a tax is implemented.

Some of the aspects that must be looked into before implementing the SST are:
- the scope/coverage of tax,
- exemptions for small businesses,
- impact on the general price level,
- education of the public,
- training of the officers involved in the implementation,
- effective computerization,
- the treatment of exports,
- transitional provisions arising from the changeover to the SST.

Malaysia should be able to have an effective and efficient SST system if similar systems in other countries are studied thoroughly.[3]

E. *Stamp duty*

Stamp duty is levied on instruments of transfer of property under Item 32(a) Schedule I of the Stamp Act, 1949 at the following rates:
- one percent on the first $ 100,000 of the amount of the money value of the consideration or the market value of the property, whichever is the greater;
- two percent on the amount in excess of the $ 100,000.

With effect from 1 January 1993, stamp duty is increased to a maximum of four percent as follows:
- one percent on the first $ 100,000;
- two percent on any amount in excess of $ 100,000 but not exceeding $ 500,000;
- three percent on any amount in excess of $ 500,000 but not exceeding $ 2,000,000;
- four percent on any amount in excess of $ 2,000,000.

The proposed amendment seeks to levy stamp duty at progressive rates on transfer of property. However, the imposition of higher duty will not burden the general public as only properties valued above $ 500,000 will be affected. It is expected that the Government will earn additional revenue of about M$ 120 million from this change.

It is proposed that with effect from 1 January 1993, the dates on which the market value of property transferred by way of gift, settlement or sale is to be determined would be as follows:

3. For further details on the issues that must be looked into before introducing a broad-based consumption tax or VAT in Malaysia, see Veerinderjeet Singh, *Malaysian Taxation: Administration & Technical Aspects*, Longman, 1992.

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Situation	Date for determining the market value
Settlement or gift	Date of execution of the instrument of trust or settlement or gift
Transfer implementing a sale under a duly stamped agreement of sale and purchase	Date of execution of such agreement
Transfer of any property granted by a statutory body, a local authority or any cooperative society registered under any laws relating to cooperative societies	Date when the final terms of transfer had been communicated to the transferee, and in the case of subsequent resale of that property, the date of consent by the statutory body or local authority or the board of the cooperative society for that resale
Transfer under a duly stamped sale and purchase agreement where financial arrangements have been made in accordance with the Syariah	Date of execution of such agreement
In any other cases	Date of execution of the instrument of transfer

Any banker, stockbroker or insurer authorized by the Minister of Finance has to pay on 1 January and on 1 July in each year to the Collector of Stamp Duty, the amount due and collected thereon as duties on unstamped cheques, contract notes or policies of insurance. No penalties, however, are specified for late payment of such duties.

The Finance (No. 2) Bill 1992 seeks to provide (with effect from 1 January 1993) a deadline of eight days from each specified date for the authorized banker, stockbroker or insurer to remit the stamp duty due to the Collector, failing which a penalty of $ 500 or ten percent of the amount due, whichever is the greater, will be imposed.

The proposed amendment seeks to ensure timely settlement of stamp duty by an authorized banker, stockbroker or insurer.

V. OTHER CHANGES

A. *Export rebate scheme on agricultural products*

This scheme was introduced in 1987 to encourage the export of agricultural products and penetration into external markets. Under this scheme, exporters of agricultural products are given an export rebate based on a certain formula.

With effect from 31 October 1992, this scheme has been withdrawn. This scheme has contributed towards a shortage of agricultural products in the domestic market thus aggravating inflationary pressures.

B. *Fund for food production*

The increase in food prices appears to be highest compared to other categories in the Consumer Price Index. The Government has decided that stronger efforts be made to increase food production.

A fund for food production will be set up (by Bank Negara Malaysia and chanelled through all commercial banks) to provide credit facilities to finance the cultivation, production and distribution of food. The object of this fund is to increase food production and supply. This fund will have a capital of M$ 300 million and will lend at a fixed interest rate of 7.75 percent per annum for a period of five years.

C. *Shipping Fund*

A M$ 800 million Shipping Fund is to be established out of which M$ 500 million will be used for new investments in the shipping industry. The purpose of the fund is to encourage new entrepreneurship and to provide long-term financing of up to ten years to existing entrepreneurs in the industry at reasonable interest rates.

As a further measure to improve shipping capacity, the import duty on vessels exceeding 26 gross tonnage has been abolished.

D. *Housing Loan Facilities*

As a measure to ensure that banks and financial institutions give priority to the provision of housing loans for medium and low-cost houses so that the public has access to such facilities, the current ceiling rate of nine percent for housing loans below $ 100,000 is retained.

As an incentive to continue the loan scheme, the Government will provide an interest subsidy of one percent to the banks and financial institutions.

E. *Human Resource Development Fund*

The establishment of a Human Resource Development Fund was announced in 1991 to finance training of labour and upgrading of labour skills. To launch the Fund, the Government has allocated M$ 16.3 million to the Fund for 1993 and will make contributions for the next two years. The private sector is expected to match this contribution. From 1996, the Fund will be financed wholly by contributions from the private sector.

F. *Corporatization of the Inland Revenue Department*

It was announced that the Government is studying the possibility of corporatizing the Inland Revenue Department to promote a more effective machinery for the collection of revenue. It is hoped that if this move materializes, it would result in a better work culture, greater efficiency and a faster response time in attending to objections and appeals by taxpayers.

G. *Zakat*

Currently, the collection of a Zakat (an obligatory payment by persons of the Muslim faith) is managed separately by the various religious authorities of the States and the Federal Territories.

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To avoid overlapping of Zakat and existing taxes, the Government is considering the collection of the Zakat to be coordinated through the Inland Revenue Department and to be distributed to States based on an agreed formula.

VI. RECENT DEVELOPMENTS

A. *Reinvestment allowance*

The Inland Revenue Department has issued guidelines and forms to facilitate the processing of a claim for reinvestment allowance (under ITA Schedule 7A). The guidelines provide the following additional information:

(1) meaning of the terms "expansion, modernization and diversification":
   (a) expansion: increase in production capacity;
   (b) modernization: where manufacturing equipment and processing are upgraded resulting in greater efficiency in production, quality improvement of product and/or reduction in costs; and
   (c) diversification: where additional/related products within the same industry are being manufactured, e.g. a manufacturer of household/industrial gloves diversifying into the production of surgical gloves.

(2) excluded capital expenditure – expenditure on replacement of machine parts will not be considered unless it can be shown that such expenditure would result in the expansion, modernization or diversification of the existing business.

The acknowledgement letter from the Malaysian Industrial Develop-ment Authority which was previously required, is no longer necessary for the purposes of reinvestment allowance.

B. *Venture capital companies*

The venture capital incentive was introduced in 1989 via ITA Section 60D and was amended in 1992. A venture capital company (VCC) which holds shares in a venture company (VC) involved in high risk ventures or new technology enjoys this incentive.

It was not until recently that the guidelines and application form relating to this incentive were finalized by the Ministry of Finance. The guidelines outline the qualifying criteria of a VCC and provide clarifications as to what constitutes "new technology" and "high-risk ventures".

Some salient features of the guidelines include:

(1) the funds of the VCC should have a seven to ten year lifespan and should be invested in VCs on a medium to long-term basis, i.e. from three to eight years;
(2) the funds of the VCC should be from individual or corporate investors and the amount invested in each VC should not be less than M$ 0.5 million;
(3) no more than ten percent of the funds of a VCC should be invested in one single company and also not more than 25 percent of its funds should be invested in one industry.

"New technology" refers to incremental improvements in existing processes and products and the use of technologies which are new to Malaysia even if these technologies are technically mature and commonly used elsewhere. New technologies refer to emerging technologies such as:

(i) automated manufacturing technology,
(ii) advance material technology,
(iii) biotechnology,
(iv) electronics,
(v) information technology, and
(vi) renewable energy technology.

"High risk ventures" include ventures which encounter risks over and above those experienced by more traditional small and medium enterprises. In general, the ventures would incorporate the following characteristics:

- high investment cost/capital investment,
- new project/product,
- new market,
- long gestation period,
- specialized skills/trained manpower,
- specific location,
- specific equipment,
- lack of or no Government protection,
- highly competitive,
- highly classified.

The Ministry of Finance is the approving authority and he will decide as to whether the VC is involved in any high risk venture or new technology.

C. *Research incentives*

The Minister of Finance has issued guidelines on the research incentives available under Section 34B (i.e. approved research company/institute and a new technology-based firm). It sets out the criteria to be met by an approved research company/institute which includes:

- wholly carrying out research work and commercially exploiting the benefit of such research;
- doing research in new emerging, advanced or high technology;
- the company should have a minimum paid-up capital of M$ 500,000;
- carrying out research in any area of the Industrial Technology Development plan or other approved fields;
- being allowed to employ foreign researchers provided there is a training programme for locals to gain the skills related to the relevant industry.

The above criteria would also apply to private research institutes. In the case of a public research institute, the only criterion is that the research institute must be administered by public funds.

A new technology-based firm is defined as a company engaged in the development or commercialization of technological innovations in fields designated as new and emerging technologies. Twenty percent of the workforce should be technological professionals and the research expenditure should exceed four percent of its turnover. New technology-based firms should have shareholders' funds of more than M$ 500,000 and there should be at least 50 percent local equity participation by the end of the third year.

[continued on page 43]

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HONG KONG:

THE PRIVY COUNCIL WANDERS IN THE WILDERNESS

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Contents

I. Introduction
II. The *Sinolink* Decision
III. The *Hang Seng Bank* Case
IV. The *TVD* Case
V. The Privy Council's Decision
VI. Is the Privy Council Out of Touch?
VII. The Commissioner's Practice Note

I. INTRODUCTION

Hong Kong imposes a 17.5 percent tax on corporations that carry on business in Hong Kong and earn profits that arise in or derive from Hong Kong.[1] Profits arising outside Hong Kong are not subject to tax. This territorial tax system, a relic of Hong Kong's colonial past, has given Hong Kong the reputation of a tax haven and helped to attract thousands of foreign investors to the territory. Unlike other jurisdictions that impose no tax on corporate profits from offshore business, Hong Kong is a major centre of international trade and finance. Therefore, when questions arise as to how to distinguish between onshore and offshore profits for Hong Kong tax purposes, the stakes are quite high.

For many years, there was little doubt, in most cases, about whether a Hong Kong taxpayer's profits arose onshore or offshore. In the few court cases that had been decided prior to 1985, the Hong Kong courts had taken the common sense approach of asking whether the profits arose from business done in Hong Kong. Thus, for example, it was held that Hong Kong tax applied to commission income earned by a Hong Kong-based ship broker that earned the commission by arranging a charter party between its offshore customer and an offshore shipowner solely by means of telecommunications with the parties from its Hong Kong office.[2] In another case, it has held that a profit derived from salvaging a disabled vessel on the high seas arose offshore, because the services were rendered offshore (literally!)[3] A third decision held that commissions received by a Hong Kong company that was a mere "letter-box" company administered by an accounting firm in Hong Kong arose offshore because all of the economic activity that produced the commissions – namely, the making of the agency and sub-agency agreements and the relevant selling activities by sub-agents – occurred outside Hong Kong.[4]

II. THE SINOLINK DECISION

In 1985, the Hong Kong High Court decided a case in a manner that caused many Hong Kong traders and their tax advisors to wonder whether Hong Kong tax might now be applied to profits derived from business done *outside* Hong Kong. The case, *Commissioner of Inland Revenue v. Sinolink Overseas Limited*,[5] involved profits earned by a Hong Kong-based company which bought goods from a European supplier and sold the goods to customers in China. It was alleged that employees of the company travelled to China where they negotiated and concluded the contracts of sale, although the judge was not satisfied on this point. The goods were shipped directly to the Chinese buyers by the European supplier.

The court held that, in the absence of convincing proof that anything of substance was done by the taxpayer offshore to earn the profits, the source of the profits was the taxpayer's Hong Kong operation.

Hong Kong tax practitioners were alarmed by the *Sinolink* decision, not so much because of the result in the case, but because of the court's analysis of the facts in determining where the profits arose. The court clearly was focusing on the taxpayer's *overall* base of administration in Hong Kong, rather than on where the particular sales transactions had been effected. This approach was a departure from the standard analysis of the issue, which was to ask where the business was done which produced the particular profits in question, regardless of where the taxpayer's other operations (including its administrative centre) might be located. The consequences of taxation based on the taxpayer's headquarters or general operations being in

1. Sec. 14, Inland Revenue Ordinance (Laws of Hong Kong, Cap. 112) (hereinafter "IRO").
2. *CIR v. Karsten Larssen & Co. (HK) Ltd.* (1951) 1 HKTC 11.
3. *CIR v. The Hong Kong & Whampoa Dock Co. Ltd.* (1960) 1 HKTC 85.
4. *CIR v. International Wood Products Ltd.* (1971) 1 HKTC 551.
5. (1985) 2 HKTC 127.

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Hong Kong would be severe, because Hong Kong's tax law generally does not provide a foreign tax credit or an exemption for foreign-taxed profits.[6]

III. THE HANG SENG BANK CASE

There ensued, between 1988 and 1992, a confusing series of court decisions on the question of locality of profits. [7] Two of these decisions were rendered by the Privy Council in London, which is Hong Kong's court of last resort. The first case to reach the Privy Council was *Commissioner of Inland Revenue v. Hang Seng Bank Limited.*[8] The facts of the case were well suited to test whether one should look at the taxpayer's overall operations as opposed to particular transactions in determining where the taxpayer's profits arise. Hang Seng Bank's operations were almost entirely in Hong Kong. The bank's internal investment division had made investments in securities, through independent brokers in London and Singapore. The securities were purchased and sold by the brokers, on behalf of the bank, in the London and Singapore securities markets, pursuant to instructions received from bank officers in Hong Kong. The profits from these purchases and sales were at issue in the Privy Council.

The Privy Council, in an opinion by Lord Bridge, decided that the profits had arisen outside Hong Kong. Lord Bridge began his analysis by stressing the territorial nature of the statutory charge to Hong Kong profits tax, reaffirming that a Hong Kong-based business can indeed earn profits from its business which arise outside Hong Kong and therefore are not subject to tax.[9] He then noted that the locality of a taxpayer's profits must be determined on a transaction-by-transaction, gross-profits basis. [10] Then he stated:

> The question whether the gross profits resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in any activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.[11]

Clearly, Hang Seng Bank's purchases and sales of securities were effected outside Hong Kong by the brokers in London and Singapore. Therefore, the bank's profits from those transactions were not taxable in Hong Kong.

IV. THE TVB CASE

The Hong Kong tax community praised the Privy Council for clarifying the issue of whether one should look at overall operations or particular transactions in determining where a Hong Kong-based taxpayer's profits arise. The effect of the Privy Council's decision was first seen in a decision of the Hong Kong Court of Appeal in 1991. The case was Commissioner of Inland *Revenue v. HK-TVB International Limited.*[12] The taxpayer (TVBI) was a Hong Kong-based company earning royalty income from sub-licensing to offshore parties the right to exhibit copyrighted films and television programmes outside Hong Kong. TVBI had acquired from the copyright owner (its parent company) the exclusive right to exhibit the films and other programmes outside Hong Kong. Employees of TVBI travelled to various countries where they negotiated sub-licensing agreements. Most of these agreements were concluded by both parties' signing the agreement in the sub-licensee's country; a minority of the agreements were concluded by TVBI's signing the agreement in Hong Kong and sending it to the licensee who then signed in its own country. The films or tapes were sent to the sub-licensees from TVBI's office in Hong Kong, and periodic fixed-fee payments were sent by the sub-licensees to TVBI in Hong Kong.

The tribunal of first instance (the Inland Revenue Board of Review) had found that TVBI's profits arose offshore, on the ground that the profits arose from the exploitation of intellectual property rights that were exercisable only offshore.[13] This decision was reversed by the High Court, which held that TVBI had earned its profits from business that was done "in and from" its base of operations in Hong Kong.[14] (Remember that the High Court was writing prior to the Privy Council's decision in the *Hang Seng Bank* case.) TVBI appealed to the Court of Appeal, which had the benefit of the Privy Council's authoritative decision in *Hang Seng Bank* to guide it in deciding TVBI's case.

The Court of Appeal held that TVBI's profits had arisen offshore, saying "the profit making activity was carried on and the services, being the provision of the rights, were rendered outside Hong Kong".[15] Alternatively, said the Court of Appeal, the profits could be viewed as arising outside Hong Kong because the licensed rights could be exercised only outside Hong Kong.[16]

The Commissioner of Inland Revenue appealed to the Privy Council. In the meantime, the Commissioner announced that he was preparing a statement of departmental practice regarding the determination of where profits arise in various

6. IRO Sec. 45 provides relief in respect of income taxes levied by a number of Commonwealth countries, none of which are major trading partners of Hong Kong. In addition, foreign taxes are generally deductible under IRO Sec. 16(1) if paid in respect of profits subject to tax in Hong Kong.
7. *Bank of India v. CIR* (1988) 2 HKTC 503; *CIR v. Hang Seng Bank Ltd.* (1989) 2 HKTC 614; *Exxon Chemical International Supply SA v. CIR* (1989) 3 HKTC 57; *CIR v. HK-TVB International Ltd.* (1990) 3 HKTC 301; *CIR v. Hang Seng Bank Ltd.* (1990) 3 HKTC 351 (PC); *CIR v. HK-TVB International Ltd.* (1991) 2 HKLR 215 (CtApp); (1992) Privy Council Appeal No. 28 of 1991, 1 HKRC para. 90-064 (CCH). See also J.P. VanderWolk, "Hong Kong Taxation of Profits from International Business: Recent Cases", 44 *Bulletin for International Fiscal Documentation* (July 1990), at 340.
8. (1990) 3 HKTC 351.
9. *Id.* at 355.
10. *Id.* at 356
11. *Id.* at 360.
12. (1991) 2 HKLR 215.
13. Case No. D52/88, 4 IRBRD 1.
14. (1990) 3 HKTC 301.
15. See *supra* note 12, at 218.
16. *Id.*

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circumstances, but that he would not issue the statement until after the Privy Council's decision in the *TVB* case.

This raised the stakes somewhat in respect of the upcoming decision, which most observers thought would be a rather unexciting affirmation of the Court of Appeal's holding in favour of TVBI.

V. THE PRIVY COUNCIL'S DECISION

In July 1992, the Privy Council handed down its decision in the *TVB* case, and it was a shocker. [17] In an opinion authored by Lord Jauncey (the only member of the *TVB* panel who was also on the panel that decided the *Hang Seng Bank* case), the Privy Council held that TVBI's profits had arisen in Hong Kong. Lord Jauncey referred to the *Hang Seng Bank* analysis set out above, and said:

> The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place. Adopting this approach, what emerges is that TBVBI, a Hong Kong-based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers. The relevant business of TVBI was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee. Their Lordships therefore consider that the profits accruing to TVBI on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under section 14.
>
> In the view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance.[18]

This passage appears to disregard entirely the fact, found by the Inland Revenue Board of Review, that TVBI's sub-licensing agreements were negotiated and often concluded outside Hong Kong. Rather, Lord Jauncey seems to have focused on the fact that TVBI's base of operations was in Hong Kong. The *other dictum* regarding "rare cases" in which Hong Kong tax is not payable bodes ill for Hong Kong business, which, if the dictum proves to be accurate, will often be subject to double taxation of their profits (as TVBI surely was, having undoubtedly suffered withholding taxes on its royalty income), since Hong Kong has no foreign tax credit mechanism and no exemption for foreign-taxed profits.

In addition, the Privy Council rejected the Court of Appeal's alternative ground, namely that TVBI earned its profits by exploiting property that was located outside Hong Kong. The Privy Council said that this view "erroneously presupposes that the rights in question had a fixed situs outside Hong Kong".[19] It was conceded that profits from the exploitation of real property located outside Hong Kong would necessarily arise outside Hong Kong, but any analogy between real property and intellectual property was said by the Law Lords to be "a false analogy".[20] No reasons were given, however, in support of these statements. It is difficult, if not impossible, to imagine what the reasons could be.

Intellectual property rights which can be exercised only in a stated jurisdiction are inextricably tied to that jurisdiction; they do not exist anywhere else. Thus the Privy Council's statements in this regard can only be described as baffling.

The *TVB* decision therefore has undone much of the work of Lord Bridge in his opinion in *Hang Seng Bank*. The scope of Hong Kong's profits tax remains unclear. The Privy Council's analysis raises interesting questions about the taxability of foreign investors in Hong Kong who have their base of operations elsewhere. Can foreign licensors now receive royalties from Hong Kong licensees free of withholding tax?[21] Will foreign-based businesses be able to sell goods in Hong Kong free of Hong Kong tax? After all, if Hong Kong-based businesses' profits arise entirely in Hong Kong due to their Hong Kong operations, then foreign-based businesses' profits should arise entirely offshore.

VI. IS THE PRIVY COUNCIL OUT OF TOUCH?

It has been suggested that the Law Lords in London do not fully comprehend the nature of business activity in Hong Kong, which results in inappropriate decisions in Hong Kong tax cases. [22] The dictum in the *TVB* opinion regarding "rare cases" in which profits arise outside Hong Kong supports this notion. It has been pointed out in a recent article that the Privy Council's statements regarding the frequency with which Hong Kong-based taxpayers might derive offshore income were "unfortunate" and "widely contrary to practice".[23] The same writer notes that counsel representing both TVBI and the Commissioner of Inland Revenue in the Privy Council practise almost exclusively in London, the implication being that counsel were unable to enlighten their Lordships as to the true state of affairs in Hong Kong.[24]

It is also worth noting that only one of the Law Lords who judged the *Hang Seng Bank* case was on the panel that judged the *TVB* case. This lack of continuity in personnel was almost certainly a factor in the lack of continuity in the Privy Council's approach to the legal issue before it.

VII. THE COMMISSIONER'S PRACTICE NOTE

As he had promised, the Commissioner of Inland Revenue issued a statement of practice following the *TVB* decision. The document, entitled, *Departmental Interpretation & Practice Notes No. 21 – Locality of Profits* and dated November 1992, restates the general principles enunciated

17. (1992) Privy Council Appeal 28 of 1991, 1 HKRC para. 90-064 (CCH).
18. 1 HKRC, at 100, 542.
19. *Id.*, at 100, 543.
20. *Id.*, at 100, 541.
21. IRO Sec. 15(1)(a) impose Hong Kong tax on offshore licensors receiving payments from Hong Kong licensees. The rhetorical question in the text merely highlights the double standard that now prevails after the *TVB* decision.
22. See A.J. Halkyard, "The Privy Council in Toyland (Beautiland)", 9 *APTIRC Bulletin* 387 (November/December 1991), at 389.
23. P. Willoughby, "Hong Kong: Source of Profits-Again!" (unpublished manuscript), at 3.
24. *Id.*

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by the Privy Council in the *Hang Seng Bank* decision and then outlines the Commissioner's view of how the principles apply to particular types of income. Surprisingly, royalties are not discussed.

The practice note is a peculiar document. The general rules for determining where profits arise are drawn from the *Hang Seng Bank* case (although no distinction is made between income from activity and income from property) and thus are unassailable. The Commissioner's applications of the rules, however, are sometimes inconsistent with the general principles. For example, the Commissioner states that he will view all of the profits from a purchase and sale of goods as arising in Hong Kong if either the purchaser or the sale of the goods was negotiated and concluded in Hong Kong. Clearly, it is theoretically impossible for all of the profits to arise from both the place of purchase and the place of sale, because they might be different places.

The practice note also suffers from ambiguous language concerning the locality of profits arising in the context of common business arrangements in Hong Kong, such as the use of a Hong Kong company for reinvoicing within a multinational corporate group, and the use of contract manufacturers in China to produce goods under a processing agreement. Thus, although the Commissioner is to be praised for rejecting the "base of operations" approach to determining where profits arise, his practice note appears unlikely to clarify the tax exposure of Hong Kong businesses with international operations in many cases.

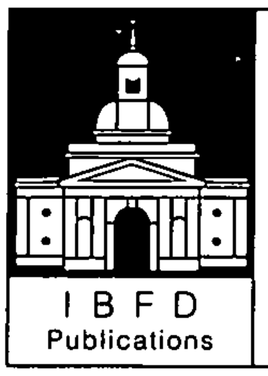
Only time will tell what the outcome of the current confusion is. Whatever course the Commissioner's practice ultimately takes, it seems likely that further litigation will ensue, as more and more Hong Kong-based businesses are investing their resources in China and elsewhere outside Hong Kong.

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INDIA:

RECENT COURT DECISION AFFECTING NON-RESIDENTS

Har Govind

INTRODUCTION

The first appellate authority under the Indian Income Tax Act 1961 ("ITA") is either the Deputy Commissioner (Appeals) or the Commissioner (Appeals).[1] Broadly speaking, appeal lies to the Deputy Commissioner (Appeals) where the order under appeal is imposed by the Income Tax Officer or the Assistant Commissioner on a non-corporate taxpayer. It lies to the Commissioner (Appeals) where the appellant is a company, where the order is imposed by, under the direction of or with the approval of the Deputy Commissioner, or where the assessment is made by an Income Tax Officer or Assistant Commissioner and the amount of income assessed or loss computed exceeds 100,000 Rs.

Either party is entitled to a further appeal to the Appellate Tribunal from a decision of the Deputy Commissioner (Appeals) or the Commissioner (Appeals).[2] Decisions of the Appellate Tribunal can be appealed to the High Court by the taxpayer or the Commissioner of Income Tax.[3] The Tribunal is the final fact-finding authority, and an appeal from its decision is only permitted on questions of law, not questions of fact. A final appeal only on questions of law lies to the Supreme Court of India.[4]

A recent High Court decision is of general interest to international readers. A well-recognized legal position in many countries is that in the case of a conflict between the provisions of domestic tax law and the provisions of a tax treaty, the provisions of the latter prevail. In *Commissioner of Income Tax v. Davy Ashmore India Pvt. Ltd.*,[5] the Revenue authorities attempted to alter this rule, by contending that in cases of inconsistency, the provisions of the ITA prevail over treaty provisions.[6] The High Court rejected the Revenue's arguments.

FACTS

The assessee, an Indian company, Davy Ashmore India Ltd. ("DA"), received a letter of intent from another Indian company, Light Metal Industries Ltd ("LM"), for the maintenance and supply of terminal equipment for a second-hand cold-rolling mill being imported by LM from a non-resident UK company, Davy Makes (Pools) Ltd. ("DM"). A purchase order was also issued by LM whereby DA was to arrange for the import of concept designs and drawings to enable LM to prepare the detailed manufacturing drawings for terminal equipment which was to be supplied by DA.

Upon receipt of the purchase order and the letter of intent, DA placed an order with DM for the supply of one print each of the concept designs and drawings for the terminal equipment. The letter of intent specifically stated that the purchase price was to be made by bank remittances in favour of DM, subject to the approval of the Reserve Bank of India, and that the concept designs and drawings would be imported by DA upon approval of the Ministry of Industries for lump-sum payment of £ 36,470, net of taxes. The assessing officer concluded that the payment of £ 36,470 made to the non-resident company DM was taxable as "royalty" income within the meaning of Explanation 2 to ITA Section 9(1)(vi). Accordingly, he applied tax at the rate of 20 percent to £ 36,470 and demanded the tax from DA, treating it as an agent of the non-resident company DM. DA appealed to the Commissioner of Income Tax (Appeals).

Mr Govind holds a Master's Degree in science and a Bachelor's Degree in law. He is former Chief Commissioner of Income Tax in New Delhi. Mr Govind currently practices as an advocate at the Supreme Court of India, New Delhi. He was the UN Consultant on taxation to the government of Iraq. He was also Director of Investigation, Monopolies Commission. Mr Govind contributes articles on a regular basis to various international law journals.

Contents

Introduction
Facts
Decision of lower appellate authorities
Issues
National law
Treaty law
High Count decision
Comment

1. Sec. 246. Unless otherwise stated all references are to the ITA.
2. Secs. 250 and 253. The assessing officer, however, may only appeal to the Tribunal under the direction of the Commissioner of Income Tax.
3. Sec. 256.
4. Sec. 261. The questions of law are framed by the Tribunal at the request of the parties or at the direction of the Court.
5. 190 ITR 626 (Calcutta).
6. The decision does not disclose any cogent reasons advanced by the Revenue in support of its argument that domestic law prevails over treaty provisions. According to the Revenue, the definition of the term "royalty" in the ITA was broader than the definition of the term under the India–UK tax treaty. By raising this argument, the Revenue perhaps wanted to make this a test case to collect a higher amount of tax.

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DECISION OF LOWER APPELLATE AUTHORITIES

On appeal, the Commissioner (Appeals) took the view that the transfer as approved by the government of India was merely for the import of designs and drawings from the non-resident against a lump-sum payment of £ 36,470. He further observed that an import licence was obtained under the import policy, and concluded that the payment to the non-resident company DM was not a payment in the nature of a royalty. The Tribunal confirmed the order of the Commissioner (Appeals). It recorded a finding that there was a transfer of drawings and designs to the assessee DA against a lump-sum payment of £ 36,470 which amounted to an outright sale. The Tribunal held that the payment of £ 36,470 could not be taxed under Explanation 2 to ITA Section 9(1)(vi).

ISSUE

From the order of the Tribunal the following question of law was referred to the High Court at Calcutta: "Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was correct in law in holding that the payment of £ 36,470 made by the assessee company to the foreign party as consideration for outright sale of drawing and design was not "royalty" exigible to tax under the IT Act?"

NATIONAL LAW

The term "royalty" is defined in Explanation 2 of ITA Section 9(1)(vi) as follows:

> For the purposes of this clause, "royalty" means consideration (including any lump-sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head, "capital gains") for:
> (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
> (ii) the imparting of any information concerning the working, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
> (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;
> (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
> (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or
> (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (v).

TREATY LAW

The term "royalty" is also defined in Article XIII(3) of the double taxation agreement between India and the United Kingdom as follows:[7]

> The term "royalties" as used in the Article means payment of any kind including rentals received as consideration for the use of, or the right to use:
> (a) any patent, trademark, design or model, plan, secret formula or process;
> (b) industrial, commercial or scientific equipment, or information concerning industrial commercial or scientific experience;
> (c) any copyright of literary, artistic or scientific work, cinematographic films, and films or tapes for radio or television broadcasting, but does not include royalties or other amounts paid in respect of the operation of mines or quarries or of the extraction or removal of natural resources.

A comparison shows that the two definitions are not the same. The differences in the definitions were dealt with at great length by the High Court.

HIGH COURT DECISION

The Revenue contended that the sale of designs and drawings by the foreign company was equivalent to a transfer of all rights concerning the designs and drawings, and the payment made to the non-resident company DM was in the nature of a royalty as defined in Explanation 2 to ITA Section 9(1)(vi) because that definition includes the *transfer of all or any rights* in technical know-how, i.e. designs and drawings. Accordingly, the tax was correctly levied by the assessing officer. The Revenue also argued that if there were any inconsistencies between the treaty and the ITA the ITA would prevail.[8]

The High Court dealt with the second contention first. It referred to the preamble to the treaty and pointed out that the charging provisions in ITA (Sections 4 and 5), defining "total income" of residents and non-residents, are subject to the provisions of the ITA, which include the double tax treaty entered into under ITA Section 90.

The terms of the treaty deviate from the general principles of taxation applicable to each country; if this were not the case the treaty would not be necessary. It therefore follows that in determining the liability of a non-resident company, if a treaty exists, it must prevail over provisions of domestic law.

The High Court further supported its view by referring to a 1982 Circular issued by the Central Board of Direct Taxes, concluding that the Circular reflected the correct legal position.[9] According to the Circular, where a treaty provides for a particular method for the computation of income, that method should be followed regardless of the provisions in the ITA. In the absence of a specific treaty provision, however, the ITA governs the taxation of income. But since the term royalty is defined in the India–UK treaty, Explanation 2 to ITA Sec. 9(1)(vi) has no application.[10]

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7. Notification 501/6/75-FTD dated 23 November 1981.
8. See *supra* note 6.
9. Circular 333 dated 2 April 1982, 137 ITR 1(St). The Revenue took the position before the High Court that the Circular was not binding on the High Court, and requested the Court to enunciate the correct law, i.e. that the provisions of the ITA should prevail over the tax treaty.
10. The Calcutta High Court also referred to a decision in the case of *CIT v. Visakhapatnam Port Trust*, 144 ITR 146, in which the Andhra Pradesh High Court, when considering the India–Germany tax treaty, held that in cases of inconsistency between the treaty and the ITA, the treaty prevails.

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The High Court next discussed the definition of the term "royalty" in the India–UK treaty. It observed that the term has been defined to mean, inter alia, the payment of any kind, including rentals received as consideration for the use or right to use any patent, trade mark, design or model, plan, secret formula or process (i.e. "know-how"). A careful reading of this definition shows that a payment may be treated as a royalty for treaty purposes if the owner of the know-how retains ownership of the know-how and merely permits the use or the right to use it. In other words, where the transferor retains a property right in the know-how and allows the use of such right, the consideration received is in the nature of a royalty. Where, however, there is an outright sale or purchase, the consideration is for the transfer of know-how and cannot be treated as a royalty. The High Court pointed out the difference between renting the know-how and an outright sale. In the present case, the High Court held that the non-resident company did not retain ownership of the know-how. Importing the know-how constituted an outright transfer or sale, so the consideration paid was not taxable as a royalty.

COMMENT

The non-resident company DM made an outright sale in the United Kingdom. It also received payment in the United Kingdom by bank transfer. The non-resident company had no permanent establishment in India as defined in Article V of the treaty. The payment was therefore not assessable as business income in India.

This decision has important application in all cases where there is a double taxation agreement with India. India currently has tax treaties with more than 50 countries. Non-resident companies will be well advised to ensure that when entering into technology transfer agreements with Indian companies, the transfer of the property in the know-how and the payments for the same are made outside the taxable territory of India to avoid taxation under other provisions of the ITA.

The relevance of this decision is that a judicial authority – the High Court – has rejected the Revenue's attempt to apply an extended definition to the term "royalty", as it appears in domestic law to a payment for an outright sale of know-how outside India. Under ITA, royalty income is deemed to be taxable in India regardless of the place of its accrual or receipt. Under the High Court decision, a payment for an outright sale of know-how outside India for which payment was also received outside India is not "royalty" income under the India–UK tax treaty. The treaty prevails over the provisions of ITA and the payment is not taxable in India. This decision is of special interest to non-residents because the provisions of the treaties are generally more favourable to them as compared to provisions of domestic tax law.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

JANUARY 1993

Tax Planning for International Treasury Operations in Europe, London (U.K.), 26-29 January (residential course) (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX (United Kingdom), Tel.: 44-71-7798601, Fax: 44-71-7798599.

FEBRUARY 1993

The new United States–Netherlands Tax Convention, New York, N.Y. (U.S.A.), 9 February (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam (the Netherlands), Tel.: 31-206267726, Fax: 31-206209397.

MARCH 1993

Corporate Taxation in the European Communities: Putting Theory into Practice, Maastricht (the Netherlands), 4-5 March (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam (the Netherlands), Tel.: 31-206267726, Fax: 31-206209397.

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NIGERIA:

1992 Reforms in Tax Structure and Policy[1]

Professor A.C. Ezejelue

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Contents

I. Introduction
II. Reforms in the Tax Structure and Policy
III. Changes in the Company Income Tax
A. Definition of profits chargeable to tax
B. Payment of tax by government-owned commercial enterprises
C. Claim of capital allowance on equipment leasing
D. Deductions and allowances
E. Rates of tax
IV. Changes in the Personal Income Tax
A. Minimum tax
B. Children allowance
C. Wife allowance
D. Fringe benefits
E. Tax rates
F. Withholding tax
G. Tax clearance certificates (TCC)
V. Other Tax Laws
A. Petroleum profits tax
B. Modified value added tax (MVAT)
C. Capital transfer tax
VI. Joint Tax Board
VII. General Administration
VIII. Conclusion

I. INTRODUCTION

The thrust of the 1992 budget is to consolidate the gains of the economic restructuring programme which are aimed at promoting greater efficiency, productivity and increased employment. Consequently, in the 1992 fiscal year, the government intends to follow policies which:

(a) curb the population growth rate;
(b) reduce the level of inflation to five percent;
(c) achieve a target real GDP growth rate of 4.6 percent;
(d) strengthen the relationship between the public and private sectors;
(e) focus on the creation of wealth;
(f) integrate the informal sector into the economic mainstream; and
(g) implement a balanced budget.

II. REFORMS IN THE TAX STRUCTURE AND POLICY

It is claimed that the structural adjustment programme (SAP) introduced in Nigeria in 1986 has transformed the national economy to a point where the private sector has become a very significant participant in economic activity. This transformation has helped to strengthen the relationship between the public and private sectors. The 1992 fiscal policy measures will embrace activities aimed at promoting the private sector as well as ensuring that the heavy dependence on oil as a single source of revenue is reversed. Accordingly, for the 1992 fiscal year government has built in some basic reforms in the tax system and administration, and these measures are the subject of this article.

The reforms to the personal and companies income taxes and the reform in the tax administration are sequel to the recommendations of a study group set up by government to review the entire tax structure and administration.

III. CHANGES IN THE COMPANY INCOME TAX

A. *Definition of profits chargeable to tax*

In order to show clearly that "royalty" is taxable, the word "royalty" will be expressly included in Section 8(1) Company Income Tax Act (CITA) which deals with the definition of profits chargeable to tax.

B. *Payment of tax by government-owned commercial enterprises*

Henceforth, the Federal Savings Bank and other banks operating as commercial enterprises, whether owned by the state or federal government, are required to pay tax and dividends like any other enterprise. This includes all privatized or commercial enterprises; in other words, all government enterprises engaged in any form of business activity must pay tax on such activities, notwithstanding that such enterprises were primarily established as not-for-profit or are themselves exempted from tax. Any balance of profits after tax is available for transfer to the owner-government.

C. *Claim of capital allowance on equipment leasing*

Due to the popularity of equipment leasing, and in view of the methods of accounting and recording adopted by the operators of leases, it became necessary to clarify

1. This paper draws from the press briefing of the Honourable Minister of Finance on the 1992 Budget Speech well as on the excerpt relating to the tax structure and administration prepared by the Federal Board of Inland Revenue Headquarters.

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the issue of who is entitled to claim the capital allowance. The lessee may claim the capital allowance in the case of "finance leases", while the lessor may claim it in "operating leases".

D. Deductions and allowances

1. Research and development (R&D) expenses

With respect to R&D expenses, only actual expenditure incurred during the year is henceforth allowed, putting to rest the previous arrangement which took effect from the 1989 fiscal year, whereby a reserve or general provision for R&D against profits was allowed. Under the current dispensation, R&D expenses may be capitalized and written off over a number of years if the R&D expenditure has long-term benefits.

2. Pioneer status relief

The pioneer status granted under the Industrial Development (Income Tax Relief) Act 1971 and administered by the Industrial Development Co-ordination Committee (IDCC) is to be refined, so that it will not only recognize the newness of the enterprise or its products, but also recognize and consider enterprises that are located in rural areas totally devoid of essential infrastructures, such as electricity, water, tarred roads and telephones. Henceforth, pioneer exemption from tax will be granted not only by a tax holiday, but also by tax relief for lack of infrastructural facilities, at rates ranging from five to 50 percent of the tax payable depending on the type of infrastructure.

To benefit from the relief the enterprise must be located at least 20 kilometres away from the infrastructural facilities. This relief, which is claimable for only three years, is available to companies that normally do not qualify for pioneer status, but which are established in rural areas where such facilities are lacking.

3. Rural investment allowance

Section 27 CITA grants an investment allowance in addition to the initial and annual allowances as follows:

- 25 percent of the expenditure incurred on a new asset as a replacement of a damaged or destroyed asset;
- 10 percent of the expenditure incurred on plant and equipment used in agricultural production.

With effect from fiscal year 1992, a rural investment allowance has also been introduced. This allowance which will be based on the capital expenditure incurred by enterprises established in rural areas will be granted to certain infrastructural facilities at rates ranging from five to 100 percent depending on the type of infrastructure.

E. Rates of tax

The following new rates of tax on companies profits are effective as from the 1992 fiscal year:

- flat rate for all companies: 35 percent
- small companies: 20 percent as in CITA, subject to a renewal for two years, provided that such small companies show evidence of good records and management and are engaged in activities considered to be in the preferred sectors of the economy as defined by government.

IV. CHANGES IN THE PERSONAL INCOME TAX

A. Minimum tax

To ensure that all income earners pay tax, the existing provision on minimum tax remains in force. In effect, an individual who earns ₦3,000 or less must pay a minimum tax of 0.5 per cent of income.

B. Children allowance

The children allowance previously set at ₦ 400 per child, subject to the maximum of four children, is increased to ₦ 500 per child.

C. Wife allowance

The wife allowance of ₦ 500 which was claimable only by a male individual with a dependent wife has been abolished, and the effect of the abolition is offset by the enhanced personal allowance claimable by any person (male or female) who has income subject to personal income tax.[2]

D. Fringe benefits

Fringe benefits are not to be paid in kind but rather monetized and paid to the employees in both the private and public sectors as allowances. Such benefits will be taxed, subject to non-taxable allowances recommended for rent. Specifically, the following will apply:

- where an employer builds houses for its employees' use, capital allowances are claimable by the employer on such housing estates. The employee is not taxed on such benefits;
- where an employer rents houses for staff accommodation, the amount paid as rent by the employer is taxed as part of the profits of the employer, less the maximum rent allowance as provided in Section 20(b) CITS;
- where an employer pays a rent allowance directly to its employees or where benefits in kind are monetized and paid to employees, such allowances are taxed in the hand of the employees, less approved deductible rent allowances.

E. Tax rates

The ceiling for the tax rates for individuals has been reduced from 55 to 45 percent.

F. Withholding tax

In 1989, withholding tax on dividends, interest, rents and royalties was regarded as a final tax for individuals. With

2. The abolition of wife's allowance was necessary to remove the apparent controversy and misconception that it generated as being discriminatory against wives.

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effect from the 1992 fiscal year, the withholding tax regime which prevailed before 1989, i.e. where such taxes were regarded as tax payment on account, is reinstated. However, this does not affect foreign investors. The withholding tax on foreign dividends will continue to remain a final tax, and the rate will be either 15 percent as provided in the CITA or the rate under a double taxation agreement, whichever is applicable. Section 15(a) CITA, which deems dividends as "franked investment income" remains in operation.

G. *Tax clearance certificate (TCC)*

As regards TCCs the following directives take effect from the 1992 fiscal year:

- where tax has been duly deducted from a taxpayer, tax clearance will not be denied if the tax deducted is not remitted by the employer;
- persons seeking public office must present their TCC for the last three years (as has been the case);
- on application the tax office must issue a TCC within two weeks or give written reasons for any denial;
- defaulting agents of deductions must pay the commercial rate of interest, and will be prosecuted accordingly.

V. OTHER TAX LAWS

A. *Petroleum profits tax*

The following amendments took effect as from 1 January 1992:

- the Memorandum of Understanding between the federal government and operators in the oil industry will be reviewed regularly to reflect developments in the oil industry. [3]
- whereas transactions in the oil industry are in dollars and operators are allowed to keep their accounts overseas in dollars, it is a new requirement that both the estimated and final tax be computed in dollars and payment thereafter be in dollars without conversion under the old system. Reconciliation will continue to be made during the 13th instalment payment.

B. *Modified value added tax (MVAT)*

The proposed introduction of MVAT has been addressed by the 1992 fiscal measures. Government has decided in principle to adopt the MVAT with a lead period of two years during which necessary machinery will be set in motion to enable the scheme to develop. Accordingly, the following guidelines have been approved by government:

- to avoid a multiplicity of tax structures, MVAT will replace the sales tax in its entirety;
- MVAT will only have a single rate;
- MVAT will cover manufacturers and importers in respect of goods;
- MVAT will cover professional services, except for medical and pharmaceutical services;
- MVAT legislation will pay special attention to the state and federal fiscal relationship;
- MVAT scheme will become fully operative in 1994.

Proponents expect that the MVAT will increase the government's revenue, provide incentives to manufacturers of priority or desirable goods to increase their output, discourage manufacturers of undesirable commodities, and possibly induce higher exports of Nigerian goods which would then be relatively cheaper after the VAT refund.[4]

Opponents of the MVAT argue that it will make locally produced commodities more costly, take a long period to manifest an increased output from the manufacturing community, and have an inflationary effect on the already hyper-inflated economy.[5]

Additionally, given the present low levels of infrastructural facilities, administrative machinery, technological development and scientific base, as well as the inflationary component of the economy, Nigeria may not be able to properly manage a new MVAT system.

C. *Capital transfer tax*

There are no changes in the provisions of the law relating to capital transfer tax, and states are urged to enforce the existing law.

VI. JOINT TAX BOARD (JTB)

The JTB has already produced a uniform personal income tax law which will be promulgated this year. The JTB is authorized to impose its decisions on matters of interpretation of the personal income tax law and procedure on any state for purposes of conforming with such interpretation. Redress from the board on matters of interpretation and procedures may be sought by taxpayers.

VII. GENERAL ADMINISTRATION

The following operational arms have been introduced for the general adminstration of tax:

- at the federal level, there will be a Federal Inland Revenue Service which will be the operational arm of the Federal Board of Inland Revenue;
- at the state level, each state will have a State Internal Revenue Service which will be the operational arm of the State Internal Revenue Board;
- at the local government level, each local government will have a Revenue Committee to be supervised by the Councillor for Finance.

In addition, each service will have a board which will constitute its governing body. There will also be a technical committee of the Boards at both the federal and state levels, which will attend to regular technical and professional matters affecting the operations of the Revenue Service and where necessary make recommendations to the Inland Revenue Board.

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3. This is in keeping with the long practice whereby the Federal Government keeps close surveillance over the operations in the industry with a view to taking cognizance of the external and internal influences in the oil industry.
4. The Guardian, "The VAT Project" 11 June 1992, at 12.
5. *Id.*

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VIII. CONCLUSION

The main thrust of the 1992 fiscal measures relating to the tax structure and policy is the government's desire to review all tax legislation with a view to re-organizing the tax structure and tax administration in Nigeria. This measure is aimed at enhancing reliefs and allowances in order to attract foreign and local investment.

Additionally, the measures will reduce the complexity of the tax system and tax administration, and broaden the tax base. To achieve this goal, government is willing to implement the recommendations of the study group on the Nigerian tax structure and tax administration, and to back them up by appropriate legislation.

It is hoped that the bold measures taken to reform Nigeria's tax structure and tax administration will be a worthwhile bequeathment of the present military administration to the incoming civilian administration.

[continued from page 32]

THE 1993 BUDGET AND RECENT DEVELOPMENTS

Veerinderjeet Singh

D. *Overseas investment in approved projects*

As announced in the 1991 Budget, with effect from year of assessment 1992, income earned from approved overseas investment projects remitted back to Malaysia would be abated by 50 percent, and dividends paid from the tax-exempt income would be tax free in the hands of the shareholders. The exemption is for a period of five years after the company commences operations and earns profit. In addition, pre-operating expenses such as the cost of market research are also allowed as a tax deduction.

A policy has recently been formulated by the Ministry of International Trade and Industry. To enjoy the incentives, the overseas project or investments must meet the following criteria:

- the project must be undertaken to overcome market access problems and must utilize Malaysian raw materials or components; or the project will help generate sufficient supply of essential raw materials and components required by the domestic industries in Malaysia; and
- the project will contribute further to South-South economic cooperation, (i.e. cooperation among countries in the South).

E. *Double tax treaties*

Malaysia has signed double tax treaties with Indonesia and Mauritius recently. A protocol amending the double tax treaty between Malaysia and France was signed on 31 January 1991. With the exception of Article 3, the protocol took effect from year of assessment 1990. Article 3 of the protocol which reduced the tax on fees for technical services (under ITA Section 4A) from 15 to ten percent of the gross fee applies to amounts paid on or after 1 January 1986. Therefore, a refund may be claimed where withholding tax had been previously deducted on Section 4A income at 15 percent.

F. *Promotion of investments (amendment) bill*

It is understood that the above bill is currently in Parliament and would probably be enacted before mid-1993. This bill codifies the proposals made in the 1992 Budget to withdraw or curtail various incentives such as pioneer status, investment tax allowance and abatement of adjusted income.

VIII. CONCLUSION

Overall, the 1993 Budget is generally a mild one with a few sweeteners thrown in. The sweeteners are mainly in the form of reduction in tax rates and some exemptions. These are largely seen as being necessary to make the introduction of a broad-based consumption tax more palatable.

What is very clear is the shift towards a broad-based consumption tax and the need for a consultative process as announced by the Minister. In the long-term, it is hoped more measures would be introduced to improve the deficit in the services account which is mainly due to outflows arising from freight, insurance and repatriation of profits.

In the final analysis, the budget is a well-planned one and with careful monitoring of this situation, the projected growth rate of eight percent for 1993 would be achieved.

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IFA News

Some Highlights From the Secretary General's 1991/92 Annual Report Presented at the Cancún Congress 1992

J. Frans Spierdijk

INTRODUCTION

The beginning of the 12-month period covered in this report was sadly marked by the passing away on 2 October 1991 of Professor Dr J.H. Christiaanse, my predecessor as Secretary General. He was commemorated at the Opening Session of the Barcelona Congress by our President Mr Karl Beusch and at many more meetings of the various Committees held during the Congress week. Our Honorary President Dr Alun G. Davies CBE wrote a moving obituary note which is published in the IFA Yearbook 1991. Surely Jan Christiaanse will be sorely missed by his many IFA friends.

At the time of writing this report we received the sad news of the death of Mr Francisco Fernández Ordoñez on 7 August 1992. He was the Chairman of our Spanish IFA Branch and member of our Executive Committee from 1987 until 1991. At the Stockholm Congress in 1990 he was appointed President-Elect of IFA but in the course of 1991 he had to resign from that position and from his membership of the Executive Committee due to the fact that he accepted to continue serving his country as Minister of Foreign Affairs. Those of us who have known him well cherish his memory with friendship and respect.

The General Assembly in Barcelona unanimously confirmed the appointment of Mr Karl Beusch as IFA President for a second term of two years. Another unanimous appointment made by the General Assembly in Barcelona was Mr David Tillinghast (USA) in the new function of Vice-Chairman of the Permanent Scientific Committee (PSC). Our congratulations to both gentlemen and our thanks for their willingness to accept these demanding positions.

The first issue of the IFA Newsletter, prepared by the General Secretariat, saw the light in May 1992. It reports among other matters on forthcoming activities of IFA Branches which have been communicated to the Rotterdam office and will intendedly be published regularly and mailed to all Branch Chairmen and Secretaries. They are requested to further distribute any news contained in the Newsletter which they consider to be of interest to their members. It is hoped that the Newsletter will have a stimulating effect on the activities of a number of National Branches, which are often not aware how active IFA is elsewhere on the national and the bilateral level.

Other matters requiring special attention at the General Secretariat this year were the drafting of amendments to IFA's Articles of Association, the implementation of some stricter rules regarding the collection of membership fees as prescribed by the General Treasurer and the coordination of the work for the PSC, which by its continuous efforts to create greater depth and variety in IFA's scientific programme at Congresses, provides our office in Rotterdam with a lot of interesting tasks to fulfil.

BARCELONA CONGRESS

The third IFA Congress in Spain – the two previous ones convened in Madrid in 1959 and 1972 – was held in Barcelona at the Palacio de Congresos where ample facilities were available. It attracted a total number of 1765 participants, including accompanying persons. We were honoured by the presence of HRH the Prince of Asturias at the Opening Ceremony which took place in the architectural beauty of the Palau de la Música Catalana.

General Reporters on main Subject I, "The determination of the tax base for real property", were Prof. Dr J. Ramallo Massanet (Spain) and Prof. L. Penuelas y Reixach (Spain). Twenty-six National Reports had been submitted in time to be published in the "Cahiers". Discussion Leader was Prof. Dr K. Vogel (Germany). Panelists were Dr M. Flubacher (Switzerland), Prof. H. Kitchen (Canada), Mr R. Leitner (Austria) and Prof. O. Oldman (USA). The meeting was chaired by Prof. E. Albi Ibáñez (Spain). Ms I. Espejo (Spain) acted as Secretary of the Subject. The Résumé Committee for Subject I was composed as follows: Mr M. Laxan (France) as Chairman and Mr G. Coulombe (Canada) as Vice-Chairman. Members of the Committee were Messrs R.A. Dales (United Kingdom), U. Lehner (Germany) and Prof. Dr R. Valdés Costa (Uruguay) as members.

Subject II, "Protection of confidential information in tax matters", was treated by Prof. J. Malherbe (Belgium) in his General Report. Thirty National Reports were included in the "Cahiers". Prof. J. Bischel (USA) was Discussion Leader for the Subject and chairing the Panel, whose members were Mr P. Gillioz (Switzerland), Mr P. Gjesti (Norway), Mr E. Honorat (Luxemburg), Dr M. Pagani (Italy) and Prof. D.W. Williams (United Kingdom). Chairman of the Working Session was Prof. Dr J.L. Lampreave Pérez (Spain), whereas Prof. J. Arrieta Martinez de Pison (Spain) acted as Secretary of the Subject. The Résumé Committee for Subject II was chaired by Mr J. Avery Jones CBE (United Kingdom). Members of the Committee were Dr S. Eilers (Germany), Mr J. Mattsson (Sweden), Mrs P. Molina (Spain), Ms S.M. Pires Nelson de Mello (Brazil) and Mr G. Tixier (France).

I refer to the Reports of Proceedings written by Dr J.B. Bracewell-Milnes (United Kingdom) on Subject I and Subject II and to the Précis on Subject I and the Resolution of Subject II and the review of same by the Chairmen of the Résumé Committees as published in the IFA Yearbook 1991 for more information.

I would like to express our gratitude to the General Reporters and the National Reporters on Subjects I and II for their con-

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siderable efforts. With their work they have added two important works of reference to the *Cahiers de Droit Fiscal International*. Our thanks also to the Discussion Leaders, the members of the Panels, the Chairmen and the members of the Résumé Committees and all other persons, including those from the floor, who actively contributed to the discussions.

Of the Seminars, the one on "Financing of Large Metropolitan Areas" was sponsored by the City of Barcelona and we owe particular gratitude to the Mayor, H.E. Sr. P. Maragall i Mira and his devoted associates. This Seminar (A) was chaired by Prof. J.J. Ferreiro Lapatza (Spain) and his Panelists were Mrs A. Agulló (Barcelona), Mr A. Castells (Barcelona), Mr F. de Grave and Mr H. Moor (Amsterdam), Prof. O. Oldman (Cambridge, Mass) and Mr R. Prud'homme (Lyon). Seminar B was on "The taxation of venture capital", which was chaired by Mr R. Baconnier (France). Panelists were Mrs C. Cloquet (Belgium), Mr R. Favreau (Canada) and Mrs J. Viegener (Germany). Seminar C dealt with "Tax treaties and local taxes", and was chaired by Mr F. White (USA). Members of the Panel were Prof. B. Arnold (Canada), Mr W.H. Boss (Switzerland), Mr E.A. da Silva (Brazil) and Mr U. Wolff (Germany). The "Limitation of treaty benefits for companies (Treaty Shopping)" seminar consisted of Mr P. Sundgren (Sweden) as Chairman, and Dr H. Becker (Germany), Mr A.W. Granwell (USA), Mr D. Hund (Netherlands), Mr D. Luethi (Switzerland) and Mr J.D.B. Oliver (United Kingdom) as Panelists. A Seminar on the "Spanish tax system" was held, chaired by Mr M.A. Lasheras Merino (Spain). Panelists were Ms I. Espejo, Messrs L. Fernández Briones, J.A. López-Santacruz Montes and G. Pérez Rodilla all from Spain.

The amount of work to prepare a Seminar and its presentation is considerable. We thank all those who were involved in the Barcelona Seminars sincerely for their contributions.

The contribution by the Chairman of the Organizing Committee and President of the Congress, Mr M. Marin Arias, has been immense. There is no doubt that he was the driving force during the many months of preparation, during the Congress itself and thereafter. On behalf of all of us I want to pay him our respect and gratitude. At the General Secretariat it has been a pleasure working with him. In this connection I would mention that we are also indebted to the Spanish Branch and Mr Marin in particular on quite a different matter, i.e. that he has been providing us for many years, free of charge, with the Spanish translations of the summaries which are printed in the "Cahiers".

PERMANENT SCIENTIFIC COMMITTEE

Hosted in a perfect manner by the Mexican and UK Branches, the PSC convened in London in February 1992 for a lengthy and interesting meeting.

The scientific proceedings of the Barcelona Congress were reviewed, including the experience of having a Seminar only in French. It was agreed that as a rule non-interpreted seminars would be held only in English, since this appealed to the majority of the IFA membership. However, the option of organizing Seminars in French, German and Spanish would be kept open, but such Seminars would be organized only in special circumstances, depending on the country where the Congress was held and the topic selected.

It was noted with regret that the response to the questionnaires, distributed during the Barcelona Congress, was small. I would like to encourage all members to communicate their observations, suggestions and proposals to the General Secretariat, either by way of the questionnaire or directly. IFA and the PSC in particular are doing their utmost to accommodate members' wishes but this is not always an easy task. We have many members, speaking many languages and coming from many different backgrounds.

Every effort is undertaken to try and select the right topics for the right people for Main Subjects and Seminars and to enliven the discussions. Special sub-committees of the PSC have been established to this end who have come up with valuable suggestions. New and more detailed letters of guidance for Discussion Leaders and Seminar Chairmen have been developed. Prof. Hugh Ault (USA), chairing the Research subcommittee helps in the selection of topical subjects, supervising at the same time the young researcher in the joint research project with the International Bureau of Fiscal Documentation (IBFD). Dr A. Manganelli (Italy) performed some very valuable work in this respect last year and we also have great expectations from Mr Peter Harris (Australia), presently working for us at the IBFD in Amsterdam.

Any suggestions and/or criticisms from members and others aimed at further improving IFA's performance are certainly most welcome. One should keep in mind, however, that IFA is an independent body with no sectional interest to promote which provides a forum for discussion to the entire international tax community – consisting of representatives from taxpayers, governments, the courts and academia – whose aim it is to promote an international tax environment which is fair to all concerned.

With regard to the selection of the Seminars, the policy was adopted for every Congress of having an "open slot" so that a "hot" topic of lively current interest can be introduced at a relatively late date, as was done with the Seminar on East-West joint ventures during the 1990 Stockholm Congress.

Preparations for the 1992 Cancún Congress are well under control. Apart from the two main Subjects, five Seminars will be held, as follows:

A. Advance ruling: practice and legality
   Chairman: Prof. Dr J.M. Rivier (Switzerland)
B. Branch Tax
   Chairman: C.L. Estes (USA)
C. Tax treatment of international loans
   Chairman: Dr R. Asorey (Argentina)
D. Consequences under tax treaties of operating through a dependent or independent agent
   Chairman: Prof. C. van Raad (Netherlands)
E. Mexican tax reaties
   Chairman: Mr R. Aguirre (Mexico)

Twenty-six National Reports were submitted for Subject I, "Transfer pricing in the absence of comparable market

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prices", and 27 for Subject II, "Tax consequences of international acquisitions and business combinations". Many thanks to Avv. G. Maisto (Italy) and Mr W.B. Taylor (USA) for all their hard work.

The Subjects and Seminars for the 1993 Florence Congress were finalized. The titles of the Subjects are "Interpretation of double taxation conventions" and "Non-discrimination rules in international taxation". The Seminars will treat: arbitrating conflicts with regard to treaties; corporate tax on distributions (equalization tax); EC corporate tax law; employee fringe benefits; environmental taxation; and new issues in Italian taxation.

In order to try and make the discussions of the two main Subjects more lively and meaningful, a new structure of the Working Sessions of the two Main Subjects was discussed at length. It was decided that this new structure would be implemented for the 1993 Florence Congress on a trial basis only, and the results would be carefully analysed afterwards. The new procedure will be explained in detail in the invitation programme of the Florence Congress.

The Subjects for the 1994 Toronto Congress were definitely fixed. Subject I will deal with "Deductibility of interest and other financing charges in computing income", with Prof. B.J. Arnold (Canada) as General Reporter. Prof. Dr A.J. Rädler (Germany) agreed to be General Reporter for Subject II, "National and international consequences of demergers".

Initial discussions were held concerning the 1995 Cannes Congress. Some interesting topics came up which will be developed further with the help of the researcher.

EXECUTIVE COMMITTEE

At the invitation of the Mexican and Dutch Branches, who proved to be perfect hosts, the Executive Committee met in the Netherlands on 3 May 1992. It gave us at the General Secretariat a nice opportunity to show the Executive Committee the "headquarters" of IFA at the World Trade Centre in Rotterdam. Mr M. Dominjon (France), Prof. L. Hinnekens (Belgium) and Mr C. Pereira de Rezende (Brazil) attended for the first time as fully fledged members.

Regarding the composition of the Executive Committee, it will be proposed to the General Council in Cancún to re-elect the following members for another statutory term of two years: Prof. Avv. P. Adonnino, J.F. Avery Jones CBE, A. Overbosch and K. Stocker. One of our dedicated members is due for statutory resignation: Mr D.A. Ward Q.C. (Canada). Subject to the approval by the General Council Mr Ward will be replaced by a member from Canada. Moreover, a new member from Spain will be proposed to fill the vacancy created by the resignation of Mr F. Fernandez Ordoñez.

With regard to the future IFA Presidency, the Committee decided to recommend to the General Council and General Assembly in Cancún to nominate Prof. Avv. P. Adonnino as President-Elect, to succeed Mr Beusch at the close of the 1993 Florence Congress.

A lengthy discussion was held on the amendments to the IFA Articles, as drafted by the General Secretariat. Apart from some editorial changes some amendments concerning the content of various articles were made, and proposals will be made to the Cancún General Council and the General Assembly for final approval.

The "Manual" for the organization of an annual IFA Congress was approved by the Executive Committee during their October 1991 meeting. It has been distributed to a number of future Congress organizers. Various requirements and recommendations are stipulated, and we are confident that it will be helpful for our future Congress organizers.

Close cooperation with the General Secretariat is surely to result in considerable time savings and efficiency gains for Organizing Committees.

THINK TANK

Since a large and growing international organization such as IFA cannot afford to stand still, and should remain critical and open to suggestions from its members, Branches and Congress participants, the Executive Committee recommended to the 11 October 1991 General Council meeting to create a committee of small composition for a period of two years, whose task would be as follows:

- to make recommendations regarding the organizational and procedural aspects of IFA's scientific programme;
- to try and establish the desires and objectives of National Branches regarding activities and come up with recommendations or suggested discussion points for the Executive Committee and the PSC;
- to consider the extension of IFA membership into new countries throughout the world.

The composition of this "Think Tank" which was approved by the General Council is:

Mr J.F. Avery Jones (United Kingdom)	Chairman
Dr R. Lenz (Switzerland)	Special Advisor
Prof. L. Fischer (Germany)	
Mr D.R. Tillinghast (USA)	
Prof. Avv. A. Fantozzi	ex officio
Mr J.F. Spierdijk	ex officio

Although some notes have been exchanged and some informal talks have taken place during the year, the first official meeting of the Think Tank Committee is scheduled during the Cancún October 1992 Congress.

MEMBERSHIP FEES

The General Treasurer will propose to maintain the membership fees for 1993 at the level of the previous year, i.e.:

- Dfl. 105 for individual members of National Branches, and
- Dfl. 115 for direct individual members,
- Dfl. 250 for corporate members, both direct and of National Branches.

To further improve on the collection of membership fees the General Treasurer has developed some stricter guidelines

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concerning the deletion of non-paying members from the files of National Branches and of Central IFA. Great care is exercised to promptly discontinue the mailing of the "Cahiers" to non-paying members. Also, the mailing of the Yearbook and the invitation programme is stopped timely.

NATIONAL BRANCHES AND MEMBERSHIP

Our 40th Branch in Egypt was officially recognized during the Barcelona Congress. Recently, a meeting with Branch officials took place in Rotterdam to discuss organizational and membership matters.

In October 1991 I attended the Technical Meeting of CIAT (Inter-American Center of Tax Administrators) in Taipei, Republic of China (Taiwan) where I met with many IFA members and potential IFA members. With active support from the Taiwanese authorities, in particular Vice Minister of Finance Cheng-I Wang, a group of members is enthusiastically engaged in forming a local IFA Branch and we look forward to further developments there. Expansion of our Association in the Far East is most important.

Our Executive Committee member from Hong Kong, where an active IFA Branch has existed for many years, Mr Ian Harris, is making every effort to promote our Association in that region. Regional Conferences (see hereafter) are also very important in this respect. After my visit to Taiwan I took the opportunity to visit the Branches in Hong Kong and Japan. It is gratifying to see how active these Branches are and to meet many members who may not always be in a position to attend our annual Congresses. Other Branch meetings I attended were in the United Kingdom, Germany and the Netherlands. On a trip to Moscow (as member of an EEC mission to Russia put together by the IBFD) I had the chance to meet with some members including Dr Irina Rusakova, who tried to bring together a nucleus of people interested in forming an international tax group. Personal contacts and correspondence are taking place with members in Ireland, Panama, Costa Rica and Jamaica about the possible formation of Branches. The influx of new members from East European countries is as yet small but hopefully this will change in due course.

At the General Secretariat we continue to be interested in what takes place in our Branches. IFA means much more to many of our members organized in active National Branches than our annual Congresses alone and we like to spread whatever useful information we receive for the benefit of other Branches through the Newsletter and otherwise.

REGIONAL CONFERENCE

After the success of the 1991 Hawaii Regional Conference, the Executive Committee officially approved the holding of another Pacific Region Conference, which will be the 3rd IFA Regional Conference. This Conference will be held in Singapore from 26-29 May 1993, at the invitation of the Singapore Branch, who is organizing this event in close cooperation with and sponsored by the US Branch. The following Branches (countries) will be represented at the Conference: Australia, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Singapore, Taiwan and the United States. Representatives will also be invited from Canada, Mexico, Thailand, Vietnam, China (PRC) and other countries.

The two main topics on which the Conference will focus are:
- Tax incentives and other considerations in establishing industrial operations in the Pacific Basin; and
- Outbound investments from the Pacific Basin.

One of the major objectives of this Conference is to try and introduce more people from Asia to our Association and to the kind of discussions that are held at IFA Congresses, in the hope that this will eventually lead to a more numerous active participation from this area.

MITCHELL B. CARROL PRIZE 1991

Out of three candidates Dr Yves Noël (Switzerland) was elected the winner of the Prize for 1991 for his legal dissertation entitled "La double imposition internationale résultant des redressements comptables entre sociétés apparentées et son élimination". The Prize was awarded during the official Opening Ceremony of the Barcelona Congress by Prof. DDr H.G. Ruppe (Austria), Chairman of the Jury. Another work submitted to the Jury deserves special mention. In his dissertation, Dr Michael Lang of Vienna, Austria, considered problems of double taxation that occur in forms of hybrid financing. Little attention has been paid to this highly topical area and Dr Lang has made a valuable contribution to preparatory work in this field. Thus the Jury was of the opinion that Dr Lang's work deserved an honourable mention.

THE 46TH CONGRESS IN CANCUN

We are all looking forward with great anticipation to Cancún, our second IFA Congress in Mexico (The first Mexican Congress was in 1974, in Mexico City). It is our first Congress with the excursions on Friday and with a tropical time schedule as another unusual feature. It will be most informal, as dictated by the climate. The two main Subjects are very interesting indeed, both from a theoretical and a practical viewpoint. The Seminars will no doubt attract a great number of interested participants.

The Organizing Committee under the enthusiastic leadership of Mr Carlos Sellerier has been working very hard to make sure that everything will run smoothly and I am certain that they will succeed.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

The relationship with the IBFD continues to be a very fruitful one. We value the input of Mr Hamaekers in our PSC meetings and I take pleasure in being aware of the many interesting developments at the IBFD through my membership on the Board of Trustees. The joint research project is proceeding in a way satisfactory to both our organizations. Prof. H. Ault, Chairman of our Research sub-committee as previously mentioned, is also a member of IBFD's Board of Trustees. He plays a key role in formulating recommendations in this area to the PSC.

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CONTACT WITH INTERNATIONAL ORGANIZATIONS

A word of gratitude to our Ambassadors for their reports as published in the IFA Yearbook. We are glad that Mr Jerome Libin (USA) was prepared to be the new Liaison Officer with the OAS.

Finally, I would mention the continuous contacts with the ICC Tax Committee and with CIAT. At the Annual CIAT Conference in Jamaica in June 1992 I was a guest speaker to address the Conference on international tax aspects which gave me an opportunity to focus the attention of the participants, among other matters, on a number of topics dealt with at recent IFA Congresses. At the Technical Conference in Benalmádena (Spain) in September I will act as General Reporter. It is important for IFA to be present and active at a forum where the interests of the international business community are represented, such as the ICC Tax Committee, and at places where the voices of government representatives can be clearly heard, such as CIAT Conferences.

OTHER IFA NEWS

SINGAPORE/US BRANCHES

The 1993 Pacific Basin Conference will be held 27-29 May 1993 in Singapore. Jointly sponsored by the US and Singapore branches the format of the conference will focus on tax incentives and other considerations in establishing industrial operations in the Pacific Basin, outbound investments from the Pacific Basin and inbound investments from Australia, Canada, New Zealand, the United States and Europe. The conference will take the form of plenary sessions on each of the topics with a discussion leader and a panel of speakers. Between the plenary sessions will be separate sessions with speakers from a number of countries giving presentations on their own territories.

US BRANCH

The 1993 Annual Meeting will be held 4-5 March 1993 at the Copley Plaza Hotel in Boston, Massachusetts. Topics to be discussed include: current judicial and administrative developments, income tax treaty and competent authority developments, transfer pricing issues, advance pricing agreements, arbitration and controversies, directions in US International tax legislation and policy, Europena income tax developments and Mexican and Canadian tax developments, combining operations from classical and integrated tax systems, and knowledge and technology transfers to and from the United States. Speakers will include government officials, practitioners and academics.

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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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 53-56 of the January 1993 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

ASIA & THE PACIFIC

Australia

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(B. 57.793)

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Planning for tomorrow today.
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Statement by the honourable John Dawkins, M.P., Treasurer of the Commonwealth of Australia, 30 June 1992.
(B. 57.761)

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Tokyo, Zaikei Shoho Sha, 1-2-14 Higashi Shimbashi, Minatoku, Tokyo, 1992, pp.440.
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(B. 57.791)

New Zealand

1993 NEW ZEALAND INCOME
tax tables for the income year 1 April 1992-31 March 1993.
Beach Haven, CCH New Zealand Limited, 17 Kahika Road, Beach Haven, Auckland 10, New Zealand, 1992, pp.430.
Book containing tables which facilitate the rapid determination of the gross tax payable by individuals for the income year 1 April 1991 to 31 March 1992. The commentary contains an explanation of tax credits and various tax rebates which may be deductible from the gross tax figure shown in the table. A summary of tax rates applicable to taxpayers other than individuals is included.
(B. 57.792)

CARIBBEAN

Jamaica

THE JAMAICAN TAX REFORM.
Edited by Roy Bahl.
Final Report of the Jamaica Tax Structure Examination Project.
Cambridge, Lincoln Institute of Land Policy, Cambridge, Massachusetts 02138, USA, 1991, pp.835.
A comprehensive account of tax reform in Jamaica in the 1980s, including background information on the value added tax introduced in 1991. All aspects of direct and indirect taxes in various economic sectors are covered. Numerous tables provide empirical data on public finance aspects of the Jamaican economy. Contributors include tax policy experts such as Carl S. Shoup, Richard Bird and Charles E. McLure, Jr.
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London, Financial Times Business Information, 1992, pp.143.
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Austria

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(B. 112.221)

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(B. 112.213)

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Internationaal fiscaal zakboekje.
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(B. 112.251)

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De Bedrijfsbibliotheek, No. 13., pp.395, 1950.- Bfr.
An extensive overview of Belgian international tax planning, with a focus on out-bound investments by Belgian companies.
(B. 112.250)

Cyprus

THE TAX LAWS OF CYPRUS.
Nicosia, Ernst & Young; Russel Lakoufis & Co., Nicosia Tower Centre, 36 Byron Avenue, P.O. Box 1656, Nicosia, Cyprus, 1992, pp.220.
Manual containing all the tax laws of Cyprus. The consolidated texts include all amendments published to date. It is the only source available and includes recent amendments (in English). Included are the

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income tax law, the assessment and collection of taxes law, the capital gains tax law, the immovable property tax law, the estate duty law and special contribution law. (The consolidated text of the VAT Law is missing, although we have been informed that it has also been prepared and published by them).
(B. 112.225)

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Germany

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GELOS – Für die Gehalts- und Lohnberechnung der Jahre 1992 und 1993; PC-Software 1993. REKOS – Reise- und Bewirtungskosten-Software.
Bonn, Stollfuss Verlag Bonn, Postfach 2428, 5300 Bonn 1.
Stollfuss Verlag has now published two programmes on floppy disks.
1) GELOS – Für die Gehalts- und Lohnberechnung der Jahre 1992 und 1993, ISBN 3-08-339693-7, 98.- DM.
Programme on floppy disk for calculating the wage tax and social security contributions withheld from gross income or to be added to the net income for calculating the gross income. The programme can be used on all IBM or compatible computers with MS-DOS version 2.11 or higher.
2) REKOS – Reise- und Bewirtungskosten-Software, ISBN 3-08-313093-7, 98.- DM (5 Zoll-Disketten), ISBN 3-08312993-9, 98.- DM (3 Zoll-Disketten).
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CONTENTS

VOL. 47 NO. 2 **FEBRUARY 1993**

INTERNATIONAL:
100 YEARS OF INCOME TAX — 59 *John Prebble*

This article attempts to explain by reference to history and to principle why it is that tax law tends to be more complex and internally consistent than other law.

INTERNATIONAL:
A TAX ON GROSS ASSETS
OF ENTERPRISES AS A FORM
OF PRESUMPTIVE TAXATION — 66 *Efraim Sadka and Vito Tanzi*

Both Mexico and Argentina levy an assets tax, and a number of other Latin American countries are considering the introduction of such a tax. This articles analyses the assets tax within the context of presumptive taxation in general. Set against the historical background of a tax on assets some aspects of presumptive taxation are discussed.

US/NETHERLANDS:
THE NEW US/NETHERLANDS
DOUBLE TAX CONVENTION:
AN INTRODUCTORY NOTE — 74 *Wim Wijnen*

On 18 December 1992 the United States and the Netherlands signed the new double tax treaty. The most important feature of the treaty is without a doubt the limitation on benefits provision. Following Mr. Wijnen's introduction we have printed a number of provisions of the treaty.

UNITED STATES:
DETERMINING RESIDENCY FOR
FEDERAL INCOME TAX PURPOSES — 84 *Leonard W. Rothschild, Jr. and Michael G. Schinner*

On 24 April 1992, the IRS issued final regulations under Code Section 7701(b) concerning the definition of residency for federal income tax purposes. This article analyses the final regulations and discusses the IRS' revisions to the proposed regulations. The article also discusses the IRS' new proposed regulations on treaty-based determinations of residency, which it issued simultaneously with the final regulations.

PEOPLE'S REPUBLIC OF CHINA:
A BRIEF INTRODUCTION TO
TIANJIN PORT BONDED ZONE — 90 *Li Zhi Hui*

Established in 1991 the Tianjin bonded zone offers competitive advantages over the special economic zones and economic development zones. This article highlights a number of the preferential investment policies and tax privileges of the zone.

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ASSOCHM/IFA CONFERENCE 92 *Peter Hann*

A report of the conference held in New Delhi, India. The conference concerned itself with four issues facing India in the area of direct taxation: international trends in corporate taxation, presumptive taxation, reform of the tax administration and interpretation of double tax treaties.

BIBLIOGRAPHY 100

- Books 100
- Loose-leaf services 103

IFA NEWS 96

CUMULATIVE INDEX 95

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INTERNATIONAL:

100 YEARS OF INCOME TAX

John Prebble

This article is based on an address delivered by the author at the fifth New Zealand-Pacific Conference and Workshop of the Institute for Taxation and Business Law, held at Port Vila, Vanuatu, on 8 to 10 July 1991. (The Institute was reconstituted as the Centre for Australian and New Zealand Law in 1992.) The paper marked the centenary of income taxation in New Zealand, which was inaugurated by the passage of the Land and Income Assessment Act 1891. The article attempts to explain by reference to history and to principle why it is that tax law tends to be more complex and internally inconsistent than other law. Several themes in the article are developed by the author in a monograph entitled "Why is Tax Law Incomprehensible?" shortly to be published in the collection, Victoria University of Wellington Inaugural Addresses (New Series). While completing this article the author was a visiting professor at the International Bureau of Fiscal Documentation, Amsterdam.

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Contents

I. Introduction
II. History
III. Tension between Natural and Artificial Law
IV. No Definition of 'Income'
V. The Capital/Revenue Distinction
VI. Illustrations
VII. Reasons for the Distinction
VIII. Adoption by the Legislature
IX. Tax Planning
X. Avoidance Strategies that Depend on the Distinction Between Capital and Income
A. Avoidance of Section 67
B. Avoidance of Section 129
C. Avoidance of Section 188A
D. Avoidance of assessability of the benefits of trade discounts
XI. Regimes in the Income Tax Act that Attack Income-to-Capital Conversions
A. Sections 67, 129 and 188A
B. The accruals regime
C. The controlled foreign company regime
D. Ordering rules in company tax regimes
E. 'Golden hello' rules
XII. The Tax System as an Instrument of Social Policy
XIII. Progressive Rates of Tax
XIV. Imputation Systems of Company Taxation
XV. Fringe Benefit Tax
XVI. Current Social Policies Within the New Zealand Income Tax Act
XVII. Interpretation of the Act
XVIII. Reasons for Strict Interpretation
XIX. Results of Strict Interpretation

I. INTRODUCTION

Of all branches of the law, income tax is the most notorious for its complexity. David Walker, editor of The Oxford Companion to English Law, is uncompromising in his opinions when it comes to income tax. He says:

> More than any other branch of municipal law, tax law is open to the reproach of being utterly incomprehensible by the individuals affected, and even frequently by their legal advisers. The enormous complexity of the rules of law on each kind of tax gives rise to an enormous volume of dispute and argument, and a great deal of litigation by way of appeal from assessments. Neither justice nor reason has any place in tax law, and many decisions of the superior courts are in plain conflict with all sense...

One question that immediately springs to mind is, what sort of person could make a career practising in that unpromising farrago, much less in studying it? Many people are familiar with the old definition of a tax lawyer: someone who is quite interested in tax, but who lacks the personality to become an accountant. Prompted by the entry in the Oxford Companion to English Law, the author suggests another definition: a tax lawyer is someone who is quite interested in law, but tolerably indifferent to justice or reason.

II. HISTORY

Parliament created income tax in New Zealand by the Land and Income Assessment Act 1891. At that stage, the country relied principally on customs duties for its revenues, though land tax, an annual tax on the value of land, was of some significance.

The second reading debate when the bill was introduced on 4 August 1891 was sandwiched unpropitiously between a discussion about inferior British mutton that was being passed off as good New Zealand product on the London market, and a depressing debate about a new law on bankruptcy. The reporter of parliamentary debates noted that John Ballance, who spoke first in the taxation debate as both Colonial Treasurer and Premier, was frequently inaudible in the gallery.

As explained by William Pember Reeves, a member of Ballance's recently installed Liberal cabinet, the principal reason for the introduction of an income tax was the oppressive and economically inexpedient impact of land tax. Land tax was all very well for taxing agriculture, where people's ability to pay was roughly proportionate to the value of their farms. Furthermore, if you had a very large and very valuable farm that did not produce enough income to pay your tax, then that was all to the good because in those circumstances the land tax promoted the government's general policy of encouraging the disintegration of large estates.

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But in respect of commerce, land tax could be a decided dampener on economic activity. Businesses generally struggle in the early years of their existence, but land tax charged them on the value of their real property whether they could pay or not. An income tax, that would vary with improving fortunes, was clearly more appropriate for businesses.

Leading for the opposition, John Bryce MP explained that he was theoretically and constitutionally opposed to all taxation, but aside from that his main objection to income tax was that it would lead to public immorality. This would come about as a result of people having to lodge returns of their income, and yielding to the temptation to lodge false ones.

One aspect of Ballance's income tax that may appeal to readers of this *Bulletin* is that it was charged at one shilling in the pound on business and commercial profits, but at only six pence in the pound (that is, half as much) on professional incomes. The subsequent departure from this self-evidently right-minded standard is something that now one can only deplore.

Apart from the United Kingdom, among Anglo-American jurisdictions New Zealand was relatively early in introducing an income tax. The United Kingdom had had an income tax for most of the 19th century, though it was not until Harcourt's budget of 1894 that the tax became a significant and permanent part of the country's economy. In fact Gladstone, under whom Harcourt originally served, had in 1853 spent three hours addressing the House of Commons about income tax in a budget speech, terminating by telling the House of Commons that the tax was 'not well adapted for a permanent portion of your fiscal system'.

Tasmania introduced a tax on some forms of income in 1880, and South Australia followed with a fully fledged income tax in 1884. The New Zealand Act of 1891 was to some extent modelled on the South Australian legislation. The other Australian states followed with income tax legislation between 1894 and 1907 and the Australian federal government introduced its income tax in 1915. The United States did not introduce a federal income tax until this century.

Since 1891, New Zealand's income tax laws have been the subject of more commissions of inquiry, amendments and consolidations than any other area of legislation. In recent decades, there has usually been at least one amending Act each year, and during the latter 1980s there were sometimes four or five. Full consolidations, with re-numbering of sections, were enacted in 1900, 1908, 1916, 1923, 1954 and 1976. Commissions of inquiry of different statuses were held in 1922, 1924 (a full Royal Commission), 1937, 1951, 1952, 1967 and 1982. From 1985 to 1990, five or six consultative committees were appointed to advise on separate elements of the Income Tax Act, and one was still sitting in 1992.

There are two reasons for all this activity. The first is the obvious one, that income taxation is fundamental to the economic systems of modern western nations, so it is worth while to make the tax as efficient as possible. The second is that the subject is inherently unduly complex, and that is the theme of this article. Why is income tax law so complicated?

III. TENSION BETWEEN NATURAL AND ARTIFICIAL LAW

A fundamental difficulty in any taxation system is to fit the laws of nature into the matrix that we recognize as the laws of men and women. One law of nature that may be accepted as an *a priori* truth is that it is possible for people to experience gains in their wealth. We know by observation that sometimes businesses are able to meet their expenses out of current earnings. Sometimes they are even better off at the end of a year than they were at the beginning. That is, they experience a gain. It does not happen often nowadays in these times of recession, but it can occur.

Gains, therefore, are a part of nature in the largest sense of the word. On the other hand, the income tax system demonstrably cannot cope with economic gains in a way that can be understood by ordinarily literate people, and the system often has difficulty in dealing with gains at all. One can reasonably ask, with all the opportunity that tax law has had to evolve, why has someone not made a better job of the legislation?

One answer to that question is that the tax system cannot be understood in logical, principled terms that stem from generally accepted truths and propositions. It is much more amenable to analysis that uses the reasoning of self-validating formalism. It is one thing to have a gain, which nature and economics and most humans recognize as a gain. It is another to define the gain in legal terms, and a third to measure it by accountancy. There is a fundamental tension between the natural law of economic activity and the man-created law of lawyers.

IV. NO DEFINITION OF 'INCOME'

In enacting income tax legislation, parliaments are faced with the ultimately impossible task of describing an economic concept in legal terms. Commonly, they avoid the task, and do not include a full definition of 'income' in tax legislation at all. They rely instead on a list of things that are stated to be income, with a final catch-all to the effect of "and any other income of any other kind".

New Zealand's income tax legislation follows this pattern, though in New Zealand's case there is a theory that the lack of a definition of 'income' in the Act has a more mundane explanation. It is a matter of history and a question of grammar. The draftsman of the 1891 Act did in fact attempt a definition of 'income', but he failed to ensure that the subject and the verb in the definition clause agreed with one another. He provided in Section 3 that 'income' means "any gains or profits derived... by any...person...which is (sic) made the subject of taxation under this Act.'

The theory is that as a result of the original draftsman's grammatical mistake in what on one view was the central provision of his Act, later drafters have not been game to have another try.

V. THE CAPITAL/REVENUE DISTINCTION

Return to the question of the tension between natural law and lawyers' law. This tension is seen in many areas, but nowhere so markedly as in the distinction between capital and income.

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Broadly speaking, the Income Tax Act taxes income, not capital. But the lawyers' and accountants' distinction between income and capital is not a distinction that is fundamental to natural law, nor to economics, for that matter. One result is that a good deal of income tax legislation, and even more of the income tax law that is set down by the judges in their reported decisions, is taken up with rules that help people to distinguish between capital and income. Even more of the legislation is taken up with rules that hamper people in their efforts to convert a taxable income gain into a non-taxable capital gain. One says 'hamper' rather than 'prevent', because these rules are far from successful. They are not successful because their objective is ultimately illogical. That is, in the end there is no logically sustainable distinction between capital gains and income gains. It follows that, in the end, rules that try to draw that distinction are often incomprehensible.

VI. ILLUSTRATIONS

The problem may be illustrated by two common legal notions, the share, that produces dividends, and the loan, that produces interest. First, take a company share that is pregnant with heavy profits. That is not something one sees in these recessionary times, but older readers may have heard of the phenomenon. There are two ways in which the shareholder can enjoy these profits. Either she can wait for a dividend to be declared, in which case she will be liable to tax on the income; or she can sell the share for a price that reflects the presence of the profit.

In the latter case, in New Zealand there is no tax, on either the underlying value of the share or on the accumulated profit, because the gain is a capital gain and New Zealand has no capital gains tax. (In jurisdictions where there is a capital gains tax there will no doubt be an impost, but often at a lower rate than on receipts that are regarded as being income gains.)

As one might expect, there are provisions in the New Zealand Income Tax Act that minimize this different treatment, and other provisions that hamper shareholders who try to take advantage of it. But these provisions highlight the problem rather than solve it. There is no logic in treating the gain in the value of the share as anything but a gain, though political considerations might lead a jurisdiction to afford concessional treatment in one way or another.

As a second illustration, suppose a lender has $ 100 to lend to a borrower. One course is to lend the money for a year, and for the borrower to promise to pay interest of $ 12. At the end of the year the borrower pays $ 112, and the lender pays tax on the $ 12 interest.

Another approach is for the borrower to write an IOU for $ 112, payable in a year's time. The borrower then sells the IOU to the lender for $ 100. A year later, the lender causes the borrower to redeem the IOU for $ 112. Then, the lender has simply sold an asset, the IOU, and there is no interest and no tax. To prevent this sort of thing happening, particularly in its more sophisticated forms, New Zealand has 38 pages of provisions in its Income Tax Act called the 'accruals regime', inserted in 1986, which is so hard to understand that the first efforts by the Inland Revenue Department to translate it into some sort of rules that people could comprehend had to be redone immediately.

While improvements could no doubt be made, the law drafters are not fundamentally to blame. What is to blame is the unsound premise of the Income Tax Act that capital can be distinguished from income. The more we try to rationalize that distinction, the more complex, and often incomprehensible, the drafting becomes.

VII. REASONS FOR THE DISTINCTION

Why is it that New Zealand, in common with many other jurisdictions, draws a distinction in its tax law between capital and income? After all, economists have known for years that the distinction is without a difference.

The traditional answer is that when 19th century judges in the United Kingdom faced the question of defining income they turned to trust law, which seemed to provide a useful analogy. Trust lawyers have been obliged for centuries to distinguish between capital and income in order to know what belongs to a life tenant, entitled to the income of an estate, and what belongs to those who will succeed to the capital on the death of the life tenant.

It was a short step to apply these centuries of law to the new idea of income tax, though a moment's thought shows that the analogy is not apposite. Judges in trust cases divide gains between two citizens. But judges in tax cases decide what portion of a citizen's property is taken for the state by legislation.

Be that as it may, the author believes that the influence of the old trust cases is far from the only reason why judges in tax cases developed the legal concept of income as we know it, though it is true that the old cases provided the rationale for judges' decisions. An equally significant factor was human nature. No matter how often the economists prove to us that there is no rational distinction between capital and income, we still believe that there is.

For instance, in the middle of the 19th century the UK income tax was still in an early stage of development. The lawyers had not yet wrenched policy away from the economists, and Peel in his 1848 budget still espoused a tax that was a tax on gains simpliciter, and a tax that did not act as an implement of social engineering, in that the tax was proportional rather than progressive.

The statesman Cobden found fault with both these features of the tax. Because he was a statesman he used words that are sonorous and impressive, but presumably because he was talking about income tax the words he chose are barely recognizable as English. He said: "If a distinction were made between permanent and precarious incomes, if a graduation of duty were established, you would have no remonstrances."

Many Victorians were quite capable of making themselves understood in the English language. But this did not apply to Cobden, so a translation is necessary. What he meant to say was that he thought there should be no tax on capital gains or windfalls, and that the rich should pay proportionately more tax than the less rich. (He could not in this context have been concerned for the poor because they did not pay income tax at all in those days.)

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Like Cobden, and like us, English judges of the latter 19th century were human, at least many of them were. To use Cobden's word, their 'remonstrance' against income tax was to make sure that it applied only to regular, annual gains, rather than to windfalls or to gains on assets held for long periods.

VIII. ADOPTION BY THE LEGISLATURE

In New Zealand, Ballance's government of the early 1890s was, like many liberal governments, often influenced by principle. Thus, New Zealand's 1891 Act charged all business profits and gains to income tax, making no distinction between capital and income. To drive the point home, Section 17(4) of the 1892 amendment Act provided that "income from a business" included gains "from the purchase, sale, or other disposition of real or personal property, or of any right, estate, or interest therein". Strictly speaking, this provision applied whether or not the gains on the sale of property accrued within or outside the regular, day-to-day operation of the business.

Of course, no-one took all this seriously, and New Zealand practice followed the law as interpreted by the English judges. But in case of excessive zeal on the part of the fiscal authorities, Parliament knocked most of the provisions that taxed capital gains out of the Act when it was consolidated in 1900.

By Section 59(3) of the consolidated Act, gains from the sale of real property were not taxable, unless the taxpayer was a dealer in land. Gains from the sale of personal property remained taxable, but there was a specific exemption for shares, the form of personal property most likely to yield a gain on sale. Gains on other forms of personal property were rare, and remain so. But one suspects that returns of income from the sale of, say, jewellery or pictures that had appreciated were rare, notwithstanding that they were taxed by the Act of 1900.

IX. TAX PLANNING

Nowadays, the distinction between capital and income gains is firmly entrenched in the tax legislation of most jurisdictions, not least of New Zealand. One result is that people spend a great deal of time and effort organizing their affairs so that they derive capital gains rather than income. They succeed in this endeavour because, economically, the two sorts of gain amount to the same thing. Without going into detail, the lists below set out a number of strategies available to the New Zealand taxpayer to minimize tax, strategies that depend on the distinction between capital and income, and a number of parts of the Income Tax Act that exist partially or wholly to frustrate people who would take advantage of the distinction.

X. AVOIDANCE STRATEGIES THAT DEPEND ON THE DISTINCTION BETWEEN CAPITAL AND INCOME

A. *Avoidance of Section 67*

Section 67 of the New Zealand Act taxes the profits derived on the sale of land in some circumstances. The section may be avoided by holding land that may be vulnerable to Section 67 in a company, and selling the shares in the company. Ordinarily, profit on the sale of shares in these circumstances is not taxable.

B. *Avoidance of Section 129*

Formerly, farmers were permitted to deduct expenditure incurred on capital development of their farms in calculating their assessable income. Section 129 was calculated to prevent them from reducing their income by spending on capital development, and then selling the farm for a tax-free capital gain. Like Section 67, Section 129 can be avoided by holding the farm in a company and selling the shares instead of the land.

C. *Avoidance of Section 188A*

Section 188A was introduced into the Income Tax Act in 1982. The primary object of Section 188A was to prevent people using farming as a tax shelter. One way to avoid Section 188A, at least partially, was again to form a company and to borrow to capitalize the company. Interest on the borrowing was fully deductible, being interest on money used to buy shares that one day might produce a dividend, and the company could spend the money on farming. If instead of forming a company to own his farm the taxpayer owned the farm as an individual and borrowed and spent the money directly, the deductibility of the interest was subject to an overall limit of $ 10,000 a year incurred in farming or other "specified activities".

Section 188A so incensed people whose support for the principle of the separation of capital and income exceeded even their support of the principle of the separation of church and state that some of them formed a whole new political organization, the New Zealand Party, that nominated candidates throughout the country in the general election of 1984. None were successful, but the party contributed to the downfall of the then populist centre-right government by capturing some of its support in key electoral constituencies.

D. *Avoidance of assessability of the benefits of trade discounts*

A retailer who is in a strong position *vis-à-vis* her supplier can often negotiate substantial reductions in the prices that she pays to the supplier. One result is that the retailer's costs go down and her profits, and thus her tax, go up. An alternative to demanding price reductions is for the retailer to persuade the supplier to make capital improvements to the retailer's premises, which results in a gain that in New Zealand is not taxable.

As far as the supplier is concerned, the cost of the improvements to the retailer's premises is a cost of marketing and thus an item that is deductible in calculating the supplier's assessable profit. Consequently, there is an asymmetry in the tax system, in favour of the taxpayer, with the item in question deductible as an expense but not taxable as a receipt.

XI. REGIMES IN THE INCOME TAX ACT THAT ATTACK INCOME-TO-CAPITAL CONVERSIONS

A. *Sections 67, 129 and 188A*

Sections 67, 129 and 188A, mentioned above, would not themselves need to exist if it were not for the fact that the Income Tax Act does not tax gains that we call capital.

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B. *The accruals regime*

The New Zealand accruals regime has been mentioned already. It is the only part of the Income Tax Act where there is a conscious, express denial of the distinction between capital and income. An important effect of the regime is, broadly speaking, to categorize all gains and losses on debt and other financial instruments as on income account. The regime has a similar effect on many other transactions that involve credit or extended payment.

C. *The controlled foreign company regime*

One way of avoiding tax is to establish a company in a tax haven as a vehicle for investment activities. The company derives income free of tax in its jurisdiction of residence, and reinvests the money. When the owner of the shares in the company wants his money he can sell shares in the company to a compliant bank that is itself based in the tax haven. The sale price is a capital receipt that is not taxable as income. The bank recovers its money by liquidating the company.

Several jurisdictions, including New Zealand, have enacted controlled foreign company regimes in order to deter their residents from carrying out this strategy. Broadly speaking, these regimes operate by taxing the profits of controlled foreign companies in the hands of their shareholders, being residents of the jurisdiction that enacts the regime.

D. *Ordering rules in company tax regimes*

Ordinary, domestic companies offer many opportunities for revenue to capital conversions. To take one example, suppose that company A and company B both need capital of $ 1000. Company A issues 1000 $ 1 shares, but company B raises its $ 1000 by issuing 100 $ 1 shares at a premium of $ 9 each. Suppose that after a year each company has distributable profits of $ 200. Company A pays an ordinary dividend of $ 200, which is taxable in the hands of its shareholders. Company B, on the other hand, reduces its share premium account by $ 200, and makes a non-taxable distribution of capital of $ 200.

Both companies retain the $ 1000 that they need as operational capital. For company A the sum is made up of 1000 $ 1 shares. For company B the operational capital is 100 $ 1 shares, $ 700 in the share premium account, and $ 200 in retained profits. Because money is fungible, the economic position of company B is the same as the economic position of company A, but the tax position of the shareholders in company B is superior.

Eventually, if the companies are wound up, the shareholders in company B will have to pay tax on the distribution of the retained profits of $ 200, whereas the shareholders in company A will recover their total capital of $ 1000 without tax. But the shareholders in company B will still be better off because their tax has been deferred, and, indeed, may in practice be avoided forever.

Like other jurisdictions, New Zealand has in its tax laws fairly elaborate rules to prevent taxpayers from effecting intra-company revenue-to-capital conversions both like the example described in the previous paragraph and that take other forms. The New Zealand legislation is in the form of ordering rules that deem distributions from companies to shareholders to be debited first to revenue sums and, only when these are exhausted, to capital items.

E. *'Golden hello' rules*

One way to reduce tax is for an employee to take some of his remuneration in the form of a lump sum as a fee for joining his employer, rather than as taxable salary. The New Zealand Income Tax Act contains rules to frustrate this practice, but not everyone agrees that they work.

XII. THE TAX SYSTEM AS AN INSTRUMENT OF SOCIAL POLICY

The second aspect of the tax system that leads to its complexity is that taxation is often used as an instrument of social policy. The most pervasive example is the progressive rate. Taxation by progression is so widespread among the tax systems of the world that one could be forgiven for suspecting that it is dictated by fiscal imperatives. But this is far from the case. In fact, income tax systems are much easier to design and to operate if they are strictly proportional in their impact. The reason for taxation by progression is to redistribute wealth. Richer people are supposed to pay proportionately more tax than poorer people. As is explained later in this article, a progressive scale of taxation by itself makes tax law complicated.

Other social engineering that is carried out through the tax system has a similar complicating effect on tax laws. When the tax system is used to deliver incentives for farm development, export encouragement, building hotels or anything else, the legislation and its administration become more complicated, to say nothing of the distorting effect on the economy as a whole.

The author's favourite incentive is in Section 114A of the New Zealand Income Tax Act 1976, which encourages taxi proprietors to attach "safety devices" to their cabs by allowing the immediate expensing of the cost of this capital equipment. The Section does not define "safety device", and one might wonder whether parliament was referring to such undoubtedly safety-promoting items as windscreen wipers or headlights.

In fact, in this context, though the reader cannot tell it from the Act, a "safety device" is a fence that is erected between driver and passenger to keep them from attacking one another. Sadly, Section 114A has had almost no impact. People riding as a passengers in New Zealand taxis who are overcome by an urge to attack their drivers do not find safety barriers standing in their way.

There is no need to go into the many incentive provisions that are found in the income tax legislation of the world, nor into the difficulties of administration and interpretation that they impose. They are not hard to imagine. In fact, most of the incentive provisions of the New Zealand legislation were removed during the late 1980s, chiefly to eliminate economic distortion. However, the question of the progressive rate is another matter. It has been a feature of tax systems for so long that many people take it for granted, rather than recognize it for what it is: an instrument of social engineering, rather than a necessary part of a tax system.

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XIII. PROGRESSIVE RATES OF TAX

It is fundamental to a progressive system of taxation that different parts of one's income bear tax at different rates: in New Zealand, the taxpayer's first dollar is taxed at a lower rate than dollar number 30,876, because after earning $ 30,875 people move into a higher tax bracket.

It is also fundamental that the same dollar of income will be taxed at different rates according to who derives the dollar. Thus, if a New Zealand parent puts money on deposit in a bank and derives a dollar of interest, the dollar will be taxed at 33 cents, assuming that the parent has used up his tranche of income that qualifies to be taxed at a lower rate. But if the parent gives the money to his infant daughter and she deposits it the interest belongs to the daughter, and she is taxed at only 24 cents. These differences are greater in New Zealand when one takes account of rebates and family support credits for people who do not earn very much. They are even more exaggerated in jurisdictions that have more steeply progressive tax scales.

These aspects of the progressive tax system present many possibilities for the tax planner. The more that income can be split among a number of people, the lower will be the total tax. In fact, the very second reported case on New Zealand's 1891 Act concerned income splitting. This was *Bell and another v. Commissioner of Taxes*.[1] This was a case of a widow who split herself into two taxpaying entities and thereby took advantage twice of the lower rates of graduated tax on the land from which she derived her income. Mrs. Bell was the beneficiary for her life of the income of two landholding trusts. Prendergast CJ held that tax had to be assessed separately on the trustees of each trust. The case involved land tax, but the questions involved have equal relevance for income tax.

Not surprisingly, the current Income Tax Act contains provisions that prevent people getting the advantage that Mrs. Bell was able to enjoy, and there are many other rules calculated to frustrate income splitting of one kind or another.

Nowadays New Zealand has a relatively flat tax scale, and the advantages obtainable from income splitting are less than they were. Nevertheless, the rules must remain in place. Saving the difference between 24 and 33 cents in the dollar (the two rates that apply in New Zealand) can still be worthwhile. In other countries income splitting produced even more fiscal savings for the taxpayer.

Income splitting is the most significant problem that results from a progressive tax scale, but it is by no means the only one as will appear from what follows.

XIV. IMPUTATION SYSTEMS OF COMPANY TAXATION

Imputation systems for company taxation impute to shareholders the tax paid by their companies. Thus, when a company pays a dividend to a shareholder the dividend can carry with it a credit for the tax that was paid on profits earned by the company, out of which the company pays the dividend. If all shareholders paid the same rate of tax, and if all companies shared that rate, the rules of imputation systems could be much simpler than they are. As it is, these rules must allow for times when company tax is lower than individual tax and for times when it is higher, as well as for variations in the rates of tax that apply to individual shareholders.

XV. FRINGE BENEFIT TAX

The New Zealand fringe benefit tax applies to most non-cash benefits that are delivered by employers to employees. The tax is imposed on the employer, as a fraction of the value of the benefit.

The theory of the fringe benefit tax is that it should cost an employer the same to provide a non-cash benefit to an employee as it would to pay the employee enough extra salary to buy the benefit out of the employee's after-tax income.

In practice, this theory cannot be worked out exactly, because an employer who wants to deliver the same benefit to each of two staff members, one with a marginal tax rate of 33 percent and the other with a marginal tax rate of 24 percent, must pay more to the first employee than to the second for the two of them to finish with the same after-tax income. The result is that whatever rate is chosen for fringe benefit tax it will be wrong for some employees.

Parliament solved the problem by setting the level at the rate appropriate for higher paid employees, that is, those whose marginal rate of tax is 33 percent. Thus, employers who provide taxable fringe benefits to employees who enjoy a marginal rate of 24 percent are losing money by the arrangement: more so if the employees' rebates place them in an even lower bracket. From a policy perspective, this is not a result that causes concern to the government, because it is usually preferable from an economic point of view to encourage employers to remunerate their staff in cash rather than in kind.

XVI. CURRENT SOCIAL POLICIES WITHIN THE NEW ZEALAND INCOME TAX ACT

The difficulties that arise from using income taxation as an instrument of social and economic policy have long been recognized. The distorting effect on the economy, which is not discussed in detail in this article, is of course the most serious. A second difficulty is that incentives delivered through the income tax system are partially hidden and their cost is difficult to measure. The third contributes to the theme of this article: using income tax legislation for incentives leads to complexity in the legislation.

New Zealand's tax reforms in the late 1980s removed the bulk of the economic and social incentives from the Income Tax Act, together with some of the redistributive effects of the Act. The reasons for these changes were primarily to remove economic distortions. But a welcome by-product was a degree of simplification of the legislation, though simplification by removal of economic incentives was more than offset by base-broadening measures such as the controlled foreign company regime that is mentioned earlier in this paper.

1. (1895) 14 New Zealand Law Reports 438, Prendergast CJ.

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XVII. INTERPRETATION OF THE ACT

In New Zealand, as in other common law countries, the courts have responsibility for the interpretation of income tax legislation. This responsibility is discharged in the context of disputes between the Commissioner of Inland Revenue, formerly the Commissioner of Taxes, and taxpayers, where there is a disagreement about the meaning of one provision or another. The first reported case on the 1891 Act, *Commissioner of Taxes v. The Gear Meat Preserving and Freezing Co. of NZ Ltd.*,[2] involved the question of whether the Gear Meat Company could deduct its interest payments in calculating its assessable income. This is a question that is still being litigated in its various forms. Only in mid-1991 the Commissioner of Inland Revenue withdrew an appeal to the Privy Council that he had lodged against a Court of Appeal decision on the point in favour of Sir Ronald Brierley, one of New Zealand's leading businessmen.

Be that as it may, in the Gear Meat Company case Richmond J in the Supreme Court made a strong start on the question of the interpretation of income tax legislation. He said at page 525: "One would also expect to find observed in any scheme of taxation adopted in a civilized country the equitable principle that no interest in property assessed and liable to taxation as belonging to A should be at the same time assessed and liable to taxation as belonging to B."

The relevance of this passage to the deductibility of interest is not important in the present context. What is important is that Richmond J approached the interpretation of tax legislation from the point of view of principle, of equity, and of the standard of conduct that people might expect of a civilized country.

Most people would think this an entirely proper way to proceed. However, any tax lawyer from a common law jurisdiction knows that it is quite against the law as propounded by other judges. In fact one of the most frequently quoted aphorisms of tax law interpretation is that there is no equity about a tax.

Three years after the Gear Meat Company case, Prendergast CJ put New Zealand tax jurisprudence back on track in *Commissioner of Taxes v. Duthie & Co. Ltd.*,[3] where he said: "However unequal or unreasonable this legislation may be, that does not permit that the true interpretation of the Act should be departed from."

Broadly speaking, that has been the principle of interpretation of tax law by the judges ever since, except that in recent years some judges have been willing to allow questions of principle a greater role.

XVIII. REASONS FOR STRICT INTERPRETATION

The most often quoted reason for the strict interpretation of tax legislation is that tax law is essentially confiscatory and therefore ought to be interpreted strictly, like a penal statute, to minimize the encroachment on the rights of the citizen. This reason is not so often called in aid nowadays, when it is appreciated that taxation is an essential operation of the body politic. Also, the reason is contrary to Section 5(j) of the New Zealand Acts Interpretation Act 1924. Broadly speaking, Section 5(j) requires statutes to be interpreted liberally. Section 5(j) governs the interpretation of all statutes, though its ostensibly comprehensive coverage has not always been an impediment to literally minded judges.

There are less obvious, but more influential, reasons for the practice of strict interpretation of tax statutes. They are related to, indeed a consequence of, the causes of complexity of tax law that have been discussed in this article: first, that income tax law is founded on a distinction without a difference, namely the purported separability of capital gains and income gains, and, secondly, the practice of using the tax system to achieve social and economic goals.

On one hand, judges seeking an ultimate foundation of principle for the fact that some gains are taxed and some are not realized that they were on a fruitless quest. On the other hand, they were faced with provisions in fiscal legislation that, far from promoting the major purpose of the legislation (assessing and gathering tax) are calculated to furnish benefits to the citizen pursuant to economic or social goals of the government that are not always fully articulated and that are often inconsistent with one another. All that judges could do was to conclude that tax law is, as it were, itself an *a priori* truth. It must be treated as a first cause that owes no debt of logic or paternity to fundamental principle. Consequently, rationalization and principle can be taken only so far; tax law must be interpreted strictly, within the confines of its own statutes.

XIX. RESULTS OF STRICT INTERPRETATION

The first result of the judges' strict interpretation of tax law is the obvious one, that it is often very difficult to reconcile one case with another, even on the facts, let alone according to principle.

The second result is indirect. Because of the strict interpretation of revenue statutes parliaments have felt compelled to draft laws in exquisite, elaborate and often incomprehensible detail, in an effort to ensure that the courts interpret them according to what was intended. Even then, the effort is sometimes in vain.

This reason helps further to explain the incomprehensibility of tax law. Incomprehensibility is something that feeds on itself. The Income Tax Act is based on a mistake of principle, and is employed to pursue goals that sit uneasily with taxation. These factors in themselves make the Act hard to understand. This lack of understanding leads judges to confine themselves to the strict words of the Act because there is no over-arching principle to which they can turn. To ensure that the courts get it right, Parliament is forced to go into increasing detail with its laws. And so the treadmill goes on.

2. (1893) 12 New Zealand Law Reports 521.
3. (1898) 17 New Zealand Law Reports 139, 143.

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INTERNATIONAL:

A TAX ON GROSS ASSETS OF ENTERPRISES AS A FORM OF PRESUMPTIVE TAXATION

Efraim Sadka and Vito Tanzi

I. INTRODUCTION

In 1988 Mexico adopted a new tax on enterprises and individuals who engage in business activities. The base of the tax was broadly the gross assets of the taxpayer. The tax became effective in 1989 and was imposed at the rate of two percent. For technical reasons it was extensively amended on 26 December 1990. In 1989 Argentina introduced a similar tax, which became effective in 1990 at the rate of one percent. Both are annual taxes calculated on the basis of the assets declared by the enterprises or other taxpayers who own real assets. Bolivia, Costa Rica, Peru and Uruguay have been considering the introduction of similar taxes. In Costa Rica in 1990 the government proposed such a tax to Congress but the proposal was rejected. It is likely that over the next decade the tax on gross assets will spread to other Latin American countries and perhaps to countries in other parts of the world.

There have been two basic reasons for the introduction of this tax in Latin America: first, the need for additional revenue in countries undergoing major adjustment programmes; second, the realization that traditional taxes on the income of enterprises do not fare well in situations of substantial inflation. Inflation generally destroys the taxable base for the traditional taxes on business income. Furthermore, enterprises accumulate large losses that can be carried forward to future years and that guarantee that the enterprises will escape paying any taxes for several years.[1] There has been a negative popular reaction in many countries to apparently viable enterprises that had over several years been declaring losses to the tax authorities.

The tax on the gross assets of commercial or business activities may appear as a recent technological development in the tax field and, in a way, it is. However, as with many "new" ideas in economics, it has a quite respectable background, a background that goes back to the 17th century and that, in this century, has received the attention of two prominent economists, namely Luigi Einaudi and Maurice Allais. Some version of this tax also featured in earlier years in the tax systems of the centrally planned economies.

In this paper we provide an analysis of this tax within the context of presumptive taxation in general.[2] The next section will survey briefly the historical background. Sections III and IV will discuss some aspects of presumptive taxation of which the tax on gross assets is an example. Section V will address more directly the tax on gross assets while Section VI will draw a few conclusions.

II. HISTORICAL BACKGROUND

The idea of a tax on the value of assets, rather than on the income that the assets generate, seems to have originated in the 17th century in the Principality of Milan when in 1760 a cadastre listing land values was enacted into law and agricultural activities were no longer taxed on some estimate of actual income generated but on the value of the land.[3] This new tax ignored the personal conditions of the owners. Writing in 1839, Carlo Cattaneo, a prominent Italian economist of the period, wrote:

> The principal effect [of this tax] was to weigh on leisure and to stimulate enterprise and effort; since, once the tax was estimated on the base of the cadastral value, all successive improvements were exempt; the better is the land cultivated, the lower is the tax.[4]

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Contents

I. Introduction
II. Historical Background
III. A Model of Presumptive Taxation
IV. Properties of Presumptive Taxation
V. A Tax on Gross Assets of Enterprises
A. Tax base
B. Tax rate
VI. Conclusion
Appendix

1. Both of these reasons were important in Argentina and Mexico.
2. For earlier discussions of taxes on presumptive income see Tanzi (1980) and Tanzi and Casanegra de Jantscher (1989).
3. That this was a new idea is indicated by the fact that the earliest date reported by the *Oxford Universal Dictionary* for the use of the word "cadastre" is 1804.
4. Cited in Einaudi (1959), at 213.

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Cattaneo added that "with a single operation one can punish leisure and stimulate effort".[5] He attributed to this tax the economic prosperity that followed its introduction in the Principality of Milan.

The principles espoused by Cattaneo were accepted and developed by Luigi Einaudi, the distinguished Italian policy maker and economist who, after World War II, became Governor of the Central Bank of Italy and President of the Italian Republic. Einaudi was one of the most respected public finance scholars in the first half of this century and to this day remains very influential in Italy and in Latin America. Unfortunately, because his work is available only in Italian, it has not had the influence it deserves in the Anglo-Saxon world.

Almost 60 years ago Einaudi presented his ideas about what he called the optimum tax (or "imposta ottima").[6] He argued against a tax based on the effective income of a taxpayer, a tax that he described as "technically impossible" and "economically disastrous" because of its effects on incentives. He favoured an income tax based on "average income" by which he meant the income that would be received in a given year by a taxpayer who (a) worked an average number of hours, (b) contributed an average level of effort, (c) took an average risk and (d) used the average technology of the time. He argued that an income tax based on "average income" (or using Einaudi's preferred terminology, on "normal income") would stimulate production and contribute to growth. The concept of "normal income" is still frequently discussed in Italy where it has many supporters and has had some effect on recent Italian tax legislation.[7] The presumptive taxes in several other countries [8] are often an application of this concept (see Tanzi and Casanegra, 1989).

Einaudi stressed that "the fertility of the idea is not limited to land. [But it can be applied] to the taxation of commercial, industrial, and professional incomes" (Einaudi, pp. 226-27). He argued that, when taxpayers are taxed on the basis of an average income and not on their actual income, they have an incentive to produce above the average, as this excess would be taxed with a marginal rate of zero. He maintained that the determination of the "normal income" *for a given category of taxpayers* should be easier than trying to ascertain the effective income of each taxpayer as is done in modern income tax systems.

Another casualty of linguistic provincialism is Maurice Allais's book, *L'Impôt sur le Capital et la Réforme Monétaire* (Tax on Capital and Monetary Reform). This book, written by a Nobel Prize winner, is unknown to English readers. It was first published in 1977 and was reissued, also in French, in 1988. It proposes a tax system based on a general tax on physical assets, a general tax on consumption and a few other revenue sources. For us the interesting tax is the one on physical assets.

The general tax on physical assets would be levied with a uniform rate of two percent (interesting enough, this is the level of the Mexican tax on gross assets) and would replace existing income taxes on individuals and enterprises. The base of the tax would be only physical assets. It would thus not include bonds, shares, money holdings and other non-physical assets (such as patents, copyrights or brand names). No deductions would be allowed. Allais proposed an ingenious system for presenting the annual declaration and for determining the value of the assets. Because of space limitations only a brief description is provided here.

The taxpayer would present an annual declaration in which she would list and provide an estimated value *for each and all* assets located in a given municipality or district. A tax payment equal to two percent of the declared value of the assets would accompany the declaration. The taxpayer could choose to remain anonymous, if she wished, as long as she provided the full list of the assets she owned and sent the full payment. Thus, in a way, the tax would be *ad rem* rather than *ad personam*. The tax administration would make public the list of all assets reported and the declared values. It would not challenge the declared values but would have the power to buy any asset which it considered undervalued provided that it paid a price equivalent to 140 percent of the declared price. Any person could also propose to buy any asset on the published list at 150 percent of the declared value. Any such proposal, however, would be accompanied by a substantial deposit in order to discourage frivolous offers. The taxpayer who owned the asset under consideration would have the option to respond by paying five percent of the declared value if the proposal to buy was made by the tax administration, and by paying ten percent of the value if the proposal to buy was made by someone else. In this latter case, half of the payment by the taxpayer would go to the person who offered to buy the asset at 150 percent of its price.

Allais argues that his general tax on physical assets would stimulate investment, would be equitable and would reduce tax evasion to practically zero. In fact, if the system worked, the job of the tax administration would be reduced largely to ascertaining that all assets were reported, a function much easier than ascertaining values.

To complete this brief historical survey, a mention should be made of the taxes on the book values of the fixed assets of state enterprises introduced in the 1960s by several centrally planned economies. These taxes, levied with rates of five to six percent, were intended to stimulate a more efficient use of capital and to provide a sort of dividend to the state which provided the capital to the enterprises. These taxes were eventually phased out.

III. A MODEL OF PRESUMPTIVE TAXATION

Suppose an individual possesses some endowment of a productive good or service. This commodity could be, for instance, land, or capital, or leisure. We assume that this

5. *Id.*, at 214.

6. Einaudi's basic ideas, together with a discussion of the experience in the Principality of Milan and of the work of Cattaneo, are outlined in Chapter 10 of Einaudi (1959). Chapter 10 is entitled, "The Italian Science and the Optimum Tax" and was first published in 1938 although the basic ideas are contained in earlier writings of 1924.

7. A recent Italian book has analysed the concept and the experiences with taxes on "normal income". See Leccisotti (1990).

8. Until 1975, presumptive income taxes were imposed in Israel on many types of self-employed individuals. Today, these taxes apply only when the taxpayers' records are poorly maintained.

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endowment generates some non-market benefit to its individual owner. For instance, she may enjoy the self-consumed landscape services, or recreational services, or crops of some piece of land, or the self-consumed housing services of a house. In the case of leisure, the individual may enjoy the direct consumption of it. Another possibility is to assume that for the endowment to produce a market good or service, the individual owner has to put some effort in the production process. She may have to hire workers and supervise them. She may have to search for the best or most efficient uses of her capital, etc.

In any event, we assume that for the endowment of the productive good or service to produce a market good, the individual owner must give up some non-market benefit which is not taxable, or invest some effort in the production process. In both cases there is a loss of utility. In order to avoid needless repetition we will simply say that the individual must make some effort in order to obtain a market, consumable, good or service from her productive endowment, and that effort is a "bad", not a "good", in that it generates disutility. We think that this is a fair description of the productive characteristics of capital, and especially land, in many developing countries. For developed countries, this setup is more suitable for the study of the labour-leisure trade-off.

Denote the consumption of the market good by x, and effort by y. We then say that individual utility (u) is some function, $u = u(x,y)$, of x and y. Utility depends positively on x, but negatively on y. Thus, the individual faces the following choice or trade-off: in order to enjoy x, she must suffer from y.

Specifically, suppose that if the individual makes a "normal" (or "average") effort, she earns from her productive endowment an actual income of n. We refer to this level of income as normal (or average) income. Of course, she can make more or less than a normal effort, in which case her actual income will be more or less than the normal income, respectively. Let us calibrate the level of effort so that a normal effort will be designated by $y = 1$. Thus, actual income (denoted by z) is given by:

(1) $z = yn$.

When normal (or average) effort is made (i.e. $y = 1$), actual income, according to equation (1), is indeed equal to normal income (i.e. $z = n$). When more than a normal effort is made (i.e. $y > 1$), then actual income exceeds normal income (i.e. $z > n$). Similarly, when less than a normal effort is made (i.e. $y < 1$), then actual income falls short of normal income (i.e. $z < n$).

The consumption that an individual can enjoy is equal to net, after-tax actual income, that is:

(2) $x = z\text{-}T \equiv yn\text{-}T$,

where T is the tax payment.

Now, suppose that the government can choose between two alternative income tax schemes. The conventional scheme is a tax on actual income, that is, a tax on z. In this case, T is some function, say T_A, of z, that is:

(3) $T = T_A(z)$.

An alternative scheme is a tax on normal (or average) income, that is, a tax on n.[9] Such a tax on normal or average income may be termed also as a tax on *presumptive* income (see Tanzi and Casanegra de Jantscher (1989)). In this case, T is some function, say T_N, of n, that is:

(4) $T = T_N(n)$.

According to this tax scheme, the individual who makes more than a normal effort and earns an actual income (z) in excess of normal income (n) gets to keep all of the excess income to herself. In this way, the individual is not penalized by the state with a higher tax liability for making more effort. Making more effort produces a higher actual income without creating a higher tax liability, unlike the case when the tax is levied on actual income. In the latter case, more effort, which means more actual income, generates also a higher tax liability. Put differently, with a tax on normal income, the marginal tax rate on actual income is zero.

The detailed derivation of our analytical model is relegated to the Appendix. In the next section, we will only state and explain heuristically the results.

IV. PROPERTIES OF PRESUMPTIVE TAXATION

Several useful and interesting comparisons can be made between the tax on normal or presumptive income and the tax on actual income. Since normal income is exogenously given (at least in the short run), it follows that the base for the normal income tax is fixed and thus does not depend on individual behaviour. In this way the normal income tax works like a lump sum tax: it imposes no marginal tax burden on actual income. Thus, it maintains Pareto efficiency. This is not to say that the tax does not change individual behaviour. To the contrary, when effort is a normal "bad" (that is, the individual will make less effort to increase actual income, if she is given a lump sum transfer – a commonly accepted assumption in the labour supply literature), then a tax on normal income increases effort and, consequently, actual income. What is implied by the efficiency of the normal income tax is that no wedge is created by the tax between the individual marginal rate of substitution between consumption (x) and effort (y), on the one hand, and the marginal productivity of her effort (n), on the other hand.[10] This is unconditionally true in the short run, since normal income is fixed in the short run.

In the longer run, individuals can invest in their human capital and increase their productive capacity. That is, they can increase normal income (n), which is the income that can be obtained by a normal level of effort (namely, $y = 1$). Hence, a tax on normal income tends to discourage investment in human capital in the long run. But so does the tax on actual income. This is because an increase in normal income means an increase in actual income as well. This disincentive effect of both forms of taxation on investment in human capital may be alleviated, in principle, and even totally eliminated, by allowing appropriate tax deductions for investment in human capital.

9. Many aspects of such a tax, in one version or another, were discussed by Tanzi (1980) and by Tanzi and Casanegra de Jantscher (1989).

10. Notice that the marginal productivity of effort is equal to normal income (n). This is because, by (1), increasing effort (y) by one unit increases actual income (z) by n.

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In contrast, the tax on actual income has the familiar disincentive effects on effort. Therefore, its redistributive capacity is severely restricted. One always has to consider the tradeoff between the size of the national pie and its distribution when employing a tax on actual income in order to reduce income inequalities.

Furthermore, actual income (or consumption) is not a good measure of utility or well-being. Utility depends not only on actual income but rather also (negatively) on work effort. Therefore, when individual A has a higher actual income than individual B, it does not necessarily mean that individual A is better off than individual B, if individual A had to make a much greater effort than individual B in order to obtain a higher actual income. Thus, to tax more heavily people with higher actual income is not necessarily equitable. For instance, John Stuart Mill (1923, p. 808) wrote:

> I am as desirous as anyone that means should be taken to diminish... inequalities, but not so as to relieve the prodigal at the expense of the prudent. To tax the larger incomes at a higher percentage than the smaller is...to impose a penalty on people for having worked harder....[11]

Therefore, because of the disincentive effects on effort and because actual income is not necessarily a good indicator of well-being, it follows that an optimal tax on actual income is not necessarily progressive, that is, the average tax rate on actual income (namely, $T_A(z)/z$) need not increase in line with actual income (namely, z). In his pioneering work, Mirrless (1971) concluded that the tax is almost linear for the bulk of the income range, that is, the marginal tax rate is almost constant (a flat rate income tax). Sadka (1976) showed that the marginal tax rate on actual income should gradually decline to zero at the top end of the income distribution.

In contrast, the optimal tax on normal income should always be progressive. That is, the average tax rate on normal income (namely, $T_N(n)/n$) increases in normal income (namely, n). Apparently, this result obtains because the normal income tax creates no disincentive effects on effort.

Another result which is most important for our purposes is that it is often the case that when actual income serves as the tax base, people with low actual incomes will not be taxed at all and may even be offered some kind or another of income supplements (a negative income tax). This creates a strong incentive not to make any effort at all to produce actual income. Most studies of optimal taxation on *actual* income suggest that people at the bottom end of the distribution of *normal* income find it in their interest to have no actual income and they in fact choose to have no income. This is socially inefficient. With a tax on normal income, this is never the case. Everyone will produce an efficient amount of actual income, given his or her normal or presumptive income.[12]

V. A TAX ON GROSS ASSETS OF ENTERPRISES

In many countries, mostly developing ones, the tax on the *actual* income of enterprises had led to many problems. A major problem is the inflationary environment of these countries which allowed companies to change true sizable profits, via nominal interest deductions, into reported losses for tax purposes (see Sadka, 1991). The enterprises simply stopped contributing to tax revenues and the withholding tax on wage earners became the major source of direct tax revenues. For instance, during the high inflation periods in the early 1980s in Israel, and before a comprehensive tax indexation scheme could exert its influence on tax revenues, wage earners accounted for roughly two thirds of all income tax revenues, compared with about 40 percent at present. Furthermore, since accumulated losses are in many cases carried forward with indexation for inflation, enterprises could go on without any contribution to tax revenues for many years.

Second, in some developing countries capital is not always allocated to its most efficient uses. The reason might be that there are alternative, socially inefficient uses by the owners of capital, which are intangible and thus untaxable; consequently, such uses become attractive to the individual, private owner, even though they are socially inefficient.

In such cases, a tax on gross assets of individuals and enterprises may serve as a tax on normal or presumptive income, as compared with a tax on actual income. This is because gross assets may be a good indicator of *normal* or *average* income. Thus, a tax on gross assets has in the long run similar effects on employment and capital accumulation as a tax on actual income, but it enhances more efficient uses of capital[13] and is easier to administer in developing countries, especially in inflationary environments.

Indeed, economic theory suggests that the market value of the firm's assets is equal to the net present value of the future (after tax) cash flows generated by these assets. That is, the market value of the assets reflects more the high *true* profits to be generated by them, rather than the low profits or even losses *reported* for tax purposes.

As mentioned earlier, a tax on gross assets of enterprises has been introduced in Mexico and Argentina, and has been under consideration in Costa Rica, Peru and Uruguay. So it is very likely that this tax will spread to other developing countries. (One may view the property tax in developed countries

11. A similar argument may apply to risk-taking when losses cannot be fully offset for tax purposes. In this case, one can argue that "to tax the larger incomes at a higher percentage than the smaller is...to impose a penalty on people for having taken a greater risk". This argument is nullified when losses are fully offset. In the latter case, the tax refund in the event of a loss compensates for the higher tax in the event of a big gain.

12. Finally, one can equivalently replace the notion of normal (or average) income by the notion of *potential* income, where the latter is defined as the income the individual can achieve when she makes the *maximum* level of effort. Whether the tax is levied on normal or potential income -- in both cases the tax base does not depend on individual behaviour. Normal income as well as potential income are both exogenously given, at least in the short run. Hence, a tax on normal income can be equivalently replaced by a tax on potential income (with a lower rate) and vice versa (see the Appendix for a formal proof). Thus, all the advantages of the normal income tax pertains to the potential income tax as well. However, normal income being an average for many taxpayers is easier to measure.

13. A tax on gross assets is neutral with respect to risk-bearing because the tax liability is then a priori given, independently of whether a high return or a low return is actually experienced. In contrast, a tax on actual income, without a loss offset, discourages risk-bearing since it cuts into the owner's high return in case of "success" without offering a tax refund in case of "failure" (loss). With full loss offset, a tax on actual income encourages risk-bearing, since it reduces the risk to the owner, by taking an equal share in profits and losses.

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as a kind of tax on gross assets, though it does not serve in lieu of a tax on the income generated by the property.) It will be therefore useful to study the main practical issue associated with a tax on gross assets. As with the implementation of any tax, key elements are the definition of the tax base and the determination of the tax rate.

A. *Tax base*

In determining the tax base, one has to pay attention to two issues: which assets to include in the base and how to evaluate them. The two issues are not totally independent of each other. For instance, one may wish to exclude a certain asset from the tax base not on theoretical grounds, but rather simply because there is no practical, meaningful way to evaluate it.

When dealing with the issue of evaluating assets, the first aspect that comes to mind is inflation. However, in order not to be overwhelmed with the effect of inflation and distract attention from other, perhaps even more complicated issues, we shall leave aside discussion of the effect of inflation for later on, and assume for the moment that the rate of inflation is negligible.

In principle, we think that the tax base should include all fixed assets, such as land, structures, machinery and equipment. These assets are essential to the production process of the firm. Coupled with labour, raw materials, energy and other variable inputs, these fixed capital assets generate a stream of incomes to the firm. The idea is then to calculate and tax the *normal*, additional (marginal) contribution of these assets to the firm's stream of incomes.

In order to avoid double taxation, the firm's holdings in fully or partially owned subsidiaries or any other companies should not be included in the firm's tax base because the subsidiary itself is liable to pay the tax on its gross assets. An exception to this rule is the firm's holdings in foreign entities. These holdings should be taxed with proper credit afforded against foreign-paid taxes. A difficulty may arise regarding enterprises that are owned by foreign firms. In this case, it is essential to work out a tax treaty with the foreign countries that will accept the tax on gross assets as an income tax, which qualifies for a foreign tax credit in the foreign countries. For otherwise, enterprises owned by foreign firms will be taxed twice: by the home country (through the tax on gross assets) and by the foreign country (via the income tax). So far, the US Internal Revenue Service has refused to grant credits against foreign taxes on gross assets, claiming that such taxes cannot be viewed as income taxes. For this reason, Mexico, for instance, made the tax on gross assets a minimum *income* tax, so that US firms will qualify for credits against taxes on gross assets paid by their subsidiaries in Mexico. We shall discuss this issue further in the concluding section.

Cash balances, accounts receivable, inventories and other current assets should not be included in the tax base. The rationale for this is that these assets are not inherent in the production process, nor do they constitute an integral part of the real economic nature of the firm's activity. They are there because production and transactions are not timeless and because of the institutional framework in which the firm operates. If the firm were always to sell its products and to pay for its labour, raw materials, etc., at exactly the same point in time, then it would hold no cash and there would be no accounts receivable (nor accounts payable on the liability side). Similarly, if production were timeless, the firm would hold no inventories. Current assets tend, by their very nature, to fluctuate considerably during the year in response to various transitory phenomena and they could not serve as a measure of the firm's "ability to pay", when the latter concept is understood to be tantamount to the firm's potential income.

In principle, the tax base should include not only tangible assets but intangible assets as well. For instance, intangible assets, such as goodwill, brand name and market power, certainly have their own contribution to the firm's ability to pay or potential income. Thus, they should, in principle, be taxed. However, there does not seem to be a practically meaningful way to establish arm's length prices for these intangibles[14] and hence they should be excluded from the tax base for practical reasons. An exception to this rule arises when the firm is sold to an arm's length party. In the latter case, it is very likely that the price paid for the firm will reflect, in addition to the production costs of the firm's *net* tangible assets plus some adjustment costs and the like (Tobin's q), also the value of the firm's intangibles. It is interesting to note in this case that the buying firm (the parent company) will include the value of the intangibles of the purchased firm (the daughter company) in its consolidated balance sheet, either as a separate item or as an imputation to the other tangible assets of the daughter firm. But the daughter company will still have no mention of the value of the intangibles in its balance sheet. Thus, when computing the value of the gross assets of the daughter firm, one has to resort to the parent company's financial statements in order to compute the value of the intangibles. Notice that our recommended treatment of intangibles creates some inequity: in one case (when they are realized), they are subject to tax; in another case, they are not. In this respect, our treatment of intangibles is no different than the conventional treatment of capital gains: when they are realized, they are taxed; when they only accrue, but are not realized, they escape the tax.

Having established what assets to include in the tax base, one has to determine what value to assign to them. Now we drop our assumption that the rate of inflation is negligible. One cannot simply rely on the (historic) book value (i.e. purchase price or production cost) of the assets. A minimal requirement will be to adjust the (depreciated) value of the assets by the rate of inflation. The latter is most commonly measured by the Consumer Price Index (CPI). The market value or replacement cost of many fixed assets, such as machinery, equipment or structures, which are relatively elastically supplied, is closely related to their production costs. In many high inflation, developing countries, wages and other input costs are indexed to the CPI. These other costs may include the cost of energy whose price is set by the government and indexed to the CPI, loans provided either directly or indirectly by the government and indexed (principal and interest) to

14. In fact, in many countries a firm would not officially admit it possesses any kind of market power, since it may invite in such a case one sort or another of government intervention to nullify such a market power.

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the CPI, imported raw materials with the rate of foreign exchange closely following the CPI and other items.

In this case, the depreciated book value of the asset, adjusted by the CPI, may be indeed a good estimate of the market value of the asset. However, for a relatively inelastically supplied factor of production, such as land, the CPI-inflated book value may deviate considerably and consistently from the market value. For such assets, one may consider adjusting the book value by a *regional* index of real estate prices or by asset-specific indexes (see Tanzi, 1981).

Lastly, since some fixed assets may be purchased and some sold during the tax year, the tax base should be a *weighted average* of the stock of gross assets that existed during the tax year. The weight assigned to each asset would be the proportion of the year the asset was owned by the firm.

An alternative would be to tax the assets owned by the firm on a specific day of the year (say, the last day of the fiscal year).

B. *Tax rate*

The first issue that we encounter when discussing the tax rate is somewhat related to the issue of the tax base: whether *gross* assets or *net* assets (that is, gross assets less debt) should be taxed. We advocate gross assets as the tax base. We prefer to impose a relatively *low* tax rate on *gross* assets than a relatively *high* tax rate on *net* assets. Suppose, for instance, that all assets (of firms and individuals) are financed 50 percent by debt (a debt-to-equity ratio of one). In this case a tax on gross assets at the rate of t is equivalent to a tax on net assets at the rate of 2t. Thus, if all firms and individuals use the same rate of debt financing, it would make no economic difference whether gross assets or net assets are taxed (since the tax rate can be adjusted accordingly). Now, firms may employ different debt-financing ratios. We nevertheless still recommend that the tax be imposed on gross assets. In this way, we eliminate any tax advantage to debt over equity financing. All gross assets, no matter how financed, are equally taxed.

This is not to say that we ignore the fact that the firm must pay interest on its debt, which reduces the amount of funds available to pay the tax. To the contrary, the rate of tax will be designed as if the assets were fully financed by debt. This amounts to exempting, at the corporate level, equity holders from tax on a return on their equity, which is equal to the interest on debt. To put it differently, dividends (up to a rate which equals the interest rate) and interest are treated equally, both being tax deductible. Of course, they should both be taxed at the individual level (through interest, dividend and capital gains taxes). In this way, one can achieve an integration of the corporate tax with the individual income tax.

Suppose that the expected real return on capital is estimated to be ρ. Assume further that the *real* rate of interest is r. Under these circumstances, the presumptive "profit" of the firm is taken to be ρ-r per one unit of value of gross assets (after allowing for an imputed interest on equity). If the existing statutory corporate tax rate is τ, then our recommended rate of tax (t) on the gross assets is given by $t = \tau (\rho - r)$.

When resources are (economy-wide) efficiently allocated, ρ and r are uniform across all firms. And to maintain interfirm and interindustry efficiency, the tax rate on gross assets must be uniform too. However, at present it is likely that capital is not efficiently allocated (and one of the aims of the tax on gross assets is to improve efficiency). Therefore, in order to allow a more gradual, smoother transition toward a more efficient resource allocation, interindustry variation in the tax rate on gross assets might be justified. This variation, if introduced, should be gradually eliminated in the longer run.

Lastly, in many countries, with a corporate income tax in place, accelerated depreciation allowances, investment tax credits and the like are often used as counter-cyclical macroeconomic policy tools intended to stimulate a sluggish economy. These tools may be preserved in our case of a tax on gross assets too, in the form of a lower tax rate for new capital assets.

VI. CONCLUSION

We outlined two purposes for a tax on presumptive income. One purpose is to extract some taxes from firms or individuals who managed to take advantage of certain economic conditions (e.g. high inflation) in order to report losses and escape the traditional income tax. Another purpose is to enhance economic efficiency in the spirit of the writings of Einaudi and Allais.

In view of the first purpose, a tax on gross assets can merely serve as a minimum income tax. Thus, the tax on gross assets does not come in lieu of the tax on *actual* income. However, the second purpose dictates that a tax on normal income should not serve as a minimum tax on income. The efficiency advantage of the tax on normal income is that it gives an incentive to the economic agents to produce above the average, as this excess would not be taxed at all (i.e. zero marginal tax rate). Hence, if the presumptive tax only serves as a minimum tax, it loses a great deal of its efficiency advantage, since all income in excess of the income level which generates the minimum tax is then subject to an ordinary tax on actual income.

Nevertheless, practical considerations tilt the balance in favour of the tax on gross assets as a minimum tax and not as a final tax in lieu of the ordinary tax on actual income. Developing countries can vastly benefit from direct foreign investments and are eager to attract such investments. The US Internal Revenue Service is unlikely to accept a tax on gross assets, when it is a final tax, as an income tax. This may be the case in other economic powers. As a result, firms located in the United States, Europe and Japan, may not be entitled to tax credits against foreign taxes on gross assets paid by their subsidiaries in foreign countries. Such firms will be doubly taxed on their investments in countries with gross asset taxes. This could be detrimental for direct foreign investment. Therefore, the tax on gross assets should serve only as a minimum tax and not as a final tax.

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APPENDIX

A. *A basic income tax model*

Following the same notation employed in the text, we note that the individual faces a standard consumer's utility maximization problem, subject to a budget constraint, that is:

(A1) $\max_{\{x,y\}} u(x,y)$
subject to: $x = z\text{-}T \equiv ny\text{-}T$.

It is assumed that u is strictly increasing in x, strictly decreasing in y, and strictly concave in (x,y). It is further assumed that consumption (x) is a normal good, while effort (y) is a normal "bad," that is: a lump sum transfer made to the individual lowers her effort.

Our analysis compares two different income tax schemes. The conventional scheme is a tax on actual income, that is, a tax on z. In this case, T is some function, say $T_A(\cdot)$ of z, that is:

(A2) $T = T_A(z)$.

An alternative scheme is a tax on normal or average income, that is, a tax on n. In this case, T is some function, say $T_N(\cdot)$ of n, that is:

(A3) $T = T_N(n)$.

In order to compare these two tax schemes, one has to specify the objective of the government, the government's revenue needs and the productive capacity of the economy. Suppose that the range of normal incomes in this economy is between $N_1 > 0$ and $N_2 < \infty$, and let F(n) describe the cumulative distribution function of normal incomes, that is: F(n) is the number of individuals with a normal income below n, or equal to n. Denote the level of effort that an individual with a normal income of n (henceforth, an n-individual) makes by y(n), so that her actual income is then $z(n) \equiv ny(n)$.

Suppose also that the government has to finance an amount G of public expenditures by income tax revenues. Let T(n) be the tax payment made by an n-individual, whether through a tax on actual income or on normal income.

The government then faces a budget constraint

(A4) $\int_{N_1}^{N_2} T(n)dF(n) = G.$

which states that tax revenues (the left-hand side of (A4)) must equal public expenditures.

In designing the tax scheme, the government attempts to maximize some social welfare function which we assume to be of the commonly employed form

(A5) $\int_{N_1}^{N_2} \frac{1}{1-\sigma} [u(n)]^{1-\sigma} dF(n),$

where $0 = \leq \sigma \neq 1$, and u(n) is the utility level enjoyed by an n-individual.

The above social welfare function is very general. Two extreme, special cases are worth mentioning. When $\sigma = 0$, we have the classical Benthamite, utilitarian sum-of-utilities social welfare function. When σ approaches infinity we have the Rawlsian max-min social welfare function, which exhibits the highest degree of egalitarianism. Thus, depending on the specific value of σ, the social welfare function (A5) can exhibit any degree of egalitarianism, from the lowest level to the highest level. In what follows, we do not assume any specific value of σ, so that our results hold in general for any degree of egalitarianism.

Our aim is to compare a tax on actual income, in which case

(A2′) $T(n) = T_A(z(n))$,

and a tax on a potential income, in which case

(A3′) $T(n) = T_N(n)$.

The optimization problem faced by the government when designing an optimal tax scheme on actual income is to choose such a tax scheme which maximizes the social welfare function (A5), subject to the budget constraint (A4). In doing so the government faces also a *market* economy implementability constraint which states that the government can dictate neither the level of effort (i.e. y(n)), nor the actual income (i.e. $z(n) \equiv ny(n)$), nor the consumption (i.e. x(n)) of an n-individual. Rather, once the government chooses a tax scheme on actual income (i.e. T_A), it is left up to an n-individual to choose her level of effort, actual income, and consumption so as to maximize her utility subject to her budget constraint (see A(1)). A similar optimization problem is faced by the government in designing an optimal tax on normal income.

Fortunately, it turns out that our basic model is isomorphic to the optimal tax model developed by Mirrlees (1971), and then further analysed for our purposes by Sadka (1976a and 1976b), and by Helpman and Sadka (1978). The results reported in the text draw on these studies.

B. *An extension: a diversity of distastes for effort*

A useful extension of the model employed so far is to let variations of actual incomes for any given level of normal income. Specifically, let us assume that for each level of normal income there are many people with different tastes for consumption and distastes for effort. That is, utility (u) becomes a function not only of consumption (x) and effort (y), but rather also of some taste parameter (α), that is $u=u(x,y,\alpha)$. For each level of normal income (n), denote the cumulative distribution function of the taste parameter by $H_n(\cdot)$.

Here again we may consider a tax on actual income and a tax on potential income. Under the latter tax, people with the same normal income (n) may generally have different actual incomes, depending on their taste parameter (α), but they are all liable for the same amount of tax.

This extended model is also isomorphic to a model of income taxation studied by Helpman and Sadka (1978). It turns out that the results presented in the text (for the original model) are valid in our extended model as well.[15]

15. Strictly speaking, we have to assume that the distributions of normal incomes and of tastes are statistically independent (that is: H_n is independent of n).

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C. *An extension: a tax on potential income*

We have so far calibrated the level of effort so that y = 1 was designated as a "normal" level of effort. Hence, an income level of n which equals ny when normal effort (i.e. y = 1) is made, was designated as normal income. Thus, a tax on n was a tax on normal income.

One may alternatively calibrate effort so that y = 1 is the maximum level of effort or potential effort. In this case, an income level of n which equals ny when the maximum effort (i.e. y = 1) is made may be interpreted as potential income. With this interpretation in mind, a tax on n is a tax on potential income (see Tanzi, 1980).

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THE NEW US/NETHERLANDS DOUBLE TAX CONVENTION: AN INTRODUCTORY NOTE

Wim Wijnen

On 18 December 1992 the Netherlands and the United States signed a new tax treaty which will replace the existing 1948 treaty. The new treaty has to be submitted for parliamentary approval in both countries, meaning that its earliest effective date is 1 January 1994. The new treaty provides for a transitional period of one year.

The most important feature of the new treaty is undoubtedly the limitation on benefits provision, an anti-abuse provision which is more or less common in recent US tax treaties. This provision restricts the benefits of the new treaty to persons who meet the requirements of a stock quotation test, an activities test or a shareholders/base erosion test. A new feature is a separate test for headquarter companies.

The limitations on benefits provisions are much more detailed and complicated than is usual in US treaties for two reasons. First, related companies are taken into account to a much larger extent. Further, these tests also take into consideration activities and related companies in other EC member states. However, it should be noted that this EC extension is limited to situations in which the treaty between the United States and the respective EC member state would have offered the same treaty benefits.

The rate of withholding taxes remains unchanged, i.e. five percent for participation dividends (participation of at least ten percent) and 15 percent for other dividends. The 15 percent rate is also available in certain circumstances for distributions by Real Estate Investment Trusts or Netherlands real estate investment companies. The withholding tax rate for interest and royalties remains at zero percent. Under certain conditions no secondary withholding tax will be levied on royalties. A branch profits tax of five percent is new.

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Other salient features of the new treaty include:
- the definition of US and Netherlands territory includes the continental shelf;
- the treaty applies to the Netherlands state profits share;
- the treaty provides for a deemed permanent establishment with respect to offshore activities continuing for more than 30 days;
- the treaty applies to the insurance excise tax;
- there is no tie-breaker rule for dual resident companies;
- capital gains on shares in real estate investment companies are taxable in the situs state; under certain conditions step-up to the value of 1984;
- lump-sum payments within five years after migration are taxable in the source state;
- exemption from dividend withholding tax for pension funds;
- exemption from tax in both states for charitable, scientific, educational and public purpose organizations.

Finally, the Netherlands will introduce legal measures to prevent the use of foreign permanent establishments as financial instruments by Netherlands incorporated companies (triangular cases). These measures are to be taken before the new treaty is sent for approval to the US Senate Foreign Relations Committee. However, if such anti-avoidance measures are not adopted into Netherlands law by that time, such measures will be set forth in a separate protocol to the new treaty.

EXCERPTS FROM US/NETHERLANDS DOUBLE TAXATION CONVENTION

Article 2
TAXES COVERED

1. The existing taxes to which this Convention shall apply are in particular:

a) in the Netherlands:
- de inkomstenbelasting (income tax),
- de loonbelasting (wages tax),
- de vennootschapsbelasting (company tax),

including the government share in the net profits of the exploitation of natural resources levied pursuant to the Mining Act 1810 (Mijnwet 1810) with respect to concessions issued from 1967, or pursuant to the Netherlands Continental Shelf Mining Act of 1965 (Mijnwet Continentaal Plat 1965) hereinafter referred to as "profit share",
- de dividendbelasting (dividend tax),

(hereinafter referred to as "Netherlands tax");

b) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding social security taxes), and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations (hereinafter referred to as "United States tax").

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The Convention shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which provides exemption from these taxes.

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the States shall notify each other of any substantial changes which have been made in their respective taxation laws.

Article 4
RESIDENT

1. For the purposes of this Convention, the term "resident of one of the States" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature, or that is an exempt pension trust, as dealt with in Article 35 (Exempt Pension Trust) and that is a resident of that State according to the laws of that State, or an exempt organization, as dealt with in Article 36 (Exempt Organizations) and that is a resident of that State according to the laws of that State. If, under the laws of the two States, an individual is a resident of both States, his residence for purposes of the Convention shall be determined under the rules of paragraph 2. An individual who is a resident of one of the States under the law of that State, or who is a citizen of the United States, and who is not a resident of the other State under its law, will, for the purposes of this paragraph, be treated as a resident of the State of which he is a resident or citizen only if (i) he would be a resident of that State and not a third State, under the principles of subparagraphs (a) and (b) of paragraph 2 of this Article, if that third State is one with which the first-mentioned State does not have a comprehensive income tax Convention, or (ii) he is a resident of that State and not a third State, if that third State is one with which the first-mentioned State does have a comprehensive income tax Convention, under the provisions of that Convention. However,

a) the term "resident of one of the States" does not include any person who is liable to tax in that State in respect only of income from sources in that State; and
b) in the case of income derived or paid by an estate or trust, the term "resident of one of the States" applies only to the extent that the income derived by such estate or trust (other than an exempt pension trust or an exempt organization organized in the form of a trust, described above in this paragraph), is subject to tax in that State as the income of a resident, either in its hands or in the hands of its beneficiaries.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both States, then his status shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
d) if he is a national of both States or of neither of them, the competent authorities of the States shall settle the question by mutual agreement.

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

4. Where by reason of the provisions of paragraph 1, a company is a resident of both States, the competent authorities of the States shall endeavour to settle the question by mutual agreement, having regard to the company's place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such company shall not be entitled to claim any benefits under this Convention, except that such company may claim the benefits of paragraph 4 of Article 25 (Methods of Elimination of Double Taxation) and of Articles 28 (Non-discrimination), 29 (Mutual Agreement Procedure) and 37 (Entry into Force).

Article 10
DIVIDENDS

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

2. However, such dividends may also be taxed in the State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other State, the tax so charged shall not exceed:

a) 5 percent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 10 percent of the voting power of the company paying the dividends;
b) 15 percent of the gross amount of the dividends in all other cases.

The provisions of subparagraph (b) instead of the provisions of subparagraph (a) shall apply in the case of dividends paid by a United States person which is a Regulated Investment Company or Real Estate Investment Trust or in the case of dividends paid by a Dutch company, which is a "beleggingsinstelling" in the sense of Article 28 of the Netherlands Corporation Tax Act (Wet op de vennootschapsbelasting 1969) (hereinafter referred to as "beleggingsinstelling").

However, neither the provisions of subparagraph (a) nor (b) shall apply in the case of:

i) a dividend paid by a United States person which is a Real Estate Investment Trust, if such dividend is beneficially owned by a resident of the Netherlands, other than a Dutch company which is a "beleggingsinstelling" or other than an individual holding a less than 25 percent interest in the Real Estate Investment Trust; such dividends shall instead be taxable at the rate provided in the domestic law of the United States;
ii) a dividend paid by a Dutch company, which is a "beleggingsinstelling", and which invests in real estate to the same extent as is required of a Real Estate Investment Trust, if the dividend is beneficially owned by a resident of the United States, other than an individual holding a less than 25 percent interest in the Dutch company, or other than a Regulated Investment Company or Real Estate Investment Trust; such dividends shall instead be taxable at the rate provided in the domestic law of the Netherlands.

3. The provisions of paragraph 2 shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

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4. The term "dividends" as used in this Convention means income from shares or other rights participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. For the purposes of this paragraph, the term "dividends" also includes, in the case of the Netherlands, income from profit sharing bonds ("winstdelende obligaties") and, in the case of the United States, income from debt obligations carrying the right to participate in profits.

5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of one of the States, carries on business in the other State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid forms part of the business property of such permanent establishment or pertains to such fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

6. Where a company which is a resident of one of the States derives profits or income from the other State, that 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 forms part of the business property of a permanent establishment or pertains to a fixed base situated in that other State, nor, except as provided in Article 11 (Branch Tax), 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.

Article 11
BRANCH TAX

1. A corporation which is a resident of one of the States and which has a permanent establishment in the other State or which is subject to tax on a net basis in that other State under Article 6 (Income from Real Property) or under paragraph 1 of Article 14 (Capital Gains), may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed only on that portion of the business profits of the corporation attributable to the permanent establishment under this Convention or the income subject to tax on a net basis under Article 6 (Income from Real Property) or under paragraph 1 of Article 14 (Capital Gains) and reduced for all taxes chargeable in that State on such profits and income, other than the additional tax referred to herein, and further reduced (but not below zero) for any increase in the net equity attributable to such permanent establishment at the end of the taxation year, as measured from the end of the preceding taxation year, and increased (but not in excess of the accumulated profits) for any decrease in the net equity attributable to such permanent establishment at the end of the taxation year, as measured from the end of the preceding taxation year.

2. Notwithstanding paragraph 4, for purposes of this Article, the term "accumulated profits" means the excess of the aggregate profits referred to in paragraph 1 of this Article for all the preceding taxation years during which this Convention was in effect, over the aggregate profits taxed under this Article during such preceding taxation years.

3. The tax referred to in paragraph 1 shall not be imposed at a rate exceeding the rate specified in paragraph 2(a) of Article 10 (Dividends).

4. In the case of the United States, the additional tax described in paragraph 1 may be imposed upon the "dividend equivalent amount" (as that term is defined in the law of the United States as on the date of signature of this Convention and as that law may be amended from time to time, but only to the extent that this definition, as amended, is in conformity with the principles of this Article).

5. Notwithstanding paragraph 4, no additional tax may be imposed under paragraph 1 with respect to income subject to tax under paragraph 1 of Article 14 (Capital Gains) which is derived from the disposition of shares or other comparable corporate rights in a company.

CHAPTER V
SPECIAL PROVISIONS

Article 26
LIMITATION ON BENEFITS

1. A person that is a resident of one of the States and derives income from the other State shall be entitled, in that other State, to all the benefits of this Convention only if such person is:

a) an individual;
b) a State, or a political subdivision or local authority thereof;
c) a company meeting any of the following tests:
   i) the principal class of its shares is listed on a recognized stock exchange located in either of the States and is substantially and regularly traded on one or more recognized stock exchanges;
   ii) A) more than 50 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies which are resident of either State, the principal classes of the shares of which are listed and traded as described in subparagraph (c)(i), and
   B) the company is not a conduit company, as defined in subparagraph 8(m); or
   iii) in the case of a company resident in the Netherlands,
   A) at least 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies resident in the Netherlands, the principal classes of the shares of which are listed and traded as described in subparagraph (c)(i);
   B) at least 70 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are residents of the United States or of member states of the European Communities, the principal classes of shares of which are substantially and regularly traded on one or more recognized stock exchanges; and
   C) the company is not a conduit company, as defined in subparagraph 8(m); or
   iv) in the case of a conduit company (as defined in paragraph 8(m)) that satisfies the requirements of subparagraph (c)(ii)(A) or (c)(iii)(A) and (B), such company satisfies the conduit base reduction test set forth in paragraph 5(d).
d) a person:
   i) more than 50 percent of the beneficial interest in which (or, in the case of a company, more than 50 percent of the aggregate vote and value of all of its shares, and more than 50 percent of the shares of any "disproportionate class of shares") is owned, directly or indirectly, by qualified persons; and
   ii) which meets the base reduction test described in paragraph 5; or
e) a not-for-profit organization that, by virtue of that status, is generally exempt from income taxation in its State of residence, provided that more than half of the beneficiaries, mem-

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bers, or participants, if any, in such organization are qualified persons.

2. a) A person resident in one of the States shall also be entitled to the benefits of this Convention with respect to income derived from the other State if such person is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and
   i) the income derived in the other State is derived in connection with that trade or business in the first-mentioned State and the trade or business of the income recipient is substantial in relation to the income producing activity, or
   ii) the income derived in the other State is incidental to that trade or business in the first-mentioned State.

   b) Income is derived in connection with a trade or business if the income-producing activity in the other State is a line of business which forms a part of or is complementary to the trade or business conducted in the first-mentioned State by the income recipient.

   c) Whether the trade or business of the income recipient is substantial will generally be determined by reference to its proportionate share of the trade or business in the other State, the nature of the activities performed and the relative contributions made to the conduct of the trade or business in both States. In any case, however, the trade or business of the income recipient will be deemed to be substantial if, for the preceding taxable year, the average of the ratios for the following three factors exceeds 10 percent (or in the case of a person electing to apply subparagraph (h), 60 percent) and each of the ratios exceeds 7.5 percent (or in the case of a person electing to apply subparagraph (h), 50 percent), provided that for any separate factor that does not meet the 7.5 percent test (or in the case of a person electing to apply subparagraph (h), the 50 percent test) in the first preceding taxable year the average of the ratios for that factor in the three preceding taxable years may be substituted:
      i) the ratio of the value of assets used or held for use in the active conduct of the trade or business by the income recipient in the first-mentioned State (without regard to any assets attributed from a third state under subparagraph (h), except in the case of a person electing to apply subparagraph (h)) to all, or, as the case may be, the proportionate share of the value of such assets so used or held for use by the trade or business producing the income in the other State;
      ii) the ratio of gross income derived from the active conduct of the trade or business by the income recipient in the first-mentioned State (without regard to any gross income attributed from a third state under subparagraph (h), except in the case of a person electing to apply subparagraph (h)) to all, or, as the case may be, the proportionate share of the gross income so derived by the trade or business producing the income in the other State; and
      iii) the ratio of the payroll expense of the trade or business for services performed within the first-mentioned State (without regard to any services attributed from a third state under subparagraph (h), except in the case of a person electing to apply subparagraph (h)) to all, or, as the case may be, the proportionate share of the payroll expense of the trade or business for services performed in the other State.

   d) Income derived from a State is incidental to a trade or business conducted in the other State if the income is not described in subparagraph (b) and the production of such income facilitates the conduct of the trade or business in the other State (for example, the investment of the working capital of such trade or business). In the case of a person electing to apply subparagraph (h), the income that is considered incidental to the trade or business shall not be greater than four times the amount of income that would have been considered incidental to the trade or business actually conducted in the Netherlands.

   e) A person that is a resident of one of the States is considered to be engaged in the active conduct of a trade or business in that State (and is considered to carry on all, or, as the case may be, the proportionate share of such trades or businesses) if such person:
      i) is directly so engaged;
      ii) is a partner in a partnership that is so engaged;
      iii) is a person in which a controlling beneficial interest is held by a single person which is engaged in the active conduct of a trade or business in that State;
      iv) is a person in which a controlling beneficial interest is held by a group of five or fewer persons each member of which is engaged in activity in that State which is a component part of or directly related to the trade or business in that State;
      v) is a company that is a member of a group of companies that form or could form a consolidated group for tax purposes according to the law of that State (as applied without regard to the residence of such companies), and the group is engaged in the active conduct of a trade or business in that State;
      vi) owns, either alone or as a member of a group of five or fewer persons that are qualified persons, residents of a member state of the European Communities, or residents of an identified state, a controlling beneficial interest in a person that is engaged in the active conduct of a trade or business in the State in which such owner is resident; or
      vii) is, together with another person that is so engaged, under the common control of a person (or a group of five or fewer persons) which (or, in the case of a group, each member of which) is a qualified person, a resident of a member state of the European Communities or a resident of an identified state.

   For purposes of subparagraphs (e) (vi) and (e) (vii), an "identified State" includes any third country, identified by agreement of the competent authorities, which has effective provisions for the exchange of information with the State in which the person being tested under this paragraph is a resident.

   f) For purposes of subparagraph (e), a person (or group) shall be deemed to own a "controlling beneficial interest" in another person if it holds directly or indirectly a beneficial interest which represents more than 50 percent of the value and voting power in such other person, provided that:
      i) an interest consisting of 50 percent or less of the value and voting power of any third person shall not be considered for purposes of determining the percentage of indirect ownership held in such other person; and
      ii) no person shall be considered to be part of a group owning a controlling beneficial interest in an entity unless such person holds directly a beneficial interest which represents at least 10 percent of the value and voting power in such entity.

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g) For purposes of subparagraph (e), a person (or group) shall be deemed to have "common control" of two persons if it holds a controlling beneficial interest in each such person.

h) For purposes of applying the rules of this paragraph, where a person that is a resident of the Netherlands is engaged in the active conduct of a trade or business in the Netherlands (or considered to be so engaged under the rules of subparagraph (e)), and activity that is a component part of, or directly related to that trade or business, consistent with the rules of subparagraph (e), is also conducted in other member states of the European Communities, that person may elect to treat all, or, as the case may be, the proportionate share of such activity as if it were conducted solely in the Netherlands, provided that each of the following three ratios exceeds 15 percent:

i) the ratio of the value of assets used or held for use in the active conduct of the trade or business within the Netherlands (without regard to any assets attributed from a third state under this subparagraph) to all, or, as the case may be, the proportionate share of the value of such assets so used or held for use within all such member states;

ii) the ratio of gross income derived from the active conduct of the trade or business within the Netherlands (without regard to any gross income attributed from a third state under this subparagraph) to all, or, as the case may be, the proportionate share of the gross income so derived within all such member states; and

iii) the ratio of the payroll expense of the trade or business for services performed within the Netherlands (without regard to any services attributed from a third state under this subparagraph) to all, or, as the case may be, the proportionate share of the payroll expense of the trade or business for services performed within all such member states.

3. A person that is a resident of one of the States shall also be entitled to all the benefits of this Convention if that person functions as a headquarter company for a multinational corporate group. A person shall be considered a headquarter company for this purpose only if:

a) it provides a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing;

b) the corporate group consists of corporations resident in, and engaged in an active business in, at least five countries, and the business activities carried on in each of the five countries (or five groupings of countries) generate at least 10 percent of the gross income of the group;

c) the business activities carried on in any one country other than the State of residence of the headquarter company generate less than 50 percent of the gross income of the group;

d) no more than 25 percent of its gross income is derived from the other State;

e) it has, and exercises, independent discretionary authority to carry out the functions referred to in subparagraph (a);

f) it is subject to the same income taxation rules in its country of residence as persons described in paragraph 2; and

g) the income derived in the other State either is derived in connection with, or is incidental to, the active business referred to in subparagraph (b).

If the gross income requirements of subparagraphs (b), (c) or (d) of this paragraph are not fulfilled, they will be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four years.

4. a) A company resident in the Netherlands shall also be entitled to the benefits of Article 10 (Dividends), 11 (Branch Tax), 12 (Interest), or 13 (Royalties) if:

i) more than 30 percent of the aggregate vote and value of all of its shares (and more than 30 percent of the shares of any "disproportionate class of shares") is owned, directly or indirectly, by qualified persons resident in the Netherlands;

ii) more than 70 percent of all such shares is owned, directly or indirectly, by qualified persons and persons that are residents of member states of the European Communities; and

iii) such company meets the base reduction test described in paragraph 5.

b) In determining whether, pursuant to subparagraph (a) (ii), a company's shares are owned by residents of member states of the European Communities, only those shares shall be considered which are held by persons that are residents of states with a comprehensive income tax Convention with the United States, as long as the particular dividend, profit or income subject to the branch tax, interest, or royalty payment in respect of which treaty benefits are claimed would be subject to a rate of tax under that Convention that is no less favorable than the rate of tax applicable to such company under Articles 10 (Dividends), 11 (Branch Tax), 12 (Interest) or 13 (Royalties) of this Convention.

5.a) A person meets the base reduction test described in this paragraph if:

i) less than 50 percent of such person's gross income is used, directly or indirectly, to make deductible payments in the current taxable year to persons that are not qualified persons; or

ii) in the case of a person resident in the Netherlands,

A) less than 70 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are not qualified persons; and

B) less than 30 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are neither qualified persons nor residents of member states of the European Communities.

b) For purposes of this paragraph, the term "gross income" means gross income for the first taxable year preceding the current taxable year; provided that the amount of gross income for the first taxable year preceding the current taxable year will be deemed to be no less than the average of the annual amounts of gross income for the four taxable years preceding the current taxable year.

c) For purposes of this paragraph, the term "deductible payments" includes payments for interest or royalties, but does not include payments at arm's length for the purchase or use of or the right to use tangible property in the ordinary course of business or remuneration at arm's length for services performed in the country of residence of the person making such payments. Types of payments may be added to or eliminated from the exceptions mentioned in the preceding definition of "deductible payments" by mutual agreement of the competent authorities.

d) For purposes of paragraph 1(c), the conduit base reduction test means the base reduction test described in this paragraph, except that the term "deductible payments" for this purpose means only those payments described in subparagraph (c):

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i) that are made to an associated enterprise (as described in Article 9 (Associated Enterprises), except that whether two enterprises are associated will be determined for this purpose without regard to the residence of either enterprise; and

ii) that are subject to an aggregate rate of tax (including withholding tax) in the hands of the recipient that is less than 50 percent of the rate that would be applicable had the payment been received in the State of residence of the payer, and subject to the normal taxing regime in that State.

6. A person, resident of one of the States, which derives from the other State income mentioned in Article 8 (Shipping and Air Transport) and which is not entitled to the benefits of this Convention because of the foregoing paragraphs, shall nevertheless be entitled to the benefits of this Convention with respect to such income if:

a) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the value of the stock of such company) is owned, directly or indirectly, by qualified persons or individuals who are residents of a third state; or

b) in the case of a company, the stock of such company is primarily and regularly traded on an established securities market in a third state,

provided that such third state grants an exemption under similar terms for profits as mentioned in Article 8 of this Convention to citizens and corporations of the other State either under its national law or in common agreement with that other State or under a Convention between that third state and the other State.

7. A person resident of one of the States, who is not entitled to benefits of this Convention because of the foregoing paragraphs, may, nevertheless, be granted benefits of this Convention if the competent authority of the State in which the income in question arises so determines. In making such determination, the competent authority shall take into account as its guideline whether the establishment, acquisition, or maintenance of such person or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the State in which the income arises will consult with the competent authority of the other State before denying the benefits of the Convention under this paragraph.

8. The following provisions apply for purposes of this Article:

a) The term "principal class of shares" is generally the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. When no single class of shares represents the majority of the voting power and value of the company, the "principal class of shares" is generally those classes that in the aggregate possess more than 50 percent of the voting power and value of the company. In determining voting power, any shares or class of shares that are authorized but not issued shall not be counted and in mutual agreement between the competent authorities appropriate weight shall be given to any restrictions or limitations on voting rights of issued shares. The "principal class of shares" also includes any "disproportionate class of shares". Notwithstanding the preceding rules, the "principal class of shares" may be identified by mutual agreement between the competent authorities of the States.

b) The term "shares" shall include depository receipts thereof or trust certificates thereof.

c) The term "disproportionate class of shares" means any class of shares of a company resident in one of the States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company.

d) The term "recognized stock exchange" means:

i) any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;

ii) the Amsterdam Stock Exchange;

iii) the NASDAQ System owned by the National Association of Securities Dealers, Inc. or the parallel market of the Amsterdam Stock Exchange; and

iv) any other stock exchange agreed upon by the competent authorities of both States, including, for this purpose, any stock exchanges listed in an exchange of notes signed at the later of the dates on which the respective governments have notified each other in writing that the formalities constitutionally required for the entry into force of the Convention as meant in Article 37 (Entry into Force) in their respective States have been complied with.

However, with respect to closely held companies, the term "recognized stock exchange" shall not include the stock exchanges mentioned under subparagraph (iii), or if so indicated in mutual agreement between the competent authorities, under subparagraph (iv).

e) The term "closely held company" means a company of which 50% or more of the principal class of shares is owned by persons, other than qualified persons or residents of a member state of the European Communities, each of whom beneficially owns, directly or indirectly, alone or together with related persons more than 5% of such shares for more than 30 days during a taxable year.

f) The shares in a class of shares are considered to be substa ntially and regularly traded on one or more recognized stock exchanges in a taxable year if:

i) trades in such class are effected on one or more of such stock exchanges other than in de minimis quantities during every month; and

ii) the aggregate number of shares of that class traded on such stock exchange or exchanges during the previous taxable year is at least 6 percent of the average number of shares outstanding in that class during that taxable year.

For purposes of this subparagraph, any pattern of trades conducted in order to meet the "substantial and regular trading" tests will be disregarded.

g) The term "qualified person" means:

i) a person that is entitled to benefits of this Convention pursuant to the provisions of paragraph 1; and

ii) a citizen of the United States.

h) The term "member state of the European Communities" means, unless the context requires otherwise:

i) the Netherlands; and

ii) any other member state of the European Communities with which both States have in effect a comprehensive income tax Convention.

i) The term "resident of a member state of the European Communities" means a person that would be considered a resident of any such member state under the principles of Article 4 (Resident) and would be entitled to the benefits of this Convention under the principles of paragraph 1, applied as if such member state were the Netherlands, and that is otherwise entitled to the benefits of the Convention between that person's state of residence and the United States.

j) The not-for-profit organizations referred to in subparagraph 1 (e) of this Article include, but are not limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations, provided, however, that in all

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events, a pension fund, pension trust, or similar entity organized for purposes of providing retirement, disability, or other employment benefits that is organized under the laws of a State shall be entitled to the benefits of the Convention if the organization sponsoring such fund, trust, or entity is entitled to the benefits of the Convention under this Article.

k) The reference in subparagraph (c)(ii) and clauses (A) and (B) of subparagraph (c)(iii) of paragraph 1 to shares that are owned, directly or indirectly, shall mean that all companies in the chain of ownership that are used to satisfy the ownership requirements of the respective clause or subparagraph, must meet the residence requirements that are described in such clause or subparagraph.

l) For the purpose of paragraphs 2, 3 and 5, the competent authorities may by mutual agreement, notwithstanding the provisions of these paragraphs, determine transition rules for newly-established business operations, newly-established corporate groups or newly-established headquarter companies.

m) For purposes of subparagraph (1)(c)(ii)(B) and (1)(c)(iii)(C), the term "conduit company" means a company that makes payments of interest, royalties and any other payments included in the definition of deductible payments (as defined in subparagraph (5)(c)) in a taxable year in an amount equal to or greater than 90 percent of its aggregate receipts of such items during the same taxable year. Notwithstanding the previous sentence, a bank or insurance company shall not be considered to be a conduit company if it (i) is engaged in the active conduct of a banking or insurance business and (ii) is managed and controlled by associated enterprises (within the meaning of Article 9 (Associated Enterprises), except that whether two enterprises are associated will be determined for this purpose without regard to the residence of either enterprise) that are qualified persons.

EXCERPTS FROM MEMORANDUM OF UNDERSTANDING

I. *In reference to paragraph 1 of Article 4 (Resident).*
It is understood that for purposes of the Convention, the Government of one of the States, its political subdivisions or local authorities are to be considered as residents of that State.

II. *In reference to paragraph 4 of Article 4 (Resident).*
It is understood that, if a company is a resident of the Netherlands under paragraph 1 of Article 4 (Resident) and, because of the application of Section 269B of the Internal Revenue Code, such company is also a resident of the United States under paragraph 1 of Article 4 (Resident), the question of its residency for the purposes of the application of this Convention shall be subject to a mutual agreement procedure as laid down in paragraph 4 of Article 4 (Resident).

VI. *In reference to subparagraph 2(a) and paragraph 4 of Article 10 (Dividends).*
It is understood that a beneficial owner of the dividends, who holds depository receipts or trust certificates evidencing beneficial ownership of the shares in lieu of the shares themselves in the company in question, may also claim the treaty benefits of subparagraph 2(a) of Article 10 (Dividends). In addition, it is understood that where a person loans shares (or other rights the income from which is subject to the same taxation treatment as income from shares) and receives from the borrower an obligation to pay an amount equivalent to any dividend distribution made with respect to the shares or other rights loaned during the term of such loan, such person shall be treated as the beneficial owner of the dividend paid with respect to such shares or other rights for purposes of the application of Article 10 (Dividends) to any such equivalent amount.

X. *In reference to Article 26 (Limitation on Benefits).*
It is understood that a taxpayer claiming benefits under the Convention must be able to provide upon request sufficient proof to establish the taxpayer's entitlement to such benefits. It is further understood, however, that the need to provide proof that a taxpayer fulfills the requirements of Article 26 (Limitation on Benefits) can impose a severe administrative burden on the taxpayer.

It is understood, therefore, that the competent authorities will endeavor to develop by mutual agreement reasonable procedures for the periodic reporting of the facts necessary to support entitlement to benefits. In developing such procedures, the competent authorities will strive to minimize the frequency of reporting. For example, once an entitlement to benefits has been documented and in the absence of relevant changes in the facts and circumstances, a taxpayer should not be required annually to provide proof that he is entitled to the benefits of the Convention, provided he reports relevant changes in facts and circumstances.

XI. *In reference to paragraphs 1(d) and 4 of Article 26 (Limitation on Benefits).*
It is understood that the proof a Dutch resident investment organization (a "beleggingsinstelling" in the sense of Article 28 of the "Wet op de vennootschapsbelasting 1969") has of the number of its Dutch resident individual and corporate shareholders as a result of the procedure used by such Dutch resident investment organization when claiming a reimbursement of tax withheld on its foreign dividend and interest income under paragraph 1(b) of Article 28 of the "Wet op de vennootschapsbelasting 1969", can be used by such Dutch investment organization to show that it fulfills the requirements of paragraph 1(d), respectively paragraph 4 of Article 26 (Limitation on Benefits).

XII. *In reference to paragraph 2 of Article 26 (Limitation on Benefits).*
As illustrated by the following examples, it is understood that in applying the rules of paragraph 2 of Article 26 (Limitation on Benefits), the proportionate share of activities of a resident of one of the States that are a component part of or directly related to a trade or business conducted by another resident of that State who claims treaty benefits may be attributed to the latter resident under subparagraph 2(e) for purposes of applying the substantial trade or business test under subparagraph 2(c). In addition, for purposes of subparagraph 2(c), the proportionate share of activities of a resident of one of the States attributable to a trade or business conducted in the other State will be used for purposes of the test under subparagraph 2(c).

Example 1
NLCo, a Netherlands corporation, owns 100 percent of the stock of USCo, a U.S. corporation, and 50 percent of the stock of NLSub, a Netherlands corporation. FCo, a French corporation, holds the remaining 50 percent of the stock of NLSub. NLCo and FCo do not directly conduct an active trade or business. USCo and NLSub are engaged in the same active trade or business. For each of the four most recently concluded taxable years, the asset values, gross income and payroll expenses of these corporations that are attributable to the trade or business were as follows:

	USCo	*NLSub*
Assets	$300	$50
Income	50	10
Payroll	60	10

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NLCo receives payments of interest and dividends from USCo. In order for these payments to be entitled to treaty benefits under paragraph 2 of Article 26, NLCo must be considered to be engaged in the active conduct of a substantial trade or business in the Netherlands. Under subparagraph 2(c), the ratios of the assets, income and payroll attributable to NLCo to the assets, income and payroll attributable to USCo must be at least 10 percent.

NLCo has no assets, income or payroll that are attributable to the trade or business. The assets, income and payroll of NLSub that are related to the trade or business may be attributed to NLCo, however, under subparagraph 2(e)(vi), since NLCo and FCo together have a controlling beneficial interest in NLSub and FCo is a resident of a member state of the European Communities. In accordance with subparagraph 2(e), therefore, 50 percent of NLSub's assets, income and payroll are attributed to NLCo for purposes of paragraph 2(c). The amounts attributed to NLCo and the percentage of USCo's corresponding amounts are as follows:

NLCo		*NLCo as a Percentage of USCo*
Assets	$25	8.3
Income	5	10.0
Payroll	5	8.3

Since none of these percentages is greater than 10 percent, NLCo is not entitled to benefits under Article 26 under the general test of paragraph 2(c). Moreover, application of the three-year average rule under that paragraph does not change the result, since the relevant amounts for the three preceding years (and the resulting ratios) are equal to those for the first preceding taxable year.

Example 2

The facts are the same as in Example 1, except that NLCo owns only 80 percent of the stock of USCo. For purposes of subparagraph 2(c), the measures of USCo's assets, gross income and payroll expense must be multiplied by NLCo's percentage ownership interest in the stock of USCo. Consequently, the values attributable to USCo and NLSub after taking into account NLCo's percentage ownership interest in the stock of these companies, and the ratio of the amounts attributed from NLSub to NLCo to the amounts attributable to USCo are as follows:

	USCo	*NLSub*	*NLCo as a Percentage of USCo*
Assets	$240	$25	10.4
Income	40	5	12.5
Payroll	48	5	10.4

Since all of these percentages exceed 10 percent, NLCo would be entitled to treaty benefits with respect to the payments received from USCo under paragraph 2.

XIII. *In reference to subparagraph (a) of paragraph 2 and subparagraph (m) of paragraph 8 of Article 26 (Limitation on Benefits)*

It is understood that for purposes of subparagraph (a) of paragraph 2 and subparagraph (m) of paragraph 8 of Article 26 (Limitation on Benefits), a bank only will be considered to be engaged in the active conduct of a banking business if it regularly accepts deposits from the public or makes loans to the public, and an insurance company only will be considered to be engaged in the active conduct of an insurance business if its gross income consists primarily of insurance or reinsurance premiums, and investment income attributable to such premiums.

XIV. In reference to paragraph (1) of Article 9 (Associated Enterprises) and subparagraph (d)(i) of paragraph 5 of Article 26 (Limitation on Benefits)

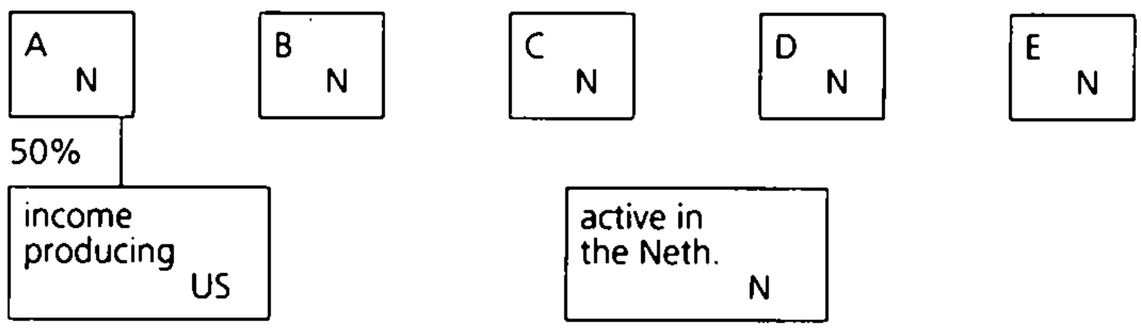
It is understood that for purposes of paragraph 1 of Article 9 (Associated Enterprises), in determining whether an enterprise participates directly or indirectly in the management, control or capital of another enterprise, an enterprise may be considered an associated enterprise with respect to an enterprise in which its only interest is represented by evidences of indebtedness where such indebtedness provides the holder of the indebtedness with the right to participate in the management, control or capital of the enterprise that issued the indebtedness, or such holder in practice participates in such management, control or capital.

XV. *In reference to paragraphs 2(a)(i) and 2(c) of Article 26 (Limitation on Benefits).*

It is understood that in applying the measurement of "substantiality" as referred to in subparagraph 2(a)(i) of Article 26, the factors referred to in subparagraph 2(c) of Article 26 as used in a specific case will take into account the fact that there might be a less than 100% participation in the income-producing activity.

For example, if a Dutch resident corporation has a 10% interest in a US corporation, in applying the substantiality test to - for instance - dividends received from the US corporation, each of the US corporations' factors as referred to in subparagraph 2(c) of Article 26 must be multiplied by the Dutch resident's percentage share in the US corporation.

The above also applies to subparagraph 2(e)(vi) of Article 26 (Limitation on Benefits). For example, take the case where both the income-producing corporation, resident of the US, and the corporation which is engaged in an active trade or business in the Netherlands are controlled by five Netherlands investment companies.



One of the investors (A) owns a 50 percent interest in the income-producing corporation; the other four investors (B, C, D and E) each own a 12.5 percent interest in the income- producing corporation. The Dutch investor (E) owns a 50 percent interest in the corporation engaged in an active trade or business; the other four investors (A, B, C, and D) each own a 12.5 percent interest in the corporation engaged in an active trade or business.

The corporation engaged in an active trade or business in the Netherlands has assets valued at $ 1 million, and the assets of the U.S. corporation are valued at $6 million. The Netherlands corporation has gross income of $ 10 million, and gross income of the U.S. corporation is $40 million. The payroll of the Netherlands corporation is $1 million, and the U.S. corporation's payroll is $5 million.

In applying the substantiality test to the dividends paid by the US corporation and received by the five Dutch investors, each of the factors must be multiplied by the investor's percentage share in the corporation engaged in an active trade or business in the Netherlands, respectively by the investor's percentage share in the US corporation. The dividends paid to the Netherlands investors (B, C and D) and the dividends paid to the 50 percent owner of the corporation engaged in active trade or business in the Netherlands (E) would pass the substantiality test. The three ratios described in the preceding paragraph as applied to the three Netherlands investors (B, C and D) would

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remain 16.7 percent, 25 percent, and 20 percent, respectively. The three ratios described in the preceding paragraph as applied to the Dutch investor (E) are 66.7 percent, 100 percent, and 80 percent.

The dividends paid to the Netherlands investor (A) will not pass the substantiality test; since in this case the three ratios are 4.2 percent, 6.25 percent, and 5 percent.

XVI. *In reference to paragraph 2(e) of Article 26 (Limitation on Benefits).*

For the purpose of subparagraphs 2(e)(vi) and 2(e)(vii) of Article 26 the following states are regarded as an "identified State" having effective provisions for the exchange of information at the date of signature of the Convention with the United States:

Australia
Austria
Barbados
Belgium
Bermuda
Canada
Costa Rica
Cyprus
Denmark
Dominica
Dominican Republic
Egypt
Finland
France
Germany
Grenada
Honduras
Iceland
Ireland
Jamaica
Korea
Malta
Marshall Islands
Mexico
Morocco
New Zealand
Norway
Pakistan
Philippines
St. Lucia
Sweden
Trinidad & Tobago

and with the Netherlands:

Aruba
Australia
Austria
Belgium
Brazil
Bulgaria
Canada
China
Czechoslovakia
Denmark
Finland
France
Germany
Greece
Hungary
India
Ireland
Indonesia
Israel
Italy
Korea
Luxembourg
Malaysia
Malta
Morocco
Netherlands Antilles
New Zealand
Norway
Pakistan
Philippines
Poland
Romania
Singapore
South Africa
Spain
Sri Lanka
Surinam
Sweden
Thailand
Turkey
United Kingdom
Zambia
Zimbabwe

It is understood that states may be added to or eliminated from the preceding lists by agreement between the competent authorities of both States.

XVII. *In reference to paragraph 2(h) of Article 26 (Limitation on Benefits).*

It is understood that in treating an activity conducted in another member state of the European Communities as conducted in the Netherlands under subparagraph 2(h) of Article 26 (Limitation on Benefits) (and subject to the restrictions therein), the activity in such other state may be conducted by any person which, if it conducted such activity in the Netherlands, would have its proportionate share of such activity attributed to the resident of the Netherlands considered to conduct such activity under subparagraph 2(e) of Article 26 (Limitation on Benefits).

XVIII. *In reference to paragraph 3(a) of Article 26 (Limitation on Benefits).*

It is understood that for purposes of paragraph 3(a) of Article 26 (Limitation on Benefits) a person will be considered to be engaged in "supervision and administration" activities, only if it engages in a number of the kinds of activities listed below. For example, a person will be considered a headquarters company if it performs a significant number of the following functions for the group: group financing (which cannot be its principal function), pricing, marketing, internal auditing, internal communications and management. A simple comparison of the amount of gross income that the headquarters company derives from its different activities cannot be used alone to determine whether group financing is, or is not, the company's principal function. The above-mentioned functions are intended to be suggestive of the types of activities in which a headquarters company will be expected to engage; it is not intended to be exhaustive.

Furthermore, it is understood that in determining if a substantial portion of the overall supervision and administration of the group is provided by the headquarters company, the activities it performs as a headquarters company for the group it supervises must be substantial in comparison to the same activities for the same group performed within the multinational.

For example, a Japanese corporation establishes a subsidiary in the Netherlands to function as a headquarters company for its European and North American operations. The Japanese corporation also has two other subsidiaries functioning as headquarter companies; one for the African operations and one for the Asian operations. The Dutch headquarters company is the parent company for the subsidiaries through which the European and North American operations are carried on. The Dutch headquarters company supervises the bulk of the pricing, marketing, internal auditing, internal communications and management for its group. Although the Japanese overall parent sets the guidelines for all of its subsidiaries in defining the world-wide group policies with respect to each of these activities, and assures that these guidelines are carried out within each of the regional groups, it is the Dutch headquarters company that monitors and controls the way in which these policies are carried out within the group of companies that it supervises. The capital and payroll devoted by the Japanese parent to these activities relating to the group of companies the Dutch headquarter company supervises is small, relative to the capital and payroll devoted to these activities by the Dutch headquarters company. Moreover, neither the other two headquarter companies, nor any other related company besides the Japanese parent company, perform any of the above-mentioned headquarter activities with respect to the group of companies that the Dutch headquarter company supervises.

In the above case the Dutch headquarters company will be considered to provide a substantial portion of the overall supervision and administration of the group it supervises.

XIX. *In reference to paragraph 7 of Article 26 (Limitation on Benefits).*

For purposes of paragraph 7 of Article 26 (Limitation on Benefits), in determining whether the establishment, acquisition, or maintenance of a corporation resident of one of the States has or had as one of its principal purposes the obtaining of benefits under this Convention, the competent authority of the State in which the income in question arises may consider the following factors (among others):

(1) The date of incorporation of the corporation in relation to the date that this Convention entered into force;
(2) the continuity of the historical business and ownership of the corporation;

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(3) the business reasons for the corporation residing in its State of residence;
(4) the extent to which the corporation is claiming special tax benefits in its country of residence;
(5) the extent to which the corporation's business activity in the other State is dependent on the capital, assets, or personnel of the corporation in its State of residence; and
(6) the extent to which the corporation would be entitled to treaty benefits comparable to those afforded by this Convention if it had been incorporated in the country of residence of the majority of its shareholders.

XX. *In reference to paragraph 7 of Article 26 (Limitation on Benefits).*

It is understood that a company resident of one of the States will be granted the treaty benefits under paragraph 7 of Article 26 (Limitation on Benefits) with respect to the income it derives from the other State, if such company:
(1) holds stocks and securities the income from which is not predominantly from sources in the other State;
(2) has widely dispersed ownership; and
(3) employs in its state of residence a substantial staff actively engaged in trades of stocks and securities owned by the company.

It is further understood that paragraph 7 of Article 26 (Limitation on Benefits) will not apply if any of the above-mentioned factors is absent.

XXI. *In reference to paragraph 7 of Article 26 (Limitation on Benefits).*

It is understood that in applying paragraph 7 of Article 26 (Limitation on Benefits), the legal requirements for the facilitation of the free flow of capital and persons within the European Communities, together with the differing internal income tax systems, tax incentive regimes, and existing tax treaty policies among member states of the European Communities, will be considered. Under such paragraph, the competent authority is instructed to consider as its guideline whether the establishment, acquisition or maintenance of a company or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority may, therefore, determine under a given set of facts, that a change in circumstances that would cause a company to cease to qualify for treaty benefits under paragraphs 1 and 2 of Article 26 (Limitation on Benefits) need not necessarily result in a denial of benefits. Such changed circumstances may include a change in the state of residence of a major shareholder of a company, the sale of part of the stock of a Netherlands company to a person resident in another member state of the European Communities, or an expansion of a company's activities in other member states of the European Communities, all under ordinary business conditions. The competent authority will consider these changed circumstances (in addition to other relevant factors normally considered under paragraph 7 of Article 26) in determining whether such a company will remain qualified for treaty benefits with respect to income received from United States sources. If these changed circumstances are not attributable to tax avoidance motives, this also will be considered by the competent authority to be a factor weighing in favor of continued qualification under paragraph 7 of Article 26.

XXII. *In reference to paragraph 8(d)(iv) of Article 26 (Limitation on Benefits).*

For purposes of subparagraph 8(d)(iv) of Article 26 (Limitation on Benefits), the stock exchanges of Frankfurt, London and Paris will in any case be listed.
The competent authorities of both States may agree to add or remove stock exchanges from the list.

XIII. *In reference to paragraph 8(e) of Article 26 (Limitation on Benefits).*

It is understood that the term "related persons" as used in subparagraph 8(e) of Article 26 (Limitation on Benefits) means associated enterprises under Article 9 (Associated Enterprises) and their owners.

XXIV. *In reference to paragraph 8(f) of Article 26 (Limitation on Benefits).*

In order to meet the "substantial and regular trading" tests under subparagraph 8(f) of Article 26 (Limitation on Benefits), a person claiming benefits under the Convention need not prove that it has not engaged in, but may need to rebut evidence that it has engaged in, a pattern of trades on a recognized stock exchange in order to meet these tests.

XXV. *In reference to paragraph 8(k) of Article 26 (Limitation Benefits).*

When a corporation resident in one of the States that is entitled to benefits under Article 26 (Limitation on Benefits) acquires a controlling interest in a corporation resident in a third state that in turn owns a controlling interest in a second corporation resident in the first-mentioned State, that second corporation may not be entitled to the benefits of the Convention due to the provisions of subparagraph 8(k) of Article 26 with respect to income derived from sources within the other State. It is understood that in these circumstances the competent authority of the other State, in considering a request for benefits under the Convention under paragraph 7 of Article 26 (Limitation on Benefits), will consider favorably a plan of reorganization submitted by the second corporation resident in the first-mentioned State, if such plan would result in the second corporation being entitled to the benefits of the Convention within a reasonable transition period (determined without regard to paragraph 7 of Article 26 (Limitation on Benefits)).

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UNITED STATES:

DETERMINING RESIDENCY FOR FEDERAL INCOME TAX PURPOSES

Leonard W. Rothschild, Jr. and Michael G. Schinner

In the July 1988 issue of the *Bulletin*, Leonard W. Rothschild, Jr. and Robert J. Magilligan presented an analysis of the proposed regulations under IRC Section 7701(b) concerning the definition of residency for federal income tax purposes. On 24 April 1992, the IRS issued final regulations under Section 7701 (b). This article analyses the final regulations and discusses the IRS' revisions to the proposed regulations. The article also discusses the IRS' new proposed regulations on treaty-based determinations of residency, which it issued simultaneously with the final regulations.

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I. INTRODUCTION

Residency status is critical to the determination of an individual's US tax liability. US residents, whether citizens of the United States or other countries, are taxed on worldwide income. Non-residents, in contrast, are taxed on income from US sources (with limited exceptions) but are denied several tax deductions allowed to US residents.

Prior to the enactment of the Deficit Reduction Act of 1984, the Internal Revenue Code (IRC) of the United States did not contain any rules for determining whether an individual was a US resident. Instead, regulations issued by the Internal Revenue Service (IRS) provided a subjective test for determining US residency which was based on an individual's intentions with regard to the length and nature of the individual's stay in the United States.

The Deficit Reduction Act of 1984 set forth in IRC Section 7701(b) a new, objective test for determining US residency for income tax purposes.[1] An individual who is not a citizen of the United States is considered to be a resident if he or she satisfies either of two tests: the "green card" test or the substantial presence test. The "green card" test is based on an individual's immigration status; the substantial presence test is based upon the number of days an individual is physically present in the United States during a three-year period.

On 9 September 1987, the IRS issued proposed regulations which discussed in detail the "green card" and substantial presence tests. Although the regulations added significant complexity to this area of the law, they also provided objective criteria with which to determine an individual's US residency status for income tax purposes.

A public hearing concerning the proposed regulations was held on 15 June 1988. After consideration of all the comments concerning the proposed regulations, the IRS issued final regulations on 24 April 1992. The final regulations adopt, with some important revisions, the proposed regulations issued on 9 September 1987.

Contents

I. Introduction
II. Determining Whether an Individual is a Resident Alien
  A. "Green Card" or lawful permanent resident test
  B. Substantial presence test
III. Days Excluded for Purposes of the Substantial Presence Test
  A. Exempt individuals
  B. Medical condition
  C. Days in transit
  D. Commuters residing in Mexico or Canada
IV. Closer Connection Exception to the Substantial Presence Test
V. Residency Starting and Ending Dates
  A. Starting date
  B. Ending date
  C. De minimis presence
  D. First year election
VI. Coordination with IRC Section 877
VII. Tax Year
VIII. Coordination with Income Tax Treaties
  A. Dual-resident taxpayers
  B. Filing requirements
  C. Proposed regulations
IX. Procedural Rules
X. Effective Dates
XI. Conclusion
Appendix

II. DETERMINING WHETHER AN INDIVIDUAL IS A RESIDENT ALIEN

A. *"Green card" or lawful permanent resident test*

Under the "green card" test an alien individual is considered a resident if the alien is a lawful permanent resident of the United States according to its immigration

1. Different rules apply for determining United States residency for federal estate and gift tax purposes. Moreover, each state may have different rules for determining residency.

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laws at any time during the calender year. Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned. Resident status is considered to be rescinded if an administrative or judicial order that is no longer subject to appeal is issued regarding the alien individual. An administrative or judicial determination of abandonment of resident status may be initiated by the alien individual, the Immigration and Naturalization Service (INS) or a US consular officer. If initiated by the individual, resident status is considered abandoned when the appropriate documentation is filed with the INS or a consular officer. If the determination is initiated by the INS or a consular officer, resident status is considered abandoned upon the issuance of a final administrative or judicial order.[2]

B. *Substantial presence test*

Individuals who are present in the United States for at least 183 days during the most recent three-year period, including the current year, are generally classified as resident aliens. Each day of presence in the current year is counted as full day; each day of presence in the first preceding year is counted as one-third of a day; and each day of presence in the second preceding year is counted as one-sixth of a day. Partial days of presence are counted as full days. The regulation does not permit an individual to round off any fractional days to the nearest whole number.[3] For example, if an alien spends 122 days in each of the current, first preceding and second preceding years in the United States, the total days are 183 (122 x 100% or 122; plus 122 x ⅓ or 40⅔; plus 122 x ⅙ or 20⅓). Accordingly, the individual meets the requirements of the substantial presence test and is considered a resident alien for the current year.[4]

If an individual is not physically present in the United States for at least 31 days during the current year, the individual will not be considered a US resident for the current year, regardless of whether the individual satisfies the three-year total of at least 183 days. However, an individual can be present in the United States for less than 31 days in the first or second preceding years and still satisfy the test.[5]

The term "United States" is defined to include the states and the District of Columbia, but does not include the possessions and territories of the United States. The term also includes the territorial waters of the United States and the seabed and subsoil of the submarine areas over which the United States has jurisdiction under international law. The term, however, does not include the air space over the United States.[6]

III. DAYS EXCLUDED FOR PURPOSES OF THE SUBSTANTIAL PRESENCE TEST

For purposes of the substantial presence test, the following days are not counted as days of presence in the United States:

- any day that an individual is present in the United States as an exempt individual;
- any day that an individual is prevented from leaving the United States because of a medical condition that arose while the individual was present in the United States;
- any day that an individual is in transit between two points outside of the United States; and
- any day on which a regular commuter residing in Canada or Mexico commutes to or from employment in the United States.

A. *Exempt individuals*

The following are exempt individuals: (1) foreign government-related individuals; (2) teachers, trainees and students; and (3) professional athletes.

1. Foreign government-related individuals

Days spent in the United States as a full-time employee of an international organization, or as an individual with diplomatic or consular status, are not counted as days of presence in the United States for purposes of the substantial presence test. Members of such persons' immediate families also qualify for this exception. Any individual who is present in the United States as a lawful permanent resident does not qualify for this exception.[7]

2. Teachers, trainees and students

Teachers, trainees and students (and their immediate families) who are admitted temporarily to the United States under a non-immigrant J, F or M visa are considered exempt individuals if they substantially comply with the visa requirements.[8] The test of compliance is made independently by the IRS. Thus, the IRS may determine that an individual is not in substantial compliance with the requirements of his or her visa, even though the visa has not been revoked.[9]

There are several limitations on the use of this exception. A teacher or trainee will not be able to exclude days of presence if the individual has been exempt as a teacher, trainee or student for any part of two of the six preceding calender years. A teacher or trainee must *include* days of presence in the current year if (i) all of an individual's compensation in the current year is income described in IRC Section 872(b)(3) (compensation paid by a foreign employer); (ii) the individual was present in the United States as a teacher or trainee in any prior year within the last six years and during such year or years all of an individual's compensation was income described in IRC Section 872(b)(3); and (iii) the individual has been exempt as a teacher, trainee or student for any part of four of the six preceding calender years.[10]

An individual will not be able to exclude days of presence as a student if the individual has been exempt as a teacher, trainee or student for any part of more than five calender years, unless the individual can show that he or she does not intend to reside

2. Reg. 301.7701(b)-1(b)(1, 2, 3).
3. Reg. 301.7701(b)-1(c)(1).
4. Reg. 301.7701(b)-1(e), ex.1.
5. Reg. 301.7701(b)-1(c)(4).
6. Reg. 301.7701(b)-1(c)(2)(ii).
7. Reg. 301.7701(b)-3(b)(2)(i).
8. Reg. 301.7701(b)-3(b)(3 and 4).
9. Reg. 301.7701(b)-3(b)(6).
10. Reg. 301.7701(b)-3(b)(7)(i), (ii).

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permanently in the United States and that he or she has complied with the requirements of the student visa.[11]

3. Professional athletes

Days spent in the United States as a professional athlete actually competing in a charitable sports event are excluded for purposes of the substantial presence test.[12]

B. *Medical condition*

An individual will not be considered present in the United States for purposes of the substantial presence test on any day that the individual intends to leave the United States and is unable to do so because of a medical condition that arose while the individual was present in the United States.[13] A medical condition will not be considered to arise while the individual is present in the United States if the condition existed prior to the individual's arrival in the United States and the individual was aware of the pre-existing medical condition.[14]

The medical condition exception is not available in the following cases: (1) where an individual who was initially prevented from leaving the United States is subsequently able to do so yet remains in the United States beyond a reasonable time for making travel arrangements to depart; and (2) where an individual returns to the United States for treatment of a medical condition that arose during the individual's prior stay in the United States.[15]

C. *Days in transit*

An individual may exclude days of presence in the United States if the individual is in transit between two foreign points and is physically present in the United States for fewer than 24 hours. The exception does not apply if an individual attends a business meeting during the 24 hour-period.[16]

D. *Commuters residing in Mexico or Canada*

An individual will not be considered present in the United States on days that the individual commutes to the United States from the individual's home in Mexico or Canada if the individual commutes to the United States on more than 75 percent of his or her working days during the working period.[17] Whereas the proposed regulations required an individual to commute on more than 80 percent of work days of the calender year, the "75 percent of work days during the working period" requirements contained in the final regulations will permit seasonal employees, as well as those who begin employment in the United States in mid-year, to exclude the days of presence on which they commute to the United States.

IV. CLOSER CONNECTION EXCEPTION TO THE SUBSTANTIAL PRESENCE TEST

An individual who satisfies the substantial presence test may nevertheless be considered a non-resident for the current year if the following conditions are met:

- the individual is present in the United States for fewer than 183 days in the current year;
- the individual maintains a tax home in a foreign country during the current year; and
- the individual has a closer connection to the foreign country in which the individual maintains a tax home than to the United States.[18]

The possessions and territories of the United States are considered foreign countries for purposes of the closer connection exception.[19]

An individual's tax home is considered to be located at his regular or principal place of business. If the individual has no regular or principal place of business or is not engaged in carrying on any trade or business, then the individual's tax home is his regular place of abode.[20]

In order to use the closer connection exception, the individual must maintain his or her tax home for the entire year. Further, the tax home must be located in the same foreign country for which the individual is claiming to have a closer connection.[21]

Regulation 301.7701(b)-2(d) sets forth some of the facts and circumstances that are considered in determining whether an individual has a closer connection with another country:

(1) the location of the individual's permanent home;
(2) the location of the individual's family;
(3) the location of personal belongings, such as automobiles, furniture, clothing and jewellery owned by the individual and his or her family;
(4) the location of social, political, cultural or religious organizations with which the individual has a current relationship;
(5) the location of the individual's personal bank accounts;
(6) the location where the individual conducts business activities (other than those that constitute the individual's tax home);
(7) the location of the jurisdiction in which the individual holds a driver's licence;
(8) the location of the jurisdiction in which the individual votes;
(9) the country of residence designated by the individual on forms and documents; and
(10) the type of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W-8 (Certificate of Foreign Status) or Form W-9 (Payer's Request for Taxpayer Identification Number).

The individual's permanent home of residence must be available at all times and not solely for stays of short duration. This implies that an individual cannot rent out his home in a foreign country and claim the closer connection exception.[22]

11. Reg. 301.7701(b)-3(b)(7)(iii).
12. Reg. 301.7701(b)-3(b)(5).
13. Reg. 301.7701(b)-3(c)(1).
14. Reg. 301.7701(b)-3(c)(3).
15. Reg. 301.7701(b)-3(c)(1).
16. Reg. 301.7701(b)-3(d).
17. Reg. 301.7701(b)-3(e).
18. Reg. 301.7701(b)-2(a).
19. Reg. 301.7701(b)-2(b).
20. Reg. 301.7701(b)-2(c)(1).
21. Reg. 301.7701(b)-2(c)(2).
22. Reg. 301.7701(b)-2(d).

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An individual may demonstrate, subject to certain conditions, that he or she has a closer connection to two foreign countries (but not more than two) within the calender year.[23]

Assuming that an individual qualifies for the closer connection exception, the individual must file a statement as prescribed in Reg. 301.7701(b)-8. The filing requirements for non-resident aliens are discussed in more detail below.

Individuals who have applied for permanent residence in the United States may not claim the closer connection exception.[24]

V. RESIDENCY STARTING AND ENDING DATES

A. *Starting date*

Under the "green card" test, an individual's residency in the first year is deemed to begin on the first day the individual is physically present in the United States as a lawful permanent resident. Similarly, under the substantial presence test, residency is deemed to begin the first day the individual is present in the United States during the year in which the test is satisfied. If an individual satisfies both tests, residency is deemed to begin with the earlier of the two residency starting dates.[25]

B. *Ending date*

Generally, an individual's residency termination date will be the last day of the calendar year. However, for an individual who meets the substantial presence test and establishes that (i) his or her tax home was in a foreign country and (ii) he or she maintained a closer connection (within the meaning of Reg. 301.7701(b)-2(d)) to that foreign country than to the United States, the individual's residency termination date is the last day during the calendar year that the individual is physically present in the United States.

The residency termination date for an individual who meets the "green card" test and the two requirements of the closer connection exception discussed above, is the first day the individual is no longer a lawful permanent resident. The residency termination date for an individual who meets both the substantial presence test and the "green card" test (as well as the two requirements of the closer connection exemption discussed above) will be the later of the first day the individual is no longer a lawful permanent resident or the last day the individual was present in the United States.[26]

C. *De minimis presence*

An individual may be present in the United States for up to ten days without triggering the residency starting date or extending the residency termination date for purposes of the substantial presence test, provided that the individual is able to meet the three requirements of the closer connection exception discussed above. Note that these days are included as days of US presence for purposes of the substantial presence test.[27]

D. *First year election*

An individual who does not meet either the "green card" test or the substantial presence test may nevertheless elect to be treated as a full year US resident if he or she satisfies the following:

- the individual must meet the substantial presence test for the immediately following year;
- the individual must be physically present in the United States for at least 31 consecutive days in the current year; and
- the individual must be present in the United States for at least 75 percent of the number of days beginning with the first day of the 31-day consecutive period and ending with the last day of the year of arrival. For purposes of this 75 percent requirement, up to five days of absence from the United States may be treated as presence within the United States.[28]

The election is made by attaching a statement to the individual's income tax return (Form 1040) for the taxable year for which the election is to be in effect. Since the election cannot be made until the individual has satisfied the substantial presence test for the year following the election year, the individual may have to request an extension of time for filing the return. The penalty for failing to file a timely return is that the individual must file his or her income tax return for the current year as a non-resident alien.[29]

VI. COORDINATION WITH IRC SECTION 877

An individual will be taxed as a US citizen who expatriated to avoid tax under IRC Section 877 if: (i) the individual is a US resident during at least three consecutive calendar years (the initial residency period); (ii) the period of residence for each of the three years includes at least 183 days; (iii) the alien is again taxed as a non-resident; and (iv) the alien then becomes a US resident within three calendar years after the residency termination date of the individual's initial residency period.

This special tax applies only if it is greater than the tax normally applicable to a non-resident alien.[30]

VII. TAX YEAR

The regulations generally require an alien individual to adopt a calendar year unless a fiscal year has been established prior to residency. An individual is considered to have established a fiscal year if the annual period during which the individual computes his or her income is a fiscal year. Accordingly, a citizen of the United Kingdom would appear to be able to continue using the UK tax year as his or her US tax year, provided appropriate fiscal year books and records are maintained for US tax purposes. The regulations also provide that an individual who has previously established a fiscal year in a foreign country may adopt the calendar year as his or her taxable year for US income tax purposes without requesting a change in accounting period.[31]

23. Reg. 301.7701(b)-2(d).
24. Reg. 301.7701(b)-2(f).
25. Reg. 301.7701(b)-4(a).
26. Reg. 301.7701(b)-4(b).
27. Reg. 301.7701(b)-4(c).
28. Reg. 301.7701(b)-4(c)(i)-(iv).
29. Reg. 301.7701(b)-4(c)(3)(v), (vi).
30. Reg. 301.7701(b)-5.
31. Reg. 301.7701(b)-(6)(a).

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VIII. COORDINATION WITH INCOME TAX TREATIES

A. *Dual resident taxpayers*

A "dual resident taxpayer" that is, an individual who is considered a resident of both the United States and the country with which the United States has an income tax treaty – may determine that he or she is a resident of the foreign country for treaty purposes and therefore claim treaty benefits so as to reduce the individual's US income tax liability.[32]

B. *Filing requirements*

A dual resident taxpayer who determines that he or she is a non-resident alien under an income tax treaty must file his or her US income tax return as a non-resident alien on Form 1040NR on or before the date prescribed by law. As part of the return, the alien individual must attach a statement ("Treaty-Based Return Position Disclosure Under §301.7701(b)-7(b) and Section 6114") to the Form 1040NR which indicates that the taxpayer is claiming a treaty benefit as a non-resident of the United States, the facts relied upon to support the position taken, and the nature and approximate amount of income and the specific treaty provision for which the taxpayer is claiming a treaty benefit. The Form 1040NR and the attached statement must be filed with the IRS Center in Philadelphia, Pennsylvania.[33]

The filing of a Form 1040NR by a dual resident taxpayer may affect the determination by the INS as to whether the individual qualifies to maintain his or her residency permit.[34] Moreover, individuals who are considered non-residents under a treaty for purposes of computing their US tax liability may nonetheless be considered residents for other purposes under the IRC. For example, an alien may be deemed a resident for purposes of Subpart F of the IRC which could cause a foreign corporation in which the individual is a shareholder to be classified as a "controlled foreign corporation".[35]

C. *Proposed regulations*

Simultaneously with the issuance of the final regulations under IRC Section 7701(b), the IRS issued proposed regulations that provide special rules for S corporations that have as a shareholder a dual resident taxpayer. The proposed regulations provide that a dual resident taxpayer who claims any treaty benefits as a non-resident of the United States so as to reduce his or her US income tax liability shall be treated as a non-resident alien of the United States for purposes of IRC Section 1361(b)(1)(C). Because an S corporation cannot have a non-resident alien as a shareholder, in the absence of a special exception, the proposed rules would cause a termination of the corporation's S election pursuant to IRC Section 1362(d)(2).[36]

The proposed regulations provide that a dual resident taxpayer who claims a treaty benefit will be treated as a US resident for purposes of IRC Section 1361(b)(1)(C) if certain conditions are met. First, the dual resident taxpayer must treated as carrying on a US business through a permanent establishment, if the S corporation carries on such a business. Second, the S corporation must withhold tax on dual resident taxpayer's distributive share of the S corporation's income under the principles of IRC Section 1446 (relating to partnership withholding on foreign partners). Third, the dual resident taxpayer must be taxed on the gain on the disposition of his or her shares in the S corporation as if the S corporation were a partnership and the individual was a foreign partner of the partnership. Finally, the dual resident taxpayer and the S corporation must enter into an agreement to ensure proper withholding of the individual's tax liability.[37]

As discussed above, a dual-resident taxpayer who claims a treaty benefit as a non-resident alien must attach a statement to his or her Form 1040NR. If the taxpayer is a shareholder in an S corporation, the proposed regulations require that the statement indicate that the taxpayer understands that claiming a treaty benefit as a non-resident may terminate the corporation's S election unless the taxpayer and the S corporation enter into the withholding agreement described above.[38]

IX. PROCEDURAL RULES

The regulations contain stringent documentation requirements for individuals claiming to be exempt individuals, claiming to have a medical condition, claiming the closer connection exception or claiming the ten-day exception for residency starting and ending dates. Generally, an individual qualifying for any of these exemptions must file a detailed statement with the IRS in Philadelphia. The regulations require that these statements be filed regardless of whether the individual files a tax return.[39]

The penalty for failure to file the prescribed statement is loss of the claimed exemption. Days that would not be counted as days of US presence under an exemption are considered days of US presence. Exempt teachers, trainees and students, however, are not subject to penalties.[40]

X. EFFECTIVE DATES

The final regulations to IRC Section 7701(b) contain important revisions to the proposed regulations issued in 1987. Tax advisors should review the final regulations, especially the reporting requirements, before advising individuals with respect to their US residency status for federal income tax purposes.

32. Reg. 301.7701(b)-7.
33. Reg. 301.7701(b)-7(b), (c).
34. Reg. 301.7701(b)-7(b).
35. Reg. 301.7701(b)-7(a).
36. Prop. Reg. 301.7701(b)-7(a)(4)(iii).
37. Prop. Reg. 301.7701(b)-7(a)(4)(iv).
38. Prop. Reg. 301.7701(b)-7(c)(3).
39. Reg. 301.7701(b)-8.
40. Reg. 301.7701(b)-8(d).

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APPENDIX
US RESIDENT OR NON-RESIDENT
(IRC Sec. 7701(b))

I. Were you citizen of the United States or did you have a "green card" at any time during the current year?

YES You are considered a resident of the United States for the entire year. The tests below do not apply.

NO You will be treated as resident only if you satisfy one of the tests below.

II. Were you physically present in the United States for 31 days or more during the current year and does the sum of 100% of days of physical presence in the United States in the current year plus 1/3 of the days in the preceding year plus 1/6 of the days in the second preceding year equal or exceed 183 days?

YES You are a resident, unless you are a:
- student
- teacher
- scholar
- diplomat

or you are present in the United States because you are:
- ill
- in transit
- commuting to a job in Mexico or Canada
- a professional athlete participating in a charitable event or you claim a closer connection to a foreign country.

NO You are not a resident.

III. Can you establish a tax home in and a closer connection to a country other than the United States and were you in the United States for less than 183 days in the current year?

YES You are a non-resident.

NO You may be a resident if you satisfy one of the above tests.

IV. Does your country of citizenship or residency have a tax treaty with the United States?

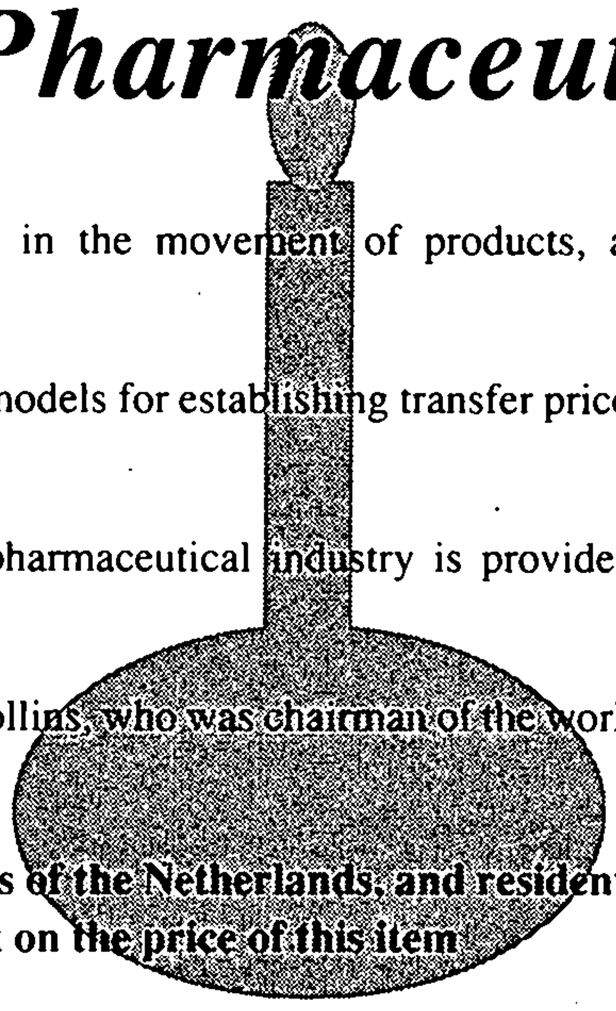
YES Consult the treaty for additional exemptions from US residency.

NO The above rules apply.

V. Were you present in the United States for at least 31 days in the current year and do you satisfy the test in II. above for the following year or were you married and were you or your spouse residents at the end of the current year?

YES You may be able to elect US residency for the entire current year (see Sec. 6013(g) and (h)).

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PEOPLE'S REPUBLIC OF CHINA:

A BRIEF INTRODUCTION TO TIANJIN PORT BONDED ZONE

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A bonded zone was established in Tianjin Harbour on 12 May 1991 with the approval of the State Council of the People's Republic of China (PRC). As a new showcase for China's reform and open policy, the bonded zone has adopted special policies that are more flexible and preferential than those in force in Special Economic Zones and Economic Development Zones. By providing an ideal investment and operational environment for Chinese and foreign trading organizations and export-oriented enterprises engaged in storage, transport, packaging and processing, the zone will put itself at the service of foreign trade, entrepot trade, transit trade and export-oriented processing industries. In the course of this process it will gradually become a typical Chinese free trade zone which maintains close ties with world markets and follows all internationally established business practices.

I. SUPERB GEOGRAPHICAL POSITION

Sandwiched between the Container Wharf and the newly built Dongtudi Pier in Tanggu Xingang Harbour, the bonded zone has the harbour's trunk road Highway No. 4 and a railway in the south, the newly built Beijing-Tianjin-Tanggu Expressway in the north and the north-south East Ring Road in the west. The entire zone covers 1.2 square km, with ample room available for future expansion.

The bonded zone derives much of its strength from Tianjin Harbour, a major foreign trade centre which enjoys high international prestige, it operates a host of international shipping lines and has the economic backing of the vast north and northwest of China. The harbour has seen continuous enlargement over the last few years, and the number of its berths is steadily growing. As an international hub for containerized shipping, Tianjin Harbour leads China in the number of containerized berths and in the capacity to handle containerized shipping.

A seaside door for the Chinese capital of Beijing, Tianjin is one of the nation's three municipalities directly under the central government. It is an important economic and trade centre in north China and, with a complete array of urban facilities, a harbour city of international calibre. Thanks to its ideal geographical position, including its close proximity to Beijing in particular, the bonded zone will display great economic vitality in the near future.

II. PERFECT EXTERNAL CONDITIONS

The Tianjin Harbour is intricately linked with the rest of China by waterways, highway, railways and airlines. It also has shipping ties with more than 300 harbours in the 160-odd countries and regions and operates some 30 regular shipping lines. A host of trunk railways and highways meet in the harbour area, such as the Beijing-Shanhaiguan, Beijing-Tianjin, Beijing-Pokou and Liqizhuang-Beidagang railways, the Beijing-Tianjin-Tanggu Expressway, and the Tianjin-Tanggu, Tianjin-Dagu and Yangzhuang-Beitang trunk highways. Tianjin and Beijing airports are close by. More importantly, the city has all facilities a world-class harbour can offer commerce, finances, customs service, commodities inspection and living facilities.

The comprehensive system of auxiliary installations of the harbour has provided the bonded zone with ideal external conditions. The harbour's power supply centre (a 110 kv transmission station) and water plant are situated next to the zone. A newly built modern network will meet the zone's telecommunications needs, and the highways have made it easy to reach the docks and beyond of the zone.

III. PREFERENTIAL INVESTMENT POLICY AND TAX PRIVILEGES

Bound by international conventions, the bonded zone follows a series of preferential policies to attract foreign capital and develop an export-oriented economy. Foreign-invested enterprises in the bonded zone enjoy more preferential treatment than their counterparts in China's special economic zones and economic and technological development zones. The additional treatment includes the following:

1. All goods, when shipped from abroad to the bonded zone or vice versa are exempt from import or export licensing and customs duties. Foreign-invested firms may engage in international trade, as may Chinese enterprises which have been delegated such power. Enterprises in the bonded zone may obtain approval to operate entrepot and transit trade.

2. Commodities and goods, when shipped out of or sold within the bonded zone, are exempt from production-related industrial and commercial consolidated tax or product tax (or VAT): goods entering the bonded zone from the non-bonded zones in China, which are eligible for export, are exempt from production-related industrial and commercial consolidated tax or may have the product tax already levied reimbursed. Bonded goods entering the non-bonded zones from the bonded zone pay industrial and commercial consolidated tax or product tax (or VAT).

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3. Exemption from customs duties and industrial and commercial consolidated tax is granted for building materials imported for the use of enterprises in the bonded zone, equipment and spare parts for production and management purposes, means of transport, office supplies and raw and auxiliary materials for production purposes.

4. The income tax on enterprises with foreign investment of a production nature in the bonded zone is levied at a reduced rate of 15 percent.

5. Upon the expiration of the tax exemption and reduction period as provided for in the tax law, export-oriented enterprises with foreign investment pay enterprise income tax at ten percent, if the value of the export products of the year exceeds 70 percent of the total value of products of the year.

6. Technologically advanced enterprises with foreign investment may, upon the expiration of the enterprise income tax exemption and reduction period as stipulated by the tax law, further enjoy a 50 percent reduction in enterprise income tax for three years based on the rate set forth in the tax law, if such enterprises remain technologically advanced enterprises.

7. Foreign-invested enterprises engaged in port and dock construction and which have an operation period exceeding 15 years may, upon approval of their applications by the tax authorities at level of municipality directly under the administration of the central government in which the enterprises are located, enjoy exemption from the first profit-making year to the fifth year, and a reduction in enterprise income tax by 50 percent from the sixth to the tenth year.

8. Foreign-invested enterprises in the bonded zone are temporarily exempt from local income tax.

9. Houses built or purchased by foreign-invested enterprises in the bonded zone are exempt from house property tax for five years beginning from the month construction is completed or when the purchase is made.

10. The enterprises may accelerate the depreciation of fixed assets.

11. A foreign exchange control system is followed in the bonded zone. Enterprises in the zone are allowed to keep their foreign exchange revenue from business operations as turnover funds.

IV. PRAGMATISM AND HIGH EFFICIENCY

The Administrative Committee of the bonded zone constitutes a new administrative system and, as authorized by the Municipal People's Government, handles administrative affairs in the bonded zone in unified way.

The Administrative Committee works to simplify administrative and work procedures and does its best to adopt international procedures to create an ideal environment under which conditions are made convenient, straightforward, simplified and highly efficient for investors.

The Administrative Committee has the authority to examine, approve and process applications for the establishment of enterprises in the bonded zone. With the certificate of approval issued by the committee, prospective investors may complete all official formalities such as registration with the industrial, taxation and customs authorities and setting up of bank accounts under the same roof. The bonded zone will ensure water and power supplies, telecommunications, public health facilities, landscaping, legal consultancy services accounting, labour and other services.

Before the bonded zone was established in May 1991, China's mainland had its first Chinese and foreign joint-venture Commercial Bonded Warehouse (CBW) established there. Over the last two years CBW has yielded remarkable economic returns and accumulated experience for the bonded work of the zone.

A general zoning plan has been mapped out, and various rules and regulations have been promulgated. Construction of infrastructure facilities is in full swing and conditions have ripened for the arrival of foreign investors.

The Tianjin Port Bonded Zone welcomes domestic and foreign business people wishing to conduct inspections and business talks and invest in the zone. It can help them succeed in the business world.

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ASSOCHAM/IFA CONFERENCE

Peter Hann

The Associated Chambers of Commerce and Industry of India (ASSOCHAM) and the International Fiscal Association (IFA) India Branch hosted an interesting, informative, and well attended conference on 6 and 7 November 1992 in New Delhi. The more than 300 participants included representatives from several neighbouring countries, including Pakistan and Bangladesh. The speakers and panellists included many of India's leading tax experts, including Dr. R.J. Chelliah, Chairman of India's Tax Reform Committee, as well as international experts such as Dr. A. Fantozzi, Chairman of the Permanent Scientific Committee of IFA. In addition, the Deputy Minister of State for Finance and the Finance Secretary gave valuable comments during the opening and closing sessions of the conference.

The conference concerned itself with four related issues which are facing India in the area of direct taxation. Firstly, the international trends in corporate taxation which India is following especially in reduction of tax rates and simplification of the system. Secondly, presumptive taxation, where India is following the lead given by other developing countries in attempting to simplify business taxation and widen the tax net. Thirdly, the reform of the tax administration, without which any legislative changes cannot take effect and be enforced; and fourthly, the interpretation of double taxation agreements, of which India has a wide and growing network.

The conference enabled participants to hear of international developments in each of these areas, and in the light of this the discussion led to a more detailed examination of the position in India.

The background to the discussion is that in India direct taxes account for only 14.6 percent of government revenue, while indirect taxes account for 64.8 percent (the rest comes from interest on government loans, profits of public sector concerns and foreign aid or grants). It is known that, in India, a large number of individuals and businesses are avoiding direct taxes, and a combination of new legislation and reformed administration could result in a great increase in the total number of direct taxpayers.

The Chelliah Committee on taxation reform has recently presented its final report, which also examines the above issues. Much discussion at the conference was conducted with reference to the findings of the Chelliah Committee, and it was noted by the conference that the measures recommended by the Chelliah Committee were in line with the international trends.

Another factor which makes reform of India's direct taxation relevant at the present time is the relaxation of the position regarding the ability of foreign companies to invest in India. Foreign companies are able to hold 51 percent equity in an Indian subsidiary, while certain selected multinationals are allowed to trade in India through 100 percent subsidiaries. There is now concern that the potential inflow of foreign investment could be deterred by high taxation rates or unsatisfactory treaty arrangements.

OPENING ADDRESSES

A welcome address was given by Dr. N.M. Dhuldhoya, President of ASSOCHAM, followed by a discussion of the conference theme by Mr. O.P. Vaish, Conference Convenor and Chairman of IFA, India Branch.

Mr. Vaish emphasized the fact that the success of any tax legislation which is introduced depends on the effectiveness of the tax administration which has to implement it. In addition to the tax itself, the taxpayer has to pay some indirect costs in complying with his tax obligations, and the extent of these indirect costs depends on the efficiency of the tax administration. If the implementation of tax legislation leads to uncertainty, undue demands for information, and arbitrary decisions, this is also a cost for the taxpayer.

In the inaugural address, the Deputy Minister of State for Finance emphasized the need for India's domestic thinking to be in line with the rest of the world. He pointed out the speed with which the government had implemented reforms suggested by the Chelliah Committee and confirmed the government's commitment to reform. He also pointed to India's success in expanding the network of bilateral tax treaties. Domestically, the government is committed to promoting fairness and eliminating delays.

In the key note address, Dr. Chelliah expressed his confidence that the reforms recommended by his committee are in line with international trends, which is an important consideration as India attempts to globalize its economy. A tax system must be created which does not change significantly from one year to the next, and this system must be supported by taxpayers who in the past have been accustomed to request changes in the tax system to benefit their particular interests. The lower tax rates should encourage greater compliance among taxpayers. Changes in tax legislation at the Federal level will not be sufficient on their own, and must be accompanied by reforms in the tax administration and also by reform of the tax systems of State governments.

Dr. Fantozzi, in a brief summary of international trends, discussed some issues resulting from the increase in cross-border transactions. He referred to the return to territoriality as a basis for establishing the tax liability of an entity. Attempts to tax entities on a worldwide basis were now being re-thought. There was an increasing concern with transfer-pricing provisions, resulting from the increased globalization. The creation of common markets in some places showed a willingness to cooperate and even to surrender some sovereignty.

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TRENDS IN CORPORATE TAXATION

In her presentation on international trends in corporate tax reform, Ms N. Payne of the International Bureau of Fiscal Documentation indicated that over the last decade there has been a trend toward lower corporate tax rates, broader tax bases and simplification of taxation systems. The tax reform movement arose due to a perception in many countries that high tax rates and special tax incentives had created tax systems which were overly complex and lacking in neutrality. The tax reforms which were implemented in developed countries to remedy this situation have also been implemented in many developing countries. The recommendations made by the Chelliah Committee are consistent with these international developments.

Ms Payne also noted the growing trend towards anti-avoidance measures, such as transfer pricing, controlled foreign corporation, thin capitalization and treaty shopping provisions. These measures are generally aimed at corporations whose transactions cross national boundaries, and are therefore gaining in importance as the number of international transactions increases. While such anti-avoidance measures are aimed at broadening the tax base and increasing tax revenues, they inevitably involve greater complexity in their implementation and therefore lead to increased costs of administration. Ms Payne's presentation was followed by a panel discussion on Indian tax reforms with participation from the floor.

The conference noted that a general feature of taxation systems throughout the world is that they have tended to be frequently amended in response to the demands of various pressure groups within a country. The result of this situation is that it is difficult for businesses to plan ahead as they do not know to what extent the tax system will change in the future. It would therefore be preferable for future tax policy to be announced a few years in advance where possible – for instance, where the tax rates are to be lowered over a period of years the government should publicize the rates of tax for some years ahead, and should then not alter this.

In line with international trends, the Chelliah Committee suggested a domestic tax rate of 40 percent, with a tax rate on branches of foreign companies around 7.5 percent higher to compensate for tax which would normally be collected on distributed profits by way of withholding tax on dividends.

More controversial was the Committee's view that the present classical system of taxing dividends, whereby no tax credit is given to the shareholder and he is in effect taxed twice, should be retained for the time being. The reason for the Committee's view is that simplicity should be retained, and also that the lowering of both the individual and corporate tax rates will reduce the disadvantage to the shareholder of double taxation.

Earlier experience in India of a 'partial integration' system aimed at relieving the double taxation of the shareholder was that it was unworkable in practice, owing to problems for the tax administration and problems of compliance. This whole issue therefore has to be seen in the light of efforts to reform the administration, and the need to change the attitude of taxpayers, which was also a concern of the conference. As in other areas, a method of taxation is being recommended on the grounds of simplicity, rather than because it is fair, because the legislation has to work in practice. More complex methods, which will lead to more fairness, must await further reform of the tax administration to enable it to cope with the additional burden caused by more complex methods.

There was discussion at the conference of the appropriate depreciation rates for plant and machinery. The international trend on this issue has been to equate the allowable depreciation rate for taxation purposes with the accounting treatment, rather than to give higher rates or even 100 percent write-offs in the year of purchase. The international tax trend is for neutrality of treatment, rather than to try to influence the behaviour of businesses by means of tax incentives. It is now recognized that the taxation system is not the appropriate place to introduce incentives for investment in plant, especially as business decision-makers often do not allow tax considerations to play a major role in such decision-making. The Chelliah Committee recommended retention of the present 25 percent depreciation rate.

A feature of the situation in India is that it has a Federal system and the individual states have the right to levy their own taxes. This leads to a difference of treatment between businesses operating in different states, especially because of the different levels of indirect taxes levied in different states. The goal of neutrality cannot therefore be achieved by reform at the federal level alone, but will require tax reform at the state level.

PRESUMPTIVE TAXATION

The second technical session comprised a panel discussion on the subject of presumptive taxation, with participation from the floor. A presumptive tax is a tax which is imposed on the basis of an estimated taxable income. A review of the international position on presumptive taxation was given by Mr P. Hann (IBFD). Developed and developing countries have often used final withholding taxes, based on gross income, when taxing non-residents. In some countries, a minimum tax is imposed, based on a percentage of turnover or of net wealth. Flat-rate taxes are increasingly being used where it is difficult to establish the taxable income of businesses, for instance because the books and records are inadequate. Presumptive taxation has the advantage of simplicity, both for the tax administration and for the taxpayer, and it consequently saves administrative time and costs. The simplicity of a tax may also encourage compliance by the taxpayer.

India has for some time had certain types of presumptive taxation in its legislation, for instance in respect of the liquor and timber trades, where inadequate books of account were maintained. Also various types of income of non-residents have been subject to a presumptive tax, as it is otherwise too easy for them to escape paying taxation in India altogether.

The background to the discussion of presumptive tax in India was that the Chelliah Committee recommended two new presumptive taxes on small businesses. Firstly, a fixed tax on businesses whose turnover was less than 500,000 Rs., and secondly the Estimated Income Scheme on small businesses with turnover above 500,000 Rs., but less than 2.5 million Rs., which would estimate profit to be a certain percentage of their turnover depending on the type of activity from which it was earned.

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Of these, the government introduced in the Finance Act 1992 a fixed tax on the lines suggested by the Committee, but did not introduce the estimated income scheme. It is, however, understood that the government are in agreement with the Committee on the necessity of such a scheme but wish to first examine the effectiveness of the fixed tax before going ahead with further schemes.

Another development which was the subject of concern at the conference was that the presumptive tax on the liquor and other trades introduced in 1988 has encountered objections on the grounds that it is unconstitutional. The objection is that the section offends against Article 14 of the Constitution which concerns equality before the law. Where the presumptive tax leads to a higher tax burden than would apply from assessment on the basis of book profit, there is a constitutional problem. From the Court decisions, it would appear that under the Constitution the taxpayer has the right to object to the imposition of the presumptive tax and to ask for the laws to be read as offering the presumptive tax as an alternative to assessment on book profit, with the taxpayer in the last analysis being able to insist on assessment based on book profit.

The Chelliah Committee recommended that to avoid legal challenges, the presumptions would have to be made rebuttable. This of course leads to the disadvantage that the taxpayer can choose the presumptive tax when it is to his advantage and reject it when it is not, so that the system always works to the taxpayer's advantage.

The possibility of opting to submit a tax return rather than paying the presumptive tax does not, however, make it less useful in attaining its principle objectives of simplification and of widening the tax net. It is important to determine the level of presumptive taxation with great care and to revise it frequently so that it does not lead to abuse by being set too low or lead to evasion because it is too high.

The conference was in agreement that a presumptive tax such as the fixed tax on small businesses has the great advantage of simplicity, and this means that it saves administrative time and also encourages compliance by the taxpayer as it avoids the necessity to submit a return of income and satisfy the tax authorities that it is correct. Small businesses have in particular suffered from over-assessment, with the resulting time and effort necessary to revise an assessment, and the presumptive tax will solve these problems. Simplification will be an incentive to taxpayers to comply with their obligations, provided that the presumptive tax is set at a reasonable level.

The discussion surrounding the presumptive tax is related to the other aspects of the Indian tax system discussed by the conference. Simplification is a trend in the whole world, and in the particular circumstances of India it is especially necessary in order to solve the problems of tax evasion and an over-burdened tax administration.

TAX ADMINISTRATION

The third technical session featured a lively panel discussion with floor participation.

The Chelliah Committee recommended reforms such as improvement of information-gathering by further computerization, education of tax officers, reform of methods of assessing tax officers, and simplification of tax laws.

The conference identified a major problem to be that too many people who are earning enough to pay tax are escaping the tax net, and that the over-burdened tax administration does not have the resources to identify these tax evaders. Therefore, more resources must be devoted to improving information-gathering and storing of data.

Linked with this is the necessity for a change in the attitudes of both taxpayers and tax administrators. Administrators should be aware that they are collecting tax on behalf of the community, and that collection involves cooperation with the taxpayer rather than confrontation. Taxpayers must see the payment of their tax as part of their duties as citizens.

It was commented that there is a tendency for too much unnecessary contact between the tax administrators and the taxpayers, with frequent requests for the taxpayer to report to the tax office during an enquiry into his affairs. Ideally, a taxpayer should pay his tax at a counter or by post in the same way that he pays an electricity bill, without lengthy procedures. The elimination of lengthy enquiries would be an incentive for taxpayers to comply with the law. The costs of compliance for the taxpayer are at present too high, and to reduce these costs would be another incentive to businesses to comply with the law, in addition to saving administrative time and costs for the tax administration.

The frequent use of search and seizure provisions was also commented on. Hundreds of such searches are carried out each year in India and they rarely result in prosecutions of offenders. Also, the issue of an assessment after a search has taken place takes too much time. During this time, the books which have been seized by the tax authorities are held by them, to the detriment of the taxpayer's business. The situation can amount to unnecessary harassment of the taxpayer. There are other measures that can be taken to combat the non-production of books and records by a taxpayer, and greater use should perhaps be made of these.

The Chelliah Committee had pointed out that the methods of assessment of the work of officers in the tax administration led to the tendency to over-assess taxpayers. Reform of assessment procedures could therefore lead to fairer treatment of taxpayers.

Also, training of administrators should aim at instilling in them a respect for the taxpayer and a realization that this respect should be maintained during the course of an enquiry into a taxpayer's affairs. Internal courses within the tax administration could perhaps be improved by inviting the participation of outside professionals.

INTERPRETATION OF DOUBLE TAX TREATIES

India is in the process of opening itself up to foreign investment by allowing foreign companies to operate through 51 percent subsidiaries and in some cases 100 percent subsidiaries. As mentioned above, it is important that the taxa-

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tion system should not counteract this policy by providing a disincentive to investment from outside India. India has a large network of double taxation treaties, and it is therefore necessary that there should be clarity and consistency in the interpretation of the treaties so that foreign companies are able to rely on treaty provisions.

Equally important is the interaction between the treaties and the domestic tax law. In India, the situation is regulated by Section 90 which authorizes the government to enter into taxation treaties and to make the appropriate decrees to put them into effect in India. The Finance Act 1991 introduced an amendment to the effect that where the domestic law gives more favourable treatment than a treaty, the domestic law shall apply.

In his keynote address for the final technical session, Dr. Fantozzi emphasized that, even though a double taxation treaty is implemented in the domestic law of a country, it remains an international agreement and should be subject to an interpretation which is acceptable to both contracting states. An attempt by a state to interpret a treaty according to definitions contained in its own domestic law may be contested by the other party to the treaty.

Subsequent discussion of the issues by the conference revealed that the problems addressed by Dr. Fantozzi are of relevance in India. As more foreign companies begin to invest in India, they will require security as to the meaning of the double tax treaties, and the most reliable course of action for them will be to obtain advance rulings on interpretations which may be contentious. For advance rulings to be reliable, the tax administration must be able to train some staff to enable them to give such rulings, and this should now be a priority.

Double tax treaties provide for a mutual agreement procedure, and another priority for India should be to ensure that such a procedure will be conducted within a reasonable time span.

CONCLUSION

The topics discussed at the conference are related, and have arisen as a result of two important developments in India. Firstly, the need to widen the direct tax net within India, and secondly the need to attract more foreign investment.

The reform of the direct tax system will not be effective unless it is accompanied by a reform of the tax administration, to enable it to cope with the additional work and new challenges. This reform must include a change in attitudes and also more efficient information-gathering systems. The widening of the tax net cannot come about without a greater effort to inform taxpayers of changes in the system and a change in the tax culture which will improve the citizens' attitudes to the payment of tax.

As a result of changes in foreign exchange regulations, an increase in foreign investment in India is expected and, indeed, has already begun. Reform of the taxation system must keep pace with this development, otherwise foreign investors will be deterred. Direct tax rates must therefore be realistic and in line with international levels, and foreign investors must also be able to rely on the network of double tax treaties without fear of legal problems over interpretation.

The concluding remarks for the conference, given by India's Finance Secretary, were well received and provided a satisfying conclusion to an informative and well organized international tax conference.

CUMULATIVE INDEX – 1993 No. 1

I. ARTICLES

Hong Kong:
Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

II. REPORTS AND DOCUMENTS

International:
Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS

44

IV. CONFERENCE DIARY

39

V. BIBLIOGRAPHY

– Books 49
– Loose-leaf services 51
– List of addresses of the major publishing houses appearing in the Bibliography 53

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IFA News

Resolutions 46th IFA Congress, Cancún, 1992

SUBJECT I: Transfer pricing in the absence of comparable market prices

Resolution (original version)

The 46th IFA CONGRESS

TAKING NOTE OF the 26 National Reports and the General Report as published in the *Cahiers de Droit Fiscal International*, Vol. LXXVIIa, and

TAKING FURTHER NOTE of the discussions held during the Congress on 12 October 1992,

RECOGNIZING THAT

1. The OECD reports *Transfer Pricing and Multinationals* (1979) and *Transfer Pricing and Multinationals, Three Taxation Issues* (1984) and virtually all the countries covered by the National Reports affirm that the "comparable uncontrolled price" is the most appropriate criterion to establish correct transfer prices;
2. the OECD reports acknowledge that if application of this criterion is impossible, other methods such as the "resale price method", the "cost plus method" or so-called "fourth methods" may be used;
3. the OECD reports, however, do not explore in detail the "fourth methods", and do not examine their consistency with the arm's length standard;

RECOMMENDS:

1. While the so-called "fourth methods" do not generally comply with the arm's length principle, there may be specific circumstances under which they do comply, e.g. because they can be applied on a transactional basis. The OECD should study the circumstances under which this may occur. Those methods that do not comply with the arm's length principle (including the comparable profit method as prescribed in the proposed US Section 482 Regulations) should not be used to determine transfer prices. They may be used only to verify whether prices established by one of the basic methods lead to generally acceptable results or to highlight potential problem areas without being used to establish replacement prices for the relevant transaction. Furthermore, use of any of these methods is acceptable if the taxpayer and the tax authorities (in two countries if need be) agree, either in an advance agreement or in a settlement, on the use of a particular method.
2. In determining an arm's length price, the law should not prescribe a specific order as to what method should be applied but it should allow the use of any method or combination of methods – provided it is a method complying with the arm's length principle – that provides the best access to and use of comparable data and appears to be the most appropriate given the facts and circumstances of the case. However, if a taxpayer has consistently used a particular method and can demonstrate that it is in accordance with the arm's length principle and appropriate in the light of the structure of its business and transactions, the authorities should also follow that method.
3. In determining the amount of a tax adjustment in a transfer pricing case, the tax authorities should not be permitted to use information that could not reasonably have been at the taxpayer's disposal at the time the transfer prices were established, unless the taxpayer makes use of such information in justifying the relevant prices.
4. In applying transfer pricing methods that comply with the arm's length principle, taxpayers and tax authorities should not take a narrow, rigid approach in defining standards of compatibility, but be prepared to refer to substantially comparable market situations to which adjustments can be made reflecting the circumstances of a particular taxpayer.
5. The OECD Model Convention should include a provision giving the taxpayer the right to approach the tax authorities of the two countries involved to obtain advance clearance, on the basis of mutual agreement, on basic elements of the transfer pricing system to be followed such as the method to be applied, the selection of the data to be used and, if required, adjustments thereto.
6. Article 9 of the OECD Model Convention should be amended to reflect more accurately the mandatory use in profit adjustments of methods based on the arm's length principle. The Commentary to this article should include a reference to the OECD Report(s) on transfer pricing to ensure that courts, when applying that article, will follow the recommendations of those OECD Report(s).
7. Paragraphs 2 and 38 of the OECD Report recognize that within affiliated groups, conditions for arm's length bargaining may be fulfilled. This could be the case if the persons having a decisive influence on the transfer price have diverging economic interests, where civil law rules prescribe certain behaviour, where group entities have their own profit responsibility and are free to contract with third parties, or where there are significant minority or even majority interests.

   The OECD Report should provide criteria to identify such situations and provide that, if they are found to be present, the price that has been established should be accepted as an arm's length price.

Notes of the Chairman of the Résumé Committee

1. At an early stage in the proceedings it was decided that the subject lent itself better to Resolutions than to a Précis or Résumé. The elements of the discussion and the arguments for the various positions are well covered in the General Report and the National Reports, as well as in numerous other publications on the subject of international transfer pricing problems. A Résumé would merely add another summary of arguments to the already voluminous material. At the same time, IFA members

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unanimously expressed the desire to eliminate double taxation resulting from transfer pricing disputes, and IFA should use the opportunity to express recommendations that support that objective.

2. It was noted that in discussions on transfer pricing, two subjects can be distinguished: the first is procedural, viz. what procedures can be developed to minimize the time and cost involved in resolving transfer pricing disputes, and the second is substantial, viz. what methods and criteria should be adopted in establishing arm's length prices. The Reports and the Congress dealt with both subjects, as can be seen from the Resolution. Another subject that was discussed extensively during the plenary sessions but which did not result in sufficient convergence for a Resolution was the distinction between methods used to *establish* transfer prices and methods used to *audit* them.

3. As regards procedure, strong support was noted for the EC arbitration convention and the US advance pricing agreements. Also, the Recommendations express the feeling that taxpayers are entitled to more protection against arbitrary and revenue-seeking actions of the authorities, and that the taxpayer's choice of method, if made with proper diligence, should be given considerable procedural weight.

4. On the issue of criteria and methods, the main concern expressed by the reporters and other participants of the Congress was the lack of definition and criteria in the application of the "fourth methods" (i.e. the methods that are sometimes used beside the "basic" methods of comparable uncontrolled price, resale price and cost plus). The trend toward the use by the revenue authorities of methods based on profitability standards rather than arm's length standards (as expressed, inter alia, in the proposed US Section 482 Regulations) was discussed at length and rejected by most participants. Another area of considerable concern was the use of information not available at the time of the transactions.

5. On some of the Resolution's recommendations, certain qualifications were noted that are listed below.

6. On Recommendation 1, there was a prolonged discussion on whether only "transactional methods" (i.e. methods that look for comparability at the level of the transaction) can be regarded as meeting the arm's length standard, or whether methods looking for comparability at the profit level may also meet that standard. If profit-based methods are applied on a transactional basis, can they then meet the arm's length standard? Generally it was felt that while there is a strong relationship between "transactionality" and "arm's length", it cannot be said to be exclusive. Specifically, a minority of the Resolution Committee members felt that no broad statements could be made branding the fourth methods and/or the US proposals as being not at arm's length.

7. On Recommendation 3, some of the Resolution Committee members felt that the use of later data should be permitted, as this could well result in a fair price and could work to the advantage of the taxpayer as well as to his disadvantage. However, the majority of the members expressed a strong feeling that such data should not be used unless introduced by the taxpayer.

8. On Recommendation 5, some Congress participants expressed the view that it is superfluous since article 25 of the OECD Model Convention already implies this right, and in fact several countries have entered into "advance mutual agreement" negotiations in specific cases based on the authority of article 25. However, the Committee members and the majority of the Congress participants favour the inclusion of a specific provision in tax conventions.

9. On Recommendation 6, a similar issue arose. The OECD reports have the same status as the Commentaries to the OECD Model Conventions, and the second sentence of the Recommendation therefore appears redundant. However, the inclusion in the Commentaries of the reference will be useful as it highlights the commitment of the OECD to the principles outlined in the reports.

10. Recommendation 7 contains a "safe haven" for transfer pricing within affiliated groups. Several Committee members felt that this was not a very realistic proposition and cases would be too few to justify the inclusion in a Resolution. However, the majority of the Committee members and of the Congress participants see considerable merit in this "prudent businessman" approach.

M.J. Ellis (Netherlands)

SUBJECT II: Tax Consequences of International Acquisitions and Business Combinations

Resolution (original version)

The tax consequences of international acquisitions and business combinations (mergers and acquisitions, M&A) were discussed at the Congress on the basis of 27 National Reports synthesized in a General Report as published in *Cahiers* Vol. 77b.

The following resolutions were adopted:

1. *The taxation of international acquisitions and business combinations*

1.1. Considering on the one hand the growing inter-dependencies of world markets and the increasingly multinational character of economic activities,

Considering the increased necessity for enterprises to optimize their worldwide efficiency and activities so as to cope with keener competition on world markets,

Considering the growing importance of international acquisitions and business combinations to adjust to such harsher free-market conditions,

Considering that domestic acquisitions and business combinations are in an increasing number of countries feasible in a tax-neutral way whilst identical international transactions and similar international re-organizations are in some cases impeded by tax hurdles,

Considering on the other hand that international acquisitions and business combinations often result in a transfer of shares, assets or other tax substrata from one tax jurisdiction to another,

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Considering that such tax hurdles are already being eliminated by 12 countries in Europe on the basis of the EC merger directive,

The Congress recommends:

A. That Governments should have due regard to the trend towards international acquisitions and business combinations and national legislation, including transaction taxes, should not impede that development.

B. In general that ways and means be devised by which any higher tax burden on international acquisitions as compared to the tax burden of similar domestic transactions are eliminated or mitigated, including the possibility of tax deferral or deferral of tax payment, taking into account the fiscal interests of the countries concerned.

C. That shareholders involved in an international acquisition or business combination should be no less favourably treated by reason only of their residence outside the country of incorporation of the companies concerned or by reason of the fact that one or several of the companies concerned are incorporated abroad.

2. *Tax inefficiencies*

2.1. Considering that mergers and business combinations often result in the flow of income through various tax jurisdictions,

Considering that such flows lead to tax inefficiencies and a higher tax burden due to the imperfect elimination of double taxation, insufficient imputation of withholding or foreign taxes, insufficient tax credits and accumulation of anti-abuse provisions,

Considering further that the structures by which such inefficiencies can be mitigated often lead to operational inefficiencies,

The Congress recommends:

that internal legislation and double taxation agreements ought to give more weight to the elimination of such higher tax burden.

2.2. Considering further that even more cumbersome structural or operational inefficiencies are caused by tax hurdles impeding after an acquisition or business combination an optimal integration and reorganization of the two formally separate economic entities.

The Congress recommends:

That ways and means should be studied and implemented to foster optimization of efficiency by facilitating international reorganizations after acquisitions in a tax neutral manner by tax deferral, deferral of tax payments or in any other way, and that this problem be adopted as the subject of a later Congress.

Notes of the President of the Résumé Committee

At the Congress session on 14 October the participants' contributions were streamlined, by being grouped into six categories:

1. Tax considerations affecting the form of acquisition.
2. Tax inefficiencies resulting from acquisitions.
3. Deductibility of interest and other financing cost incurred in the context of an acquisition.
4. Possibility and limits of tax deductibility of the purchase price or part thereof.
5. Preservations of carry-forward of pre-acquisition losses.
6. Case studies, stapled shares, etc.

Consideration of all the six topics resulted in a discussion on the necessity of careful acquisition tax planning and various methods available for such planning.

1. *Tax considerations affecting the form of acquisition*

In addition to the advantages and disadvantages of share purchase, purchase of assets and merger respectively set out in the reports it clearly emerged that the bargaining on the conditions of an acquisition will be influenced by any tax money payable or potentially payable by either party to the revenues involved. In addition, the acquirer would take into account any tax or operational advantages or inefficiencies resulting from the structures of the deal.

2. *Tax inefficiency resulting from the acquisition or business combination*

Tax inefficiencies occurring during and more especially after an acquisition mainly result from the flow of income from its source to the eventual shareholder through several tax jurisdictions. They are due to imperfect elimination of double taxation, insufficient imputation of withholding or foreign taxes, and insufficient tax credit. In addition the problem of the even more cumbersome structural and operational inefficiencies caused by tax hurdles impeding the optimal integration of two formerly separate economic entities and the tax hurdle to implement the required reorganizations was broached. Such tax impediments to international reorganizations are referred to in the Resolution.

In the discussion the importance of careful tax planning to minimize the foregoing tax inefficiencies were stressed. Four tax planning features were more specifically discussed under points 3 to 6.

3. *Deductibility of interest and other financing cost*

From the deliberations it emerged that no sterner rules in respect of debt financing of the acquisition of share or in respect of thin financing are warranted in cases where these problems arise in the context of acquisition or a business combination. On the contrary, such transactions often provide additional economic and business justification for debt financing of either or both, the acquirer or the target.

4. *Deductibility of purchase price*

There was a consensus that any tax-free revaluation of assets available in domestic transactions should also apply internationally. As regards the possibility of allocating a larger part of the purchase price to depreciable assets like covenants not to compete, the acceptability of such methods would seem to be controversial except where warranted by special circumstances.

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5. *Preservation of losses carried forward*

Whilst recognizing the necessity of preventing abuses, it was felt in general that acquisitions or business combinations should not affect the carry-forward of losses to the extent that business activity of the acquired company continued.

6. *Case studies, stapled shares*

As an example of a method for coping with situations of extreme tax inefficiencies, stapled shares and similar vehicles were explained and discussed. Attention was, however, drawn to the tax and operational inefficiencies and to the transfer price problem which must be solved to achieve integration of the operations of the two stapled companies.

Dr. A. Burckhardt (Switzerland)

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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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 53-56 of the January 1993 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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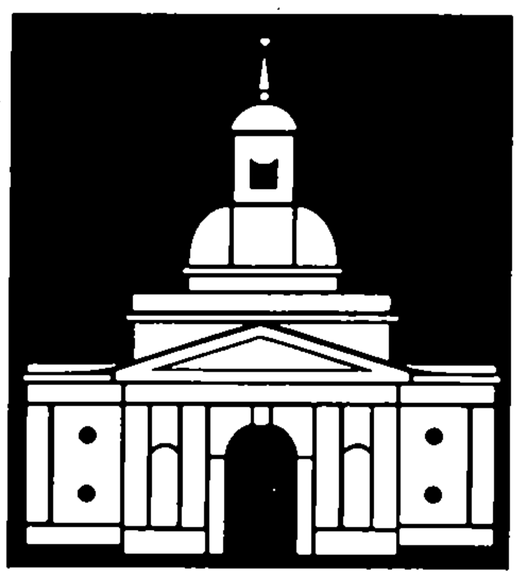
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CONTENTS

VOL. 47 NO. 3 **MARCH 1993**

THE FIRST CARIBBEAN TAX CONFERENCE — 107 — *Dr Willem G.Kuiper*

The first Caribbean tax conference was held in October 1992 in Aruba. This landmark event brought together tax experts from the Caribbean, the United States and Europe to discuss recent tax and foreign investment developments in the Caribbean, tax consequences of doing business in the region and financial services. This issue features a number of the papers presented during the very successful conference

EXCERPTS FROM THE ADDRESS OF THE MINISTER OF FINANCE OF ARUBA — 108 — *H.E. Mr Roland H. Laclé*

The Minister of Finance opened the conference with a call to the United States and the governments of other industrialized governments to conclude double taxation treaties with the Caribbean countries.

RECENT TAX AND FOREIGN INVESTMENT DEVELOPMENTS IN THE CARIBBEAN — 109 — *Annette T. Johnson*

Contrary to widely held perceptions only five of the 27 territories in the Caribbean levy no taxes at all – the majority have relatively developed tax systems which are as diverse in their approach to taxation as are countries of Western Europe. Ms Johnson overviews the tax systems of the Caribbean region, including the overseas features which have influenced the development of these systems.

TAXATION OF FOREIGN INVESTMENT IN JAMAICA — 116 — *Christine A. Gore*

Ms Gore looks at a number of incentives available to investors in Jamaica. Her conclusion – the Jamaican taxation of foreign investment needs to be re-examined with a view to ensuring that such legislation fulfils its objective, i.e. creating incentives, and not impediments to the investor.

TAX REGIME AND INVESTMENT INCENTIVES IN THE FRENCH CARIBBEAN ISLANDS (MARTINIQUE, GUADELOUPE AND GUYANE) — 122 — *Pierre-Jean Douvier*

French law is fully applicable in the Overseas Departments although it may be adapted for the specific circumstances of the island. This article takes a look at how the tax laws work in Martinique, Guadeloupe and Guyane.

DOUBLE TAXATION AGREEMENTS OF CARICOM: A REVIEW OF EXISTING PRACTICE AND PROSPECTIVE POLICY OPTIONS — 129 — *Bruce Zagaris*

This article discusses the Commonwealth Caribbean double taxation agreements and their effect on trade, commerce and investment. The article in particular considers the principal double taxation agreements to which the Caribbean countries are parties, and explains the legal effects of these agreements.

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BIBLIOGRAPHY	150	
– Books	150	
– Loose-leaf services	154	
CONFERENCE DIARY	149	
CUMULATIVE INDEX	156	

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THE FIRST CARIBBEAN TAX CONFERENCE

Dr Willem G. Kuiper
Technical Director, IBFD International Tax Academy

INTRODUCTION

In 1992 the IBFD International Tax Academy (ITA) organized the first Caribbean Tax Conference in cooperation with the Foundation First Caribbean Tax Conference. The conference, held in Aruba from 7-9 October, was intended to be the first major tax event to bring together tax experts from the region, as well as from the United States and Europe. Ninety-eight delegates from 21 countries (including ten countries in the region) attended the conference. The conference programme was divided in three parts:

- recent tax and foreign investment developments in the Caribbean;
- tax consequences of doing business in the Caribbean from a US and European perspective (with special focus on tax information exchange agreements);
- financial services in the Caribbean, including the domestic and international tax consequences thereof.

After a welcome speech by the conference chairman, Mr Maarten J. Ellis and the official opening of the conference by H.E. the Minister of Finance of Aruba, Mr Roland H. Laclé, the first speaker was Ms Annette T. Johnson who gave an overview of the tax systems in the region and different overseas (Dutch, French, English) features which have influenced the development of these systems. Ms Johnson also discussed the highlights of recent tax reforms in some of the countries concerned, including Barbados and the Dominican Republic, the activities of CARICOM in the area of taxation, some trade and investment issues under the Lomé Agreement and the Caribbean Basin Initiative, the various tax incentives under the CARICOM Harmonization Fiscal Agreement and the influence of the UN model treaty on tax treaty negotiations by Caribbean countries. Many of the issues raised by Ms Johnson were discussed in more detail during the subsequent presentations, workshops and panel discussions.

The next speakers were Ms Christine Isaacs and Mr Colin Brewer who discussed domestic and international tax aspects of the tax systems of their respective countries, i.e. Jamaica and Barbados. These presentations were followed by a number of workshops, each dealing with the tax consequences of a foreign multinational company investing in the region, i.e. the Bahamas, Barbados, the British Virgin Islands, Jamaica and the French Caribbean islands.

The second day commenced with a presentation by Mr Alan W. Granwell who discussed the US tax consequences of doing business in the Caribbean in light of recent international tax developments in the United States and US international tax policy objectives, including the US policy as to whether or not tax treaties should be concluded with Caribbean countries. The focus then moved across the Atlantic to the European tax consequences of doing business in the Caribbean (with particular reference to the special tax relationship between the Netherlands and the Netherlands Antilles). During the panel discussion, Mr Hubert M. Bierlaagh and some of the other speakers deliberated on the potential impact of the EC tax directives and other EC tax regulations on doing business in the Caribbean.

Ms Grace Perez-Navarro of the IRS highlighted the contents and practical use of tax information exchange agreements, primarily between the United States and countries in the region, but also in a wider context. One of the issues discussed during the subsequent panel discussion was the US position as regards its demand to enter into tax information exchange agreements versus its reluctance to conclude comprehensive double taxation agreements with countries in the Caribbean. Other issues discussed by the panel included:

- the consequences and application of the US Caribbean Basin Initiative; and
- the impact of regional tax harmonization, including the tax treaty policy of Caribbean countries, on foreign investment from the United States, Latin America and Europe.

The central topic of the third day was financial services in the region. A number of tax, investment and banking experts from the region (including Aruba, the Netherlands Antilles, the Bahamas, the British Virgin Islands and Barbados) overviewed the relevant aspects of financial services from the perspective of their respective countries. A number of workshops followed, which focused on the same countries and during which case studies and other practical aspects of financial services were discussed.

During the wrap-up session, the importance of this type of seminar, particularly for Caribbean countries, was emphasized by several speakers and delegates. Taking into account the increased efforts of Caribbean countries to achieve a higher degree of harmonization of their fiscal systems and ongoing discussions on the use and abuse of the Caribbean in relation to other parts of the world, either in general or for specific types of transactions, there was a general consensus that a second conference of this type should be held in the not too distant future. ITA expressed its willingness to contribute to such a conference, which will probably take place in early 1994.

The ITA and the editor of the *Bulletin* are pleased to publish this special issue which contains a number of the papers presented during the First Caribbean Tax Conference.

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EXCERPTS FROM THE ADDRESS OF THE MINISTER OF FINANCE OF ARUBA

H.E. Mr Roland H. Laclé

I am very pleased to have the opportunity to address you at the opening of the First Caribbean Tax Conference. You have come from 17 different countries to attend this conference, which precedes the annual meeting of the International Fiscal Association. The number of participants clearly indicates that the initiative of the First Caribbean Tax Conference meets a need. I am pleased that my country's private sector has offered this opportunity to provide you with information on the possibilities for investments and financial services in this region.

It appears to me that the Caribbean region has become very appealing to the world of financial investors. This is also the case for Aruba. The world of financial services imposes special demands. Political and economic stability, good infrastructure, including telecommunication and adequate accessibility, are among those demands. I am pleased that my country scores very high in this respect, which contributes to increasing confidence. This confidence not only results in an increase in financial services, but is a prerequisite for foreign investors and for economic activities.

In respect of economic activities, delegates attending this conference will address the question of the fiscal relations of our region with the industrialized world. Fiscal relations with Europe and the United States will also be brought into focus.

Kindly allow me to make an observation, which relates to the question of fiscal relations between the United States and our region. My remarks are not intended to pre-empt tomorrow's speakers. On the contrary, please regard this part of my speech as an attempt to contribute to the discussions.

Double taxation treaties are usually concluded when the economic activities between countries justify them. As I was told the United States follows this policy. If I understand it correctly, it is the US view that the economic links with most countries of this region are far too small for the conclusion of double taxation treaties.

One of the provisions in a double taxation treaty is the exchange of information provision. Unless there is a treaty base no information is exchanged. This is understandable: information supplied by a citizen of a country to the tax authorities of that country in fulfilment of statutory obligations should not be passed on to the tax authorities of another country in the absence of very compelling reasons. These reasons can be explained in light of the importance of a correct observance of treaty provisions. The exchange of information provision constitutes only one part of a double taxation treaty. As the economic ties between the countries concluding the treaty become closer, the exchange of information becomes more important. You might say that mutual administrative assistance crowns the cooperation between countries as laid down in double taxation treaties.

The last decade evidences an increasing need for mutual administrative cooperation, not only on a bilateral, but also on a multilateral level. As a result the OECD and the Council of Europe jointly designed a treaty aimed to meet this need. This multilateral treaty may be considered a supplement to what countries already agreed on bilaterally in double taxation treaties. Thus, in historic perspective, there were first the bilateral treaties, followed by the multilateral treaty as a further elaboration on administrative cooperation.

But there is more. The United States also uses the Tax Information Exchange Agreement (TIEA) which is intended for countries that, based on the criterion of economic activity, are not eligible for a double taxation treaty.

Earlier I explained that the provisions for the exchange of information form a part of a double taxation treaty. There can only be question if there is a sufficient economic activity between the states concluding the treaty. As regards the TIEA it is precisely the crucial criterion of economic activity that appears to play a minor role.

I am under the impression that there is some inconsistency here. If I understood well, there is either sufficient economic activity justifying a tax treaty, of which the exchange of information may form a part, or so little economic activity that there can be no reason for a tax treaty of any nature.

When I mention here that our Government does not embrace the idea of concluding a TIEA, this is merely caused by the objection in principle to this phenomenon. I would like to call on the US policy makers to give shape in another way to the solidarity between their country and countries in our region as regards fiscal relations. In order to promote economic activity in Aruba, the government sees the conclusion of double taxation treaties as a viable instrument. Underlining the special relation of neighbourhood between the United States and our region, I would request that the United States seriously take into consideration the alternative of a policy of complete and full-fledged double taxation treaties with the Caribbean countries. Let there be no mistake that in these treaties the exchange of information should receive the attention it deserves in view of international developments.

It goes without saying that when I make this call on the United States, it should be seen within the context in which I made my observation. Of course, I would also call on other industrialized countries to pursue this policy.

Finally, I would like to express the wish that this first Caribbean tax conference will offer you everything you expect from it, and even more.

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RECENT TAX AND FOREIGN INVESTMENT DEVELOPMENTS IN THE CARIBBEAN

Annette T. Johnson
LL.B., LL.M., research associate of the IBFD

Contents

I. Introduction
II. Recent Tax Developments
III. CARICOM
IV. Foreign Trade and Investment
V. Tax Incentives
VI. Tax Treaties
A. Permanent establishment
B. Busines profits
C. Independent professionals
D. Tax sparing
VII. Non-Tax Jurisdictions

I. INTRODUCTION

Contrary to widely held perceptions, only five of the 27 territories in the Caribbean region levy no taxes at all.[1] The remainder have relatively developed tax systems and taxes account for a large portion of government revenue. Moreover, Caribbean jurisdictions are as diverse in their approach to taxation as are Western European countries.

The 12 countries which make up the Caribbean Community (hereinafter "CARICOM") – Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts-Nevis, St. Lucia, St. Vincent and Trinidad and Tobago – have similar tax systems, evolved from pre-independence British colonial tax legislation. Most of these countries' tax systems share common features such as a partial imputation system for corporate and individual taxation, the remittance basis of taxation for certain foreign income and the credit method for the relief of double taxation. Guyana is the only country within this group which levies a capital gains tax.

French income tax law extends to its Caribbean Overseas Departments of Martinique and Guadeloupe, Guyane and St. Martin. With a few differences such as the exclusion of one-third of locally-derived income from the tax base, the tax system in these territories is identical to that of France.

The income tax systems of Aruba, Surinam and the Netherlands Antilles are based on Dutch tax legislation without some of its recent refinements. Common features of these income tax systems include the participation exemption, the taxation of capital gains as normal business profits, the non-integration of personal and corporate taxation and the exemption method for the avoidance of double taxation.

The income tax law of the United States forms the basis of the tax systems of Puerto Rico and the US Virgin Islands. Puerto Rico's 1954 Tax Code is based on the US Internal Revenue Code of 1939, as amended by the 1987 Tax Reform Act. The tax code of the US Virgin Islands is a virtual replica of the US Internal Revenue Code.[2]

Taxation matters aside, the overriding factor common to all these territories is their status of lesser developed countries (LDCs) characterized by scarcity of capital, a large agricultural sector, with the export of commodities and primary materials far exceeding that of manufactured goods. Fiscal incentives have therefore been widely utilized to encourage direct investment in underdeveloped sectors such as manufacturing as well as in the more advanced tourism sector. The dependencies of the United Kingdom and the Netherlands, which are associated with the EC,[3] have also utilized special fiscal measures to encourage their development as specialized non-tax jurisdictions given the limitations imposed on traditional industrial activity by their size and insularity.

II. RECENT TAX DEVELOPMENTS

Following the trend in OECD countries and other LDCs, major tax reforms have been undertaken in four of the larger tax jurisdictions within the past six years. Significant changes were introduced in Barbados and the Dominican Republic during 1992 and in Jamaica and Trinidad and Tobago in 1986 and 1989, respectively.[4]

In all four cases, tax reform was part of a package of measures implemented within the broader framework of economic adjustment programmes agreed with the multilateral lending agencies. These countries had shown a substantial fiscal deficit

1. See Appendix I.
2. Under the provisions of the Naval Service Appropriations Act of 1922 48 U.S.C. 1397, the Virgin Islands apply the income tax laws in force in the United States as the tax laws of the Virgin Islands. See IRS Revenue Ruling 83-10, also released as News Release IR-82-158 dated 29 December 1982.
3. Art. 227(3) of the Treaty of Rome established the association of Aruba, Anguilla, British Virgin Islands, Bermuda, Cayman Islands and Netherlands Antilles with the European Community as set out in Part IV thereof. The main elements of Part IV of the Treaty of Rome and implementing provisions established in Council Decision 91/482/EEC include the progressive abolition of customs duties on trade between the 12 member states of the EC and the associated territories and the provision of economic development assistance of EC states to the associated territories.
4. A comprehensive tax reform was also undertaken in Grenada between 1986 and 1987. The most significant features of the reform were the reduction in the number of taxes from 20 to 7, the abolition of income taxes on corporations and individuals and the introduction of a value added tax. For an account of the reforms, see W.A. Samuel, "Tax Reform in Grenada", 42 *Bulletin for International Fiscal Documentation* (March 1988), at 123.

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(excess of government expenditure over revenue intake) during the 1980s.[5] Increasing government revenue through a reform of the tax system and expenditure restraint were therefore important elements in the type of adjustment necessary to move towards fiscal balance in the 1990s.

Unlike many LDCs, income taxation has been an important source of tax revenue in these four countries for many years even in the absence of a broad industrial base. The development of the income tax base has been attributed to the early presence of foreign enterprises in the agricultural and mineral sectors. These provided an accessible tax base for corporate taxation and offered an easier foothold for the administration of individual income taxes.[6] It was not surprising therefore, that the reforms in these countries included significant changes to individual income tax and some changes to corporate taxation.

Domestic retail taxes remain important revenue sources and the reforms in Jamaica and Trinidad included replacing the numerous indirect retail taxes by a single value added tax.[7]

As in any tax reform, the aims of the reforms in the Caribbean included the public finance goals of efficiency, simplicity and equity. As efficiency implies increased revenue yield, the reform measures sought to broaden the tax base for personal taxation. In addition, exempt items of income were brought within the tax net.

The decisive step towards broadening the tax base for personal income tax was the abolition of the large number of personal deductions previously accorded to individual taxpayers. In addition, steeply progressive rate structures with high (in excess of 50 percent) marginal rates were replaced by lower marginal rates and fewer brackets.

The abolition of personal deductions was intended to simplify administration to the extent that it removed the disproportionate burden placed on the tax administrations' resources in processing the small number of claims for the available deductions. The administrative resources employed in multiple calculations occasioned by the numerous tax brackets could be devoted to enforcing compliance, thereby increasing revenue yield. Abolishing the deductions also addressed equity considerations, to the extent that taxpayers with like income were to be treated equally whether or not they chose to dispose of that income in a tax advantageous manner.

In Barbados, the pre-reform rate structure of five marginal rates of between 20 and 50 percent was replaced by a dual rate system. Tax is levied at 25 percent on the first BDS$ 24,200 of taxable income, and 40 percent on taxable income over that amount.

In Jamaica the pre-reform rate structure of five marginal rates of between 30 and 57.5 percent were replaced by a single flat rate of 33.33 percent.[8]

Under the pre-reform schedular tax system[9] in the Dominican Republic, the total net income of individuals was taxed under a progressive rate structure with no fewer than 16 marginal rates of between three percent and 70 percent. These were replaced by a progressive triple-rate structure, under which the first RD$ 60,000 is exempt. Fifteen percent tax is payable on income between RD$ 60,000 to 100,000; 25 percent on income between RD$ 100,000 and RD$ 150,000 and 30 percent on the excess over RD$ 150,000. The top marginal rate is to be decreased by one percent over the next three years so that in the year 1996 the top marginal rate will be 25 percent.[10]

In Trinidad, the pre-reform rate structure consisting of 11 marginal rates ranging from five to 50 percent was replaced by four brackets of between five and 45 percent.[11]

The second common feature of the reforms was the replacement of personal deductions by a standard fixed deduction. In Jamaica and Barbados, individuals were accorded a plethora of tax deductions ranging from life insurance, medical and dental expenses, household helpers, mortgage interest and alimony. These were replaced by a standard deduction of J$ 14,352 and BDS$ 13,000, respectively.[12] In the Dominican Republic, pre-reform deductions which were available in the form of personal and family allowances/credits have been replaced by a standard deduction of RD$ 60,000. In Trinidad the approach was slightly different: personal deductions for, *inter alia*, medical expenses, mortgage interest, housekeepers and dependent relatives were replaced by a non-refundable tax credit of TT$ 600 per year for each taxpayer, rather than a standard deduction.

The reforms in three countries also introduced the taxation of interest on bank deposits by withholding at source. Interest on bank deposits had been previously excluded from the tax base. In Barbados the withholding tax rate for interest is 12.5 percent (with no refund of tax if total income is less than the basic deduction). In Trinidad the rate is 15 percent, with a refund of excess withholding for taxpayers in the five percent tax bracket. In Jamaica the withholding tax rate is 33.3 percent, with an exemption for taxpayers whose income is below the basic deduction.

There was no overall consistency in the treatment of corporate income tax. In Jamaica the rate was reduced from 35 per-

5. Between 1981 and 1988 the fiscal deficit as a proportion of GDP averaged 6% in Barbados, 2% in the Dominican Republic and 7% in Jamaica and Trinidad and Tobago, respectively. See Inter-American Development Bank, *Economic and Social Progress in Latin America 1990 Report* (Baltimore: Johns Hopkins University Press, 1990) and Caribbean Development Bank, *Annual Report 1990*.
6. R.T. Gobin, "A Survey and Analysis of the Tax Systems in the Caribbean Common Market", 33 *Bulletin for International Fiscal Documentation* (October 1979), at 445. For an overview of the relationship between economic development, tax administration and the revenue importance of different taxes, see C.Y. Mansfield, "Tax Reform in Developing Countries - the Administrative Dimension", 44 *Bulletin for International Fiscal Documentation* (March 1990), at 137.
7. Jamaica's value added tax, the General Consumption Tax was introduced in October 1991, some five years after the reform of direct taxation.
8. Sec. 7, Income Tax (Amendment) Act 16/1980. The rates for tax years before December 1980 contained 8 marginal rates of between 30 and 80%.
9. Under schedular tax systems which were exported to the Western hemisphere from continental Europe, income from different sources is taxed separately. Thus separate assessments are made on business profits, income from movable capital, etc. A complementary tax is usually imposed on the total amount of an individual's income.
10. Art. 296 Ley 11-92, approving El Codigo Tributario de la Republica Dominicana (Official Gazette, No. 9835, 16 May 1992).
11. The highest marginal rate was subsequently reduced to 35% in 1990.
12. Under the pre-reform system in Barbados, individuals whose total personal deductions were less than BDS$ 15,000, could claim that sum as a lump sum deduction. Individuals whose actual personal deductions exceeded the amount were able to claim the full amount thereof.

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cent to 33.33 percent. In Barbados, the rate was increased to 40 percent from 35 percent. In Trinidad the 49.5 percent maximum combined rate of the four taxes on corporations was reduced to a single 45 percent rate.

The reforms in the Dominican Republic included the abolition of tax incentives with the exception of those granted to assembly and manufacturing enterprises operating in the Free Zones. The incentives were, like those currently granted in the other three countries, in the form of exemption from corporate taxes and import duties. The export assembly sector in the Dominican Republic saw significant growth in the 1980s though the tax preferential treatment meant that the sector provided only a limited contribution to government revenue.[13] The tax incentive laws of the other three countries have not be reviewed since the reforms.

III. CARICOM

CARICOM was established by the Treaty of Chaguaramas in 1973, replacing the Caribbean Free Trade Association (CARIFTA) in order to establish a single market.[14] In addition to the 12 full members, Anguilla, Bermuda, Cayman Islands, Colombia, the Dominican Republic, Haiti, Mexico, the Netherlands Antilles, Puerto Rico, Surinam and Venezuela have observer status in several CARICOM institutions.[15] Cuba's recent request for observer status is being considered.

Though the integration process has been to some extent restricted by the predominance of nationalist interests among member states, increasing economic regionalism in the global economy and in neighbouring regions has increased pressure on CARICOM to establish a single market by 1994. In addition, several initiatives have been taken towards that goal.

By Article 40 of the Annex to the Treaty, member states agreed to harmonize fiscal incentive laws under which tax concessions are granted to encourage investment. To this end, the Agreement on Fiscal Incentives to Industry was concluded in 1974. It provides guidelines to member states offering tax incentives to investment and in fact forms the basis of the legislation providing tax incentives to industry in several member states including Barbados, Antigua, Jamaica and Trinidad and Tobago. Although the Harmonization Agreement provided more generous incentives for investment in the LDCs, its existence has ensured some uniformity in the development of fiscal incentive policy in the region, minimizing distortive intra-CARICOM competition in this area. A revised draft of the Harmonization Agreement was prepared in 1991, with new emphasis on exports and other foreign exchange earning activities.

By Article 41 of the Annex to the Treaty, member states agreed to adopt common principles in negotiating double taxation treaties with third countries. In addition, a CARICOM double taxation treaty was drafted to regulate double taxation between the more developed members (Barbados, Jamaica, Guyana and Trinidad and Tobago) and the lesser developed members. However, the treaty was never ratified by member states and is not in force.

An important step towards the free movement of capital was the commencement of cross border trading on the stock exchanges of Barbados, Jamaica and Trinidad and Tobago in April 1991. About 90 companies are listed on the three exchanges with an estimated value of US$ 1.5 billion.

To date, the most important achievement in progress towards a single market is the introduction of a common external tariff ranging from five to 35 percent on all imports from outside CARICOM.

IV. FOREIGN TRADE AND INVESTMENT

Trade between countries in the Caribbean region with OECD countries has been facilitated over the years by preferences accorded under the Lomé Convention IV and the Caribbean Basin Initiative.[16]

The Lomé accord is a multilateral economic aid agreement concluded between the 12 EC member states and the African, Caribbean and Pacific (ACP) states of which the independent Caribbean territories form part.[17] Trade preferences granted under Lomé which are of special interest to Caribbean states include duty-free access to the EC for certain agricultural commodities and minerals. Economic assistance takes the form of grants and low interest financing for large capital projects and improvements to existing infrastructure.[18]

The Caribbean Basin Initiative (CBI) is, on the other hand, more in the nature of a unilateral economic aid package developed by the United States in the mid-1980s for the benefit of designated Caribbean territories. Initially temporary, CBI was made permanent and extended in 1990.

The primary thrust of the CBI is the provision of duty-free access to the US market for products assembled or manufactured in a CBI country, to the extent that at least 35 percent of the customs value of the final product is attributable to direct processing costs in one or more CBI countries. Agricultural products also qualify for duty-free access. Duty-free access is not permitted for textiles and apparel, canned tuna, leather footwear, watches and watch parts. Investors may obtain an advance ruling from the US Customs Service on the eligibility of proposed products for duty-free treatment.

Access to financing on favourable terms for CBI projects is facilitated by the provision of what are commonly known as "Section 936 funds" from qualified financial institutions based in Puerto Rico. Under Section 936 of the US Internal Revenue Code, as amended by the Tax Reform Act 1986, US corporations are granted exemption from federal income tax

13. See Inter-American Development Bank, *Economic and Social Progress in Latin America 1990 Report*, *supra* note 5.
14. For a summary of the text of the treaty, see "Readers' Guide to the Treaty of Chaguaramas Establishing the Caribbean Community", 33 *Bulletin for International Fiscal Documentation* (June 1979), at 258.
15. CARICOM has recently concluded a framework agreement with Venezuela and is negotiating the establishment of one-way duty- free access for CARICOM goods to the Venezuelan market.
16. Canada offers preferential trade terms to many Caribbean countries within the framework of the Caribcan economic assistance package.
17. CARICOM members, Dominican Republic, Haiti and Surinam.
18. Under the present Lomé IV Convention, the Caribbean region will receive 348.5 million ECUs in grants.

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on passive investment income derived from the reinvestment of exempted business profits in Puerto Rico or any CBI beneficiary country with which the United States has a Tax Information Exchange Agreement.[19] The funds are administered by the Economic Development Administration of Puerto Rico. Estimates indicate that in February 1991, up to US$ 500 million of qualifying Section 936 funds had been invested in CBI projects.[20]

There is currently evidence of concern in CBI beneficiary countries that duty-free access under CBI may be curtailed now that the North American Free Trade Agreement (NAFTA) has been signed, especially in view of projected increased US imports from Mexico. A US/CARICOM Trade and Investment Council has been established as the framework within which CARICOM beneficiary countries are to have discussions with the United States on the likely impact of NAFTA on CBI.

V. TAX INCENTIVES

Although there are other specific tax incentive regimes in each, CARICOM members share a tax incentive scheme based on the Agreement on the Harmonization of Fiscal Incentives to Industry (hereinafter the "Agreement") established by CARICOM in 1974. The following summary is based on the revised draft of the Agreement prepared in 1991.

The Agreement establishes five to 20-year periods of exemption from corporation tax for approved enterprises and their CARICOM-resident shareholders as well as import duty relief for imports of capital equipment and inputs from outside CARICOM. A company incorporated under the laws of a member state and a branch of a foreign company may qualify for the benefits of the scheme.

Approved enterprises fall into one of three categories: (i) an enclave enterprise is one which manufactures exclusively for export outside CARICOM or for the benefit of another enclave enterprise; (ii) highly capital intensive enterprises are those with capital investment of EC$ 40 million in any LDC or EC$ 80 million in an MDC; and (iii) Group I, II or III enterprises which are manufacturing enterprises whose classification depends on the local value added to product manufactured.

Group I enterprises are those whose final product has local value added of 50 percent or more; Group II enterprises are those with local value added of between 25 and 50 percent; and Group III are those with local value added of between 10 and 25 percent of the sale price of the product manufactured.

Local value added (expressed as a percentage of the total cost of the product) is the amount by which the cost of the product in a continuous 12-month period exceeds the aggregate value of (i) imported raw materials, components, fuels and services; (ii) wages and salaries paid to non-nationals of member states; (iii) interest and management charges paid to non-residents other than to a branch of a non-resident bank; and (iv) depreciation of imported capital equipment. The percentage of local value added is weighted according to a formula whose factors include net extra-regional foreign exchange earnings, remuneration paid to CARICOM nationals, the cost of regional raw material input and net intra-regional foreign exchange earnings. In effect, this means that the greater the foreign exchange earnings or remuneration paid to locals, the higher the local value added percentage will be.

The incentives consist of exemptions from indirect taxes (customs duties and other taxes on imports) on factory equipment, plant and machinery, spare parts and raw materials imported for use in the enterprise in constructing, altering or extending the factory or manufacturing process. Direct (corporate) tax exemptions vary in the countries from between five to 20 years, with Group I and enclave enterprises enjoying tax holidays of up to nine or ten years.

Dividends distributed out of profits derived during the tax holiday period to resident shareholders are exempt from income tax. Dividends paid to shareholders resident outside CARICOM are only exempt to the amount by which local tax exceeds the liability of the recipient in his country of residence. If the dividends are exempt from tax in the residence country of the recipient, they are exempt from tax at source. However, if they are taxable in the residence country, they will be taxed at a rate represented by the difference between the source country rate and the residence country rate. By contrast, all payments of interest on loan capital, overdraft or debenture to non-residents are subject to withholding tax.

VI. TAX TREATIES

The countries in the Caribbean region have a well-developed tax treaty network as shown in Appendix II. The majority of these treaties were negotiated after independence, although a few UK treaties with OECD states which had been extended to its Caribbean territories remain effective. The CARICOM treaty between less developed member states and more developed member states is not included in the table shown in Appendix II because it was never ratified by member states and is not in force.

Caribbean treaties, including those concluded before the official release of the UN model for tax treaties between developed and developing countries, show a consistent departure from two basic assumptions underlying the OECD model towards a broadening of source jurisdiction. Those two assumptions are (i) that the country of source will limit the scope of its jurisdiction to tax source income and reduce its tax on that income; and (ii) that the country of residence will prevent or eliminate double taxation by the credit or exemption method.[21] An examination of some of the articles in the Caribbean treaties which have traditionally entailed a limitation on the scope of source country jurisdiction illustrates the extent of that departure from the OECD model.

19. The United States currently has Tax Information Exchange Agreements with Barbados, Bermuda, Costa Rica, Dominica, Dominican Republic, Grenada, Jamaica, St. Lucia and Trinidad and Tobago.
20. R. Sierra, "Funding Caribbean Basin Initiative Activities with Section 936 Funds", 18 *International Tax Journal* (1992), at 27.
21. C. Miller, "Alternatives to the OECD Model", in *Taxation and International Capital Flows – a symposium of OECD and non-OECD countries* (OECD 1990).

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A. *Permanent establishment*

As there is much literature exposing the inappropriate nature of the PE concept in tax treaties between developed and developing countries, it is sufficient to summarize the basic problem.[22] The use of the PE concept to allocate taxing jurisdiction between developed and developing countries demands substantial revenue sacrifice which is absent when the concept is used in tax treaties between countries which are at a similar stage of development, with reciprocal investment flows.

Developing countries like those in the Caribbean have addressed the problem by broadening the PE definition which is used to determine the nature and scope of activities justifying source country taxation as well as the provisions for allocating income to the PE. Hence most Caribbean treaties with the notable exception of the Dominican Republic/Canada, Germany/Trinidad and Tobago, Surinam/Netherlands and the Netherlands Antilles/Norway treaties include a store or sales outlet in the PE definition.

Most Caribbean treaties follow the UN model with respect to building sites, treating a site which exists for six months or more as a PE. However, there are a few exceptions at both extremes: the Trinidad/Sweden treaty which goes further than the UN model in that all building sites are considered PEs with no time limitation while the Dominican Republic/Canada treaty has a 12 month period as in the OECD model. With the recognition in the Commentary to Article 5 of 1992 OECD model that the 12-month test is often abused (by enterprises which divide contracts into several parts of less than 12 months, attributing each part to a different company within the same group), one wonders whether a test of six months or even three months as in the Jamaica/Canada treaty may become the standard negotiating position of Caribbean countries in treaties with OECD countries.

Many Caribbean treaties follow the UN model paragraphs regarding dependent and independent agents. The UN model broadens the scope of the OECD model paragraph on dependent agents by including an agent who lacks authority to bind the enterprise which he represents but nevertheless habitually maintains a stock of goods from which he regularly makes deliveries on behalf of he enterprise. The Barbados/Sweden, Barbados/Canada, Jamaica/Denmark, Trinidad/Germany and Trinidad/Sweden treaties all follow the UN model. An interesting deviation from both the UN and OECD models, which appears to have been included as a result of bilateral negotiations, is the Dominican Republic/Canada accord which treats an agent who purchases agricultural or mineral produce or livestock on behalf of an enterprise as a PE thereof.

Most Caribbean treaties with OECD countries, with the notable exception of the Barbados/Norway and Jamaica/Germany treaties, follow the UN model's restricted the definition of independent agent and exclude commission and other independent agents whose activities are almost "wholly devoted on behalf of an enterprise". Such agents are not treated as independent agents and may be regarded as a PE of the enterprise to which most of their activities are devoted.

Several Caribbean treaties, including the Surinam/Netherlands, Jamaica/Canada, Barbados/Canada, Jamaica/Germany and Jamaica/UK treaties, include the collection of insurance premiums (except for re-insurance) or the insurance of risks through employees or dependent agents in the definition of PE.

B. *Business profits*

Although many Caribbean treaties follow the business profits article of the OECD model incorporating an arm's length allocation of profits to the PE, several extend the scope of source country taxation by incorporating the force of attraction principle as in the UN model. The business profits articles in the Barbados/Finland, Barbados/Norway, Barbados/Sweden, Trinidad/Sweden as well as the Jamaica/Denmark and Surinam/Netherlands treaties provide for attribution to the PE of profits earned from activities similar to the PE's activities which are carried out without any connection to the PE. All of these treaties go further than the UN model in that they place the onus on the enterprise to prove that the activities generating income attributed to the PE under the force of attraction principle could not have reasonably been undertaken by the PE.

C. *Independent professionals*

Most Caribbean treaties deviate from the OECD model in respect of the taxation of the income derived by independent professionals. The United Kingdom's treaties with Jamaica and Trinidad do not incorporate the fixed base concept. The Trinidad/UK treaty, like that with Italy, accords taxing jurisdiction to the source country where the professional is present for a period of 30 days or more in a tax year while the Jamaica/UK treaty allows source country taxation, regardless of the time present therein or the amount of remuneration received. However, the analogous article in the Barbados/UK treaty adopts the OECD model article thereby retaining the fixed base concept.

Other treaties, such as the Barbados/Canada and Jamaica/Denmark treaties, follow the UN model's expansion of source country jurisdiction by adding to the fixed base concept (of the OECD model) the criteria of duration of stay in the source country and the amount of remuneration derived there.

D. *Tax sparing*

Most Caribbean treaties with the exception of those concluded with the United States adopt tax sparing provisions the object of which is to minimize the nullification of the benefits accorded to enterprises under tax incentive schemes by the imposition of full taxation in the country of residence.

22. For a brief analysis and historical overview of the PE concept, see P. Moore, "The Permanent Establishment Concept in Tax Treaties: Old Bottles for New Wine?" 6 *Queens Law Journal* (1981), at 482. For a detailed account of the development of the concept, see *The Permanent Establishment Concept in Tax Treaties between Developed and Developing Countries* (Osgoode Hall Law School: 1987 thesis submitted by author).

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Many treaties limit the tax sparing credit for ten years, subject to review after agreement between the competent authorities.

VII. NON-TAX JURISDICTIONS

Only five of the territories traditionally referred to in the literature – Anguilla, Cayman Islands, Bahamas, Bermuda, Turks and Caicos Islands – are full tax havens, i.e. no income tax is levied on individuals or corporations. Nevertheless to the extent that the Cayman Islands and the Bahamas issue guarantees (mandatory for exempt companies and trusts) against the future imposition of direct taxes for 20 years, these jurisdictions do not apparently rule out imposition of taxes in the future.

The other territories which have developed a financial services sector do in fact levy income and corporation taxes but they exclude certain types of entities from the scope of taxation or apply reduced rates of corporation tax to those entities. Among the territories in this group are the British Virgin Islands (BVI), Aruba, the Netherlands Antilles and Belize on the Central American mainland.

The BVI, the Netherlands Antilles and Aruba best illustrate this duality approach. The BVI levies corporation tax on the worldwide income of "ordinary" companies at 15 percent; investment income which is tax exempt in the jurisdiction in which it arises is taxed at a reduced rate of one percent. By contrast, international business companies which, inter alia, must be owned entirely by non-residents and are prohibited from carrying on business in the BVI are completely exempt from tax in the BVI. However, individuals resident in the BVI are taxed on their worldwide income at progressive rates of between three and 20 percent; non-domiciled residents are taxed on a remittance basis in respect of certain foreign-source income such as pensions.

The Netherlands Antilles levy a profit tax on *onshore* corporations at relatively high rates of between 32 and 38 percent. Reduced rates of tax of between 2.4 and three percent apply to *offshore* corporations. Although both onshore and offshore corporations are regulated by the Commercial Code of the Netherlands Antilles, offshore corporations are, like BVI IBCs, distinguished by the fact that they may only engage in commercial activities outside of the Netherlands Antilles exclusively for the benefit of non-residents.

The distinction drawn above is important and it is recognized by very few of the OECD countries which include "watch lists" of countries with a privileged tax regime in their controlled foreign corporation (anti-tax haven) legislation.[23]

The list produced by the tax authorities of Spain includes most Caribbean territories but omits Belize and St. Kitts-Nevis both of which have offshore sectors; Cuba, Haiti, the Dominican Republic, Puerto Rico and the French Overseas Departments are not mentioned.[24]

The list produced by the Italian authorities does recognize the distinction and divides Caribbean territories into one of two groupings.[25] The first grouping lists territories which are deemed to have a privileged tax regime, i.e less than 23.9 percent and it includes all full tax havens plus St. Kitts-Nevis and Grenada. The second grouping lists countries which have a privileged regime for specific activities such as tax incentive schemes or international business companies legislation. Although Belize introduced IBC legislation in 1990, it is not listed among countries in the second grouping.

23. In some countries such as France these lists are issued by the tax administration and do not have the force of law. In others such as Spain, the list forms part and parcel of the legislation.
24. The Spanish list is contained in Royal Decree 1080/1991 of 5 July 1991, supplementing Law 17/1991 of 27 May and Law 31/1990 of 27 December 1990.
25. The list is contained in Ministerial Decree of 24 April 1992, supplementing the anti-tax haven provisions of Law 413 of December 1991.

APPENDIX I

TAX RATES IN THE CARIBBEAN COUNTRIES

	INDIVIDUAL	CORPORATE	BRANCH	DIVIDENDS	INTEREST	ROYALTIES
Anguilla	–	–	–	–	–	–
Antigua*	25%[1]	40%	–	–	40%[2]	25%
Aruba*	5%-32%	27%-34%	–	–	–	–
Bahamas	–	–	–	–	–	–
Barbados*	25%-40%	40%	10%	15%	15%	15%
Belize*	15%-45%	45%	–	–	25%	25%
Bermuda	–	–	–	–	–	–
British Virgin Islands*	3%-20%	15%	–	–	–	–
Cayman Islands	–	–	–	–	–	–
Cuba	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Dominica	20%-40%	30%	–	15%	25%	25%
Dominican Rep.	15%-30%	30%	–	30%	15%[3]	30%
Grenada	–	30%-40%	–	–	–	–
Guadeloupe & Martinique[4]	5%-56.8%	34%	34%	25%	18%	18%
(French) Guyane[4]	5%-56.8%	34%	34%	25%	18%	18%
Guyana	10%-50%	35%	–	15%	25%	25%

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	INDIVIDUAL	CORPORATE	BRANCH	DIVIDENDS	INTEREST	ROYALTIES
Haiti	30%	10%-35%	–	15%	15%	15%
Jamaica	33.3%	33.3%	33.3%	33.3%	33.3%	33.3%
Montserrat*	5%-20%	20%	–	–	20%	20%
Netherlands Antilles*	21%-33.5%	27%-34%	–	–	–	–
Puerto Rico	9%-38%	22%	–	25%	17%	17%
St. Kitts-Nevis*	5%-55%	40%	10%	–	10%	10%
St. Lucia	10%-30%	33.3%	–	–	–	25%
St. Vincent	10%-55%	45%	–	15%	25%	25%
Surinam	18%-50%	35%-45%	–	25%	–	–
Trinidad Tobago	5%-35%	45%	25%	25%	30%	30%
Turks & Caicos	–	–	–	–	–	–

* Denotes the existence of legislation permitting the incorporation of entities with offshore fiscal status, most of whose activities are exempt from tax or taxed at reduced rates.

n.a. denotes that data were not available.

1. On business income only; employment income is not subject to tax.
2. Witholding tax on interest to non-resident individuals is 20%.
3. 15% applies only to interest paid to non-resident credit institutions; 30% (reduced to 25% by 1995) applies to any other interest payments.
4. In the French DOMs (départements d'outre-mer) only ⅔ of income from DOM sources are taken into account for tax purposes.

APPENDIX II

CARIBBEAN TAX TREATY NETWORK

	CAN	DEN	FRA	FIN	GER	ITA	JAP	NETH	NOR	SWE	SWI	UK	USA
Antigua											*1	*	
Aruba								*					*2
Bahamas													*3
Barbados	*			*					*	*	*1	*	*
Belize											*1	*	
Bermuda													*4
British Virgin Islands							*1				*1		
Dominica											*1		
Dominican Rep.	*												
Grenada												*	
Guyana	*											*2	
Jamaica	*	*			*				*	*		*	*
Netherlands Antilles								*	*				*2
St. Kitts-Nevis											*1	*	*
St. Vincent											*1		*3
Surinam								*					
Trinidad	*	*	*		*	*			*	*		*	*

1. Extension of United Kingdom treaty.
2. Not yet in force.
3. Shipping and Air Transport Agreement.
4. Limited double taxation agreement for the taxation of insurance income and mutual assistance in tax matters.

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TAXATION OF FOREIGN INVESTMENT IN JAMAICA

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Contents

I. Introduction
II. Manufacturing Sector
III. Tourism Sector
IV. Agricultural Sector
V. Export Free Zone
VI. Miscellaneous Taxes
A. Transfer tax and stamp duty
B. Customs duties
C. Payroll taxes
VII. Foreign Exchange Investment
VIII. Double Taxation Agreements
A. US treaty
B. UK treaty
C. Swedish treaty
D. Canadian treaty
IX. Conclusion

I. INTRODUCTION

In 1987 Jamaica's income tax system was radically reformed. We changed from an imputation system to a classical system of taxation and abandoned a graduated scale of income tax in favour of a flat rate of 33.33 percent for both bodies corporate and individuals. The income tax rate payable by individuals in Jamaica has since been reduced from 33.33 percent to 25 percent by a recent amendment to the Income Tax Act. This new rate of income tax for individuals became effective on 28 December 1992.

With the 1987 reform the definition of "company distributions" was extended to include "the transfer of any profit of a body corporate to any person outside the Island".[1] The intention here was probably to impose a branch profits tax, but a much wider net was cast than was necessary. What, however, did not happen as a result of the reform is that the definition of dividends in the incentive legislation was not extended to include the transfer of the profits of the branch, so that although the branch's operations were in fact exempt from tax, since 1987 they are liable to branch profits tax from which, technically anyway, they are not exempt, even though they are supposedly enjoying the incentive.

Neither the incentive legislation nor the double taxation agreements have been reviewed since the 1987 reform. This has created a number of problems, some of which I will mention below.

Tax incentives are available for investors in the following sectors:

(1) manufacturing – both for local consumption (including CARICOM) and for export,
(2) tourism – both hotels and resort villas,
(3) agricultural,
(5) bauxite and alumina,
(6) petroleum refinery,
(7) cement industry,
(8) shipping,
(9) motion picture industry,
(10) free zone operations.

I will focus on the incentives available to the first three sectors, i.e. manufacturing, tourism and agricultural, and the last one, i.e. free zone operations.

II. MANUFACTURING SECTOR

Persons wishing to obtain incentives for manufacturing products in Jamaica for consumption by Jamaica and other CARICOM countries may apply to the Minister responsible for industry pursuant to the provisions of the Industrial Incentives Act (IIA). The incentive may be enjoyed by either a Jamaican registered company or a branch of an overseas company.[2] The Act provides for a ten-year period of relief from income tax on the company's profits arising from the manufacture of the approved product[3] and for the payment of tax-free dividends to Jamaican resident shareholders.[4] Shareholders resident in other territories are relieved from so much of the tax as exceeds the shareholder's liability to tax in his country of residence.[5]

The IIA itself makes reference to the Harmonization of Fiscal Incentives Agreement (HFIA) which is an agreement entered into between CARICOM countries in 1973.[6] The HFIA seeks to limit incentives granted by member countries (other than the less developed countries) and to tie the period of relief granted by any member country to the amount of local value added in the manufacturing process.

1. *Id.* Sec. 34(1).
2. Industrial Incentives Act Sec. 2.
3. *Id.* Secs. 11 and 12.
4. *Id.* Sec. 13(4).
5. *Id.* Sec. 13(5).
6. Harmonization of Fiscal Incentives to Industry Agreement of 1 June 1973.

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Local value added is defined in the HFIA as the percentage of total sales of an approved product which exceeds the aggregate amount of the following:

- value of imported raw materials and services;
- salaries paid to persons who are not nationals of member states;
- profits distributed to persons not resident in a CARICOM country;
- interest, management charges and other income payments accruing directly or indirectly to persons not resident in a CARICOM country other than a bank; and
- depreciation on imported plant, machinery and equipment.[7]

The HFIA provides that where the local value added exceeds 50 percent of the selling price of the unit the maximum tax holiday which a member state should grant is nine years.[8] Where the local value added is 25-50 percent, the tax holiday is a maximum of seven years[9] and where the local value added is between 10-25 percent the tax holiday must not exceed five years.[10]

Highly capital-intensive industries (i.e. those with capital investment of not less than $ 50 million EC currency)[11] are entitled to a ten-year tax holiday.[12]

In addition to the company's profits being relieved from income tax,[13] the HFIA provides for relief from tax on the dividends declared by the company to persons resident in CARICOM,[14] and relief from so much of the income tax due on dividends paid to persons resident outside of CARICOM as exceeds the shareholder's liability to tax in his country of residence.[15]

Whilst the IIA does not contain any provisions authorizing the granting of approvals for any periods other than ten years nor for the conferral of incentives other than the tax holidays described above, there have been approvals purportedly granted pursuant to the IIA which contain the reliefs referred to in the HIFA. Since the IIA does not confer the power to grant that type of approval, it seems that these approvals are ultra vires. However, as far as I am aware, even where the terms of the approval contain the much narrower HFIA incentives, the approved company is allowed to enjoy the IIA benefits.

As far as I am aware the Orders are not enforced and indeed it is the ten-year incentive that is enjoyed by an approved company.

In terms of the practical aspects of applying for approval, there are no prescribed forms or required information set out in the IIA. The IIA does, however, provide that in determining whether or not to grant approval the Minister must have regard to the following considerations:

- the effect that approval will have on existing industries;
- whether manufacture of the product would utilize raw materials and skills available in Jamaica;
- whether the existing capacity for the manufacture of the product is sufficient to meet the demand for the product; and
- the element of risk involved in establishing a successful manufacture of the product.[16]

The application is usually made by letter from an attorney. It is always helpful, although not essential, for the investor to have made contact with and to have the support of JAMPRO Limited (the Government's agency for investment promotion). The letter should contain a description of the proposed operation, with particular emphasis placed on the number of local persons being employed and the capital which will be invested. Whilst local borrowing by an overseas investor is no longer restricted, it is not encouraged. Of course, information about the intended market should be included. Where the intended market is Jamaica as opposed to other CARICOM countries, great emphasis will have to be placed on the import replacement possibilities of the enterprise and the consequent net foreign exchange savings to Jamaica.

Where the intended market is outside the CARICOM region, the application should be made under the Export Industry (Encouragement) Act (EIEA). The incentives are identical to those available under the IIA and, of course, the application is made to the same Minister. The applicant may be either a locally registered company or a branch of an overseas company.[17]

Again, Orders purportedly made under the EIEA appear to conform to the provisions of the HIFA and may be ultra vires, see discussion above).

There is no prescribed form of application for approval under the EIEA and application is by way of letter to the Minister. However, the EIEA is somewhat more helpful in that it provides that the Minister must be satisfied that the applicant will manufacture for export exclusively to countries outside CARICOM, is adequately financed, has employed adequate trained personnel, has access to the necessary technical information, is able to obtain adequate raw materials and possesses or will possess the necessary factory space.[18] Also, the element of risk involved will be taken into account as to the effect approval, if granted, would have on existing industries.[19]

III. TOURISM SECTOR

Turning to the tourism sector, tax incentives are available for both hotel enterprises and villa enterprises.

A hotel can be as small as ten bedrooms with facilities for preparing and serving meals.[20] The incentive period is in most cases ten years.[21] Convention-type hotels (i.e. hotels with 350 rooms and convention facilities) are entitled to con-

7. *Id.* Art. 1.
8. *Id.* Arts. 6 and 7 and Appendix I.
9. *Id.*
10. *Id.*
11. *Id.* Art. 4.
12. *Id.* Art. 5.
13. *Id.* Art. 7.
14. *Id.* Art. 11(2)
15. *Id.* Art. 11(3).
16. IIA Sec. 3(3).
17. Export Industry (Encouragement) Act Sec. 2.
18. *Id.* Sec. 4(1).
19. *Id.* Sec. 3(3).
20. Hotels (Incentives) Act Sec. 2.
21. *Id.* Sec. 7(1).

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cession periods of 15 years[22] and hotels operated in special development areas so designated by the Minister of Tourism may enjoy incentives of 11 to 15 years.[23]

Applicants may be either Jamaican incorporated companies or subsidiaries or branches of overseas companies or "any other body approved as such by the Minister".[24] It should be noted that the incentive is available to either the owner or the tenant of the hotel *and* the operator but not to all three entities.[25]

The incentive is relief from income tax for the concession period on profits arising from the approved hotel enterprise.[26] Dividends paid out of such profits are also not liable to tax if paid to a Jamaican resident or to a person resident in a country in which they are relieved from income tax on the dividend.[27] Where the shareholder is liable to tax in his country of residence, he is relieved from so much of the Jamaican income tax as exceeds his liability to tax in his country of residence.[28]

Whilst there are no statutory requirements in relation to the form of application, there is in fact an application form which the Ministry of Tourism requires each applicant to fill out. This includes five-year cash flows and profit and loss accounts and must include detailed architectural drawings.

Persons interested in the resort cottage industry may also enjoy the incentives available under the Resort Cottages (Incentives) Act. Individuals as well as bodies corporate, wherever resident, may apply provided they are either the owner or the tenant or the operator[29] of a building comprising not less than two furnished bedrooms, a furnished living room, bathroom facilities and facilities for the preparation and consumption of meals and used or intended to be used by transient guests for reward.[30] The concession period is seven years,[31] and where the applicant is a company, relief from income tax on dividend income is identical to the relief discussed above.[32] Application is made to the Minister of Tourism and there is an application form which must be accompanied by architectural drawings.

All of the other pieces of incentive legislation follow basically the same framework. In all cases, except under the Motion Picture Industry (Encouragement) Act, the approved enterprise is not permitted to make initial or annual allowances during the concession period in respect of its plant, equipment or machinery.[33] That Act allows the investor an investment allowance of 70 percent of capital expenditure incurred in the acquisition of motion picture facilities.[34]

Each piece of legislation permits the approved enterprise to carry forward losses created during the concession period for six years after expiration of the tax holiday.[35] General law, however, now allows an enterprise to carry forward losses indefinitely consequent upon the 1986 reform. It is therefore anticipated that these provisions will be amended to bring them in line with the general income tax law.

Turning to the Income Tax Act (ITA) itself, we see some real incentives tucked away in remote subsections of the Act. Section 12(s) gives the Minister of Finance power to exempt from income tax income derived as interest on moneys from investments in a hotel enterprise approved under the Hotel Incentives Act or in a recognized resort cottage approved under the Resort Cottages (Incentives) Act. Note that the relief is only available to an investor resident in a country in which he is not liable to pay tax on the interest and that the relief is indefinite. The relief is not available to a Jamaican resident but is available to any investor in the project – whether or not that person has an interest in the ownership of the hotel.

Another interesting provision is found in Section 12(w) of the ITA. The Minister of Finance has the power to exempt from income tax dividend income arising from an investment in a hotel enterprise approved under the Hotel Incentives Act or from an investment in a resort cottage approved under the Resort Cottages (Incentives) Act. The investor must, however, be resident in a territory in which he is not liable to pay tax on the dividend. Again, it seems that the relief may be indefinite and is not available to a Jamaican resident.

IV. AGRICULTURAL SECTOR

The incentives available to an agricultural enterprise are also contained in the ITA, and accordingly application for relief is to the Minister of Finance and not to the Minister of Agriculture. The period for which relief is granted is entirely at the Minister's discretion and is available to anyone – an individual, body corporate or partnership. The longest incentive period granted that I am aware of is 12 years. Shareholders of approved companies are not liable to pay income tax on dividends received by them from the company if they are Jamaican residents.[36] If the shareholder is resident in a country with which Jamaica has a double taxation agreement, then the shareholder will be relieved from so much of the Jamaican income tax as exceeds his liability to tax on the dividend in his country of residence.[37] Shareholders resident in other countries are not entitled to relief from income tax on the dividend.[38]

There is also another interesting incentive available to an agricultural investor contained in the same section of the ITA. Where the approved farmer carries on any other business, he may set off losses incurred in the approved agricultural activity against the income arising from that other business.[39]

22. *Id.* Sec. 7(5).
23. *Id.* Sec. 7(3).
24. *Id.* Sec. 2.
25. *Id.* Sec. 8.
26. *Id.* Sec. 9(1).
27. *Id.* Sec. 10(4).
28. *Id.* Sec. 10(5).
29. Resort Cottages (Incentives) Act Sec. 7(1).
30. *Id.* Sec. 2.
31. *Id.*
32. *Id.* Sec. 8.
33. Industrial Incentives Act Sec. 10(4); Export Industry Encouragement Act Sec. 11; Hotels (Incentives) Act Secs. 9(2) and (3); Resort Cottages (Incentives Act Secs. 7(2) and (3).
34. Motion Picture Industry (Encouragement) Act Sec. 15(3).
35. Industrial Incentives Act Secs. 11 and 12; Export Industry Encouragement Act Sec. 11; Hotels (Incentives) Act Sec. 9(5); Resort Cottages (Incentives) Act Sec. 7(5); Motion Picture Industry (Encouragement) Act Sec. 10(1).
36. ITA Sec. 36D(8).
37. *Id.* Sec. 36D(9).
38. *Id.* Sec. 36D(10).
39. *Id.* Sec. 36D(7).

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V. EXPORT FREE ZONE

Indefinite relief from income tax is available to an approved enterprise operating in an export free zone pursuant to the provisions of the Jamaica Export Free Zone Act. Activities for which approval is available under the Act are:

- warehousing and storing,
- manufacturing,
- transshipment,
- loading and unloading operations,
- exporting and importing,
- service operations,
- packing and shipping,
- assembling,
- processing, refining, purifying and mixing,
- merchandising.[40]

VI. MISCELLANEOUS TAXES

I want to turn now to a topic that no one talks about much – the taxes that an investor who enjoys incentives must pay.

A. *Transfer tax and stamp duty*

Transfer tax and stamp duty are levied on most land transactions and on the issue or sale of shares in private companies incorporated in Jamaica.

On the sale of land, transfer tax at the rate of 7.5 percent[41] is imposed on the market value of the land, regardless of the sale price paid by the purchaser to the vendor.[42] Transfer tax is by law borne by the vendor only[43] and stamp duty at the rate of 5.5 percent[44] is borne by either party, but usually it is shared equally.

Stamp duty at the rate of one percent of the annual rental is also paid on leases[45] and may be borne by either party or both parties in such proportion as they shall agree.

On the sale of shares, transfer tax at the rate of 7.5 percent is payable, again on the market value of the shares regardless of the sale price and is borne by law by the vendor.[46] Stamp duty at the rate of one percent of the value of the shares is usually borne equally by the vendor and the purchaser.[47]

Stamp duty at the rate of one percent is also due and payable to the government on the creation of shares and the issue of mortgages, debentures and most security documents.

B. *Customs duties*

Customs duties were levied on the importation of plant, machinery and equipment, which most incentive investors were exempt from and which has now for the most part been replaced by the General Consumption Tax (GCT). Whilst these investors are still exempt from GCT and customs duties on the importation of goods into Jamaica, they are not exempt from GCT on goods and services provided to them or supplied by them in Jamaica.

C. *Payroll taxes*

As an employer, an approved investor will have to contribute to:

National Insurance Scheme	–	2.5% of emoluments not exceeding J$ 377 per annum per contributor employee.[48]
National Housing Trust	–	3% of emoluments of each contributor employee[49]
Education Tax	–	2% of all emoluments paid by the employer.[50]
Human Employment and Resource Training Trust	–	3% of total emoluments.[51]

VII. FOREIGN EXCHANGE INVESTMENT

At around the same time that the Jamaican government started its liberalization of the foreign exchange controls it created two forms of foreign exchange investment in Jamaica which are both tax free. When the incentives available to these investments are compared to the incentives available to persons interested in investing in manufacturing, agriculture, construction, tourism or other substantial and economically beneficial enterprises, it is indeed remarkable.

The Government created two accounts which financial institutions, mostly only commercial banks and other authorized dealers, were allowed to offer to overseas investors (i.e. non-residents) from April to September 1992.[52] The first is an "A" account. To open an "A" account the investor had to be an individual and needed to prove that he was not a Jamaican resident. Any amount could be deposited to this account and the interest rates range from three to four percent. The interest is paid tax free.[53] There is no foreign exchange risk in that the investor is guaranteed to get back foreign exchange at the rate at which he put it in and the account is maintained in foreign exchange.

With a "B" account the depositor accepts the foreign exchange risk, but the risk is compensated or reduced in many cases by the interest rate that is payable on the deposit. The interest is paid tax free to non-residents.

In Jamaica, the interest rates on deposits of J$ 1 million for periods of over six months normally range from 23 to 27 per-

40. Jamaica Export Free Zones Act, First Schedule.
41. Transfer Tax Act Sec. 3(1).
42. *Id.* Sec. 4(1).
43. *Id.* Sec. 3(1).
44. Stamp Duty Act, Schedule "Conveyance".
45. *Id.* Schedule "Lease".
46. Transfer Tax Act Sec. 3.
47. Stamp Duty Act, Schedule "Shares".
48. National Insurance Act Sec. 4(2)(b) and Second Schedule.
49. National Housing Trust Act Sec. 11 and National Housing Trust (Contributions) Regulations, 1979.
50. Education Tax Act Sec. 4 and Appendix.
51. Human Employment & Resource Training Act Sec. 12 and Third Schedule Sec. 4.
52. Non-residents owning foreign exchange accounts in Jamaica remain entitled to the tax exemption after September 1992.
53. It is now possible for Jamaicans to open foreign exchange accounts but only non-residents enjoy tax-free interest.

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cent per annum, but there is presently a downward decline in these rates.

Note that these investments create no jobs and provide no spin off support to the rest of economy. There is full repatriation of capital in very short periods of time and there is very little, if any, medium or long-term benefit to the development of the country.

Another little known provision in the ITA allows an investor to make a foreign exchange investment with a building society and enjoy the investment completely free of Jamaican income tax where that investor is resident in a country in which the Commissioner of Income Tax is satisfied that he is not liable to pay tax on that income.[54]

VIII. DOUBLE TAXATION AGREEMENTS

Jamaica has concluded eight double taxation agreements other than the Caribbean tax treaty which was concluded in 1973. They are:

United States	–	1980
United Kingdom	–	1973
Sweden	–	1985
Canada	–	1978
Denmark	–	1955
Germany	–	1974
Israel	–	1984
Norway	–	1956

I want to look briefly at provisions of four of the treaties and highlight three aspects of these agreements.

A. *US treaty*

Under the US treaty, a company is a Jamaican resident company if it is managed and controlled in Jamaica[55] and, of course, a company is resident in the United States if it is incorporated in the United States. If a company is resident in both territories by virtue of these rules, it is deemed to fall outside the treaty, except for the provisions of the articles relating to dividends, non-discrimination, mutual agreement procedure, exchange of information and entry into force.[56] Of course, companies incorporated but managed and controlled in the United States, which occurs frequently, fall completely outside the treaty.

Dividends paid by a company resident in Jamaica to a company resident in the United States enjoy a treaty dividend rate of ten percent of the gross dividend if the beneficial owner is a company owning ten percent or more of the voting stock of the company paying the dividend.[57] In all other cases, the treaty rate is 15 percent of the gross dividend.[58]

As is standard in all US treaties, there are no tax sparing provisions, and accordingly the granting of incentives to Jamaican resident companies beneficially owned by US companies really only operates as a gift of the Jamaican tax to the US government since the US government taxes the income anyway. The US treaty does, however, exempt from accumulated earnings tax the income of a "Jamaican company" derived from the manufacture of approved products under Jamaica's incentive legislation.[59] Note the term "Jamaican company" is not defined in the treaty. A Jamaican resident company is also exempt from accumulated earnings tax if individuals who are residents of Jamaica own more than 75 percent of the voting power of the company throughout the last half of the tax year.[60]

B. *UK treaty*

Under the treaty with the United Kingdom, the residence of the company is determined by the management and control test. If the company is resident in both countries by virtue of that test then it is deemed to be resident in the territory in which effective management is situated.[61] The treaty withholding rates on dividends paid by a Jamaican resident company to a UK resident is 22.5 percent of the gross dividend if the company beneficially owns more than ten percent of the voting power of the company paying the dividend.[62] In all other cases, the treaty rate is 15 percent. The tax sparing provisions of the treaty grant tax credits for the tax that would have been payable not only on the dividend that is paid but also in respect of the tax that would have been paid by the company paying the dividend.

C. *Swedish treaty*

The Swedish treaty is virtually identical in these respects to the UK treaty except that the treaty withholding rate on dividends is ten percent if at least 25 percent of the voting power of the company is owned by the Swedish company, and 22.5 percent in all other cases.[63]

D. *Canadian treaty*

In the case of the Canadian treaty, a company's residence is determined on the basis of its place of management, and if by virtue of that test the company is resident in both territories, then the matter must be settled by mutual agreement.[64] The treaty rate on dividends is generally 15 percent[65] but is increased to 22.5 percent if:

(a) the beneficial owner of the dividend is a company resident in Canada which holds at least ten percent of the voting power of the company paying the dividend; or

54. ITA Sec. 12(s).
55. The Double Taxation Relief (Taxes on Income) (United States of America) Order 1980 Art. 4(1).
56. *Id.* Art. 4(3).
57. *Id.* Art. 10(2).
58. *Id.* Art. 10(2).
59. *Id.* Art. 10(5).
60. *Id.* Art. 10(5).
61. The Double Taxation Relief (Taxes on Income) (United Kingdom) Order, 1973 Art. 3(3).
62. *Id.* Art. 8(4).
63. The Double Taxation Relief (Taxes on Income) Kingdom of Sweden) Order, 1985 Art. 10(2).
64. The Double Taxation Relief (Taxes on Income) (Canadian) Order, 1979 Art. IV.
65. *Id.* Art. X(2).

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(b) the beneficial owner of the dividend is a company resident in Canada regardless of the voting power which it holds in the Jamaican resident company provided the Jamaican resident company qualifies under the tax laws of Canada as a foreign affiliate.[66]

Again, the Canadian treaty includes tax sparing provisions similar to the UK treaty.

IX. CONCLUSION

Jamaica's taxation of foreign investment is desperately in need of rationalization insofar as there remain several inconsistencies and inequities which have negative and disincentive implications for the investor. As indicated above, certain legislation has been amended without reference to other relevant legislation, thereby creating uncertainty in many instances as to the exempted status of the investor. This problem needs to be addressed at length by the Jamaican government to ensure that the legislation relating to investments and taxation in fact creates incentives and not impediments to the investor.

66. *Id.* Art. X(3).

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TAX REGIME AND INVESTMENT INCENTIVES IN THE FRENCH CARIBBEAN ISLANDS (MARTINIQUE, GUADELOUPE AND GUYANE)

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* Bureau Francis Lefebvre. The author wishes to express his gratitude to Vincent Agulhon, Associate, Bureau Francis Lefebvre for his assistance.

I. INTRODUCTION

The French Overseas Department (DOM) of Guadeloupe consists of two main islands, Grande-Terre and Basse-Terre, a smaller island Marie-Galante to the south east, and another island La Désirade to the east. Guadeloupe also has a number of small dependencies, mainly Saint-Barthélémy and the northern half of Saint-Martin.

The DOM of Martinique consists of a single island.

The DOM of Guyane lies north of the South American coast, with Surinam to the west and Brazil both to the south and to the east.

French law is fully applicable in the DOMs although the legislation and administrative organization of these DOMs may, if necessary, be adapted to their specific circumstances. Consequently, French company law fully applies to DOMs. Income tax, corporation tax and TVA (VAT) are categorized as state taxes (*impôts d'Etat*) under the French central government's full and exclusive responsibility; responsibility for direct local taxes is shared by the central government and the local authorities. The *octroi de mer*, a tax on imports levied only in the DOMs (and recently amended), is in large part under the control of the local authorities.[1]

Contents

I. Introduction
II. Taxation of Individuals
A. Domestic definition of domicile and residence
B. Fiscal regime for resident individuals
C. Fiscal regime for non-resident individuals
III. Taxation of Companies
A. General
B. Societes de personnes
C. Societes de capitaux
IV. Special Regulations Issued to Prevent International Tax Evasion
A. CGI Article 209 B
B. CGI Article 238 A
C. CGI Article 57
D. CGI Article 990 D
V. Tax Treaty Network
VI. Other Taxes
A. Value added tax
B. *Octroi de mer*
C. Customs duties
D. Import/export
VII. Incentives and Tax Planning in the French West Indies
A. Residents of France
B. Non-residents of France

II. TAXATION OF INDIVIDUALS

Individuals resident in France are taxable on their worldwide income, unless a treaty provides otherwise. If the right to tax certain income is granted to a state other than France by virtue of an income tax treaty, France retains the right to apply the so-called effective tax rule. Under this rule, although France cannot tax the relevant income, French income is subject to tax at the worldwide rate. This rule does not apply to non-residents who are generally taxed at a minimum rate of 25 percent on their French-source income (18 percent in the DOMs).

A. *Domestic definition of domicile and residence*

An individual is domiciled in France if he fulfils any one of the following tests:

(1) the individual has his home in France. In general, an individual's home is the place where his family lives, i.e his usual place of abode. This definition allows France to tax an individual working abroad if his family (spouse and children) lives in France;

(2) the individual has his principal place of abode in France. This criterion focuses on where the individual spends most of his time, even if it is in a hotel while his family lives abroad. In general, if an individual spends more than 183 days in France during a calendar year, he will be deemed to have his principal place of abode in France. However, jurisprudence has specified that the 183 days test is not definitive; an individual may be regarded as resident of France if he stays a longer time in France as compared to other jurisdictions, even if the time spent in France is less than 183 days;

(3) the individual engages in a business activity in France. This criterion attracts an individual into the French income tax net if he engages in a remunerative activity in France (whether or not salaried), unless he provides evidence that the business activity is merely ancillary;

(4) the individual has the centre of his economic interests in France. This criterion is rather broad, and thus subject to discussion. An individual has the centre of

1. In 1978, the EC Court of Justice held that the Treaty of Rome and secondary EC law apply integrally to French DOMs (see text below).

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his economic interests where he manages his investment activity or where he has the headquarters for his personal business activities. This could be the place from which he earns the majority of his income.

B. *Fiscal regime for resident individuals*

Unlike corporations, individuals resident in France (regardless of nationality) are subject to income tax on their worldwide income, whether or not remitted to France. Generally, taxable income is the net aggregate of the taxpayer's income categories: real property, commercial and industrial business, agriculture, non-commercial activities (e.g. liberal professions), employment compensation, movable capital and certain capital gains.

The net taxable income is taxed at graduated rates up to 56.8 percent. The tax so computed is adjusted by allowable tax credits and reductions, notably a 40 percent tax relief available for Guyane residents (limited to Ffrs. 44,070), and a 30 percent tax relief available for residents of Guadeloupe and Martinique (limited to Ffrs. 33,310). Certain capital gains and income from (mostly) non-negotiable debt instruments may be subject to a final payment, which satisfies the tax liability in full.

In most cases income tax is imposed on the household rather than on the spouses separately. The computation of income tax is as follows: first, the net result of the various income categories (with the exception of capital gains taxed at a flat rate and certain types of interest subject to a final levy) are aggregated to arrive at taxable income. Taxable income is then divided by a coefficient reflecting the taxpayer's marital status and number of dependents. The standard tax table is thereafter applied to the result and the income tax thus computed is multiplied by the same coefficient to arrive at the gross tax burden. The gain achieved by application of the family coefficient is limited to an amount fixed annually. The tax burden is then reduced by 30 or 40 percent depending on the DOM where the taxpayer is a resident.

C. *Fiscal regime for non-resident individuals*

Depending on treaty provisions, non-resident individuals are subject to tax on their French-source income (whether continental France or DOM) including:

- income from employment or professional activity performed in France;
- income from an industrial, commercial, agricultural or "handicraft" business or real property situated therein;
- capital gains, pensions and annuities, income from French securities, copyrights, patents, licences, etc., and generally any profit-making activities exercised in continental France or in a DOM.

As for residents, the tax burden of non-resident individuals is computed under the family coefficient system and the standard tax table. Nevertheless, the tax rate resulting from that computation may not be lower than the legal rate fixed at 18 percent for the DOMs, unless the individual can prove that this rate is higher than the rate which would have resulted from application of the French tax table to the individual's worldwide income. Most reductions are not granted to non-residents in determining their tax base.

Special rules apply to French-source salaries and wages paid to non-residents. A withholding tax is levied on the annual wages paid to a non-resident individual by a debtor domiciled in the DOMS: zero percent up to Ffrs. 57,060, ten percent between Ffrs. 57,060 and 165,580 and 18 percent over Ffr. 165,580. The schedules vary each year and differ depending on the period of payment and the time spent in France for the relevant activity. This withholding tax is final as to wages taxed at zero or ten percent. The portion taxed at 18 percent is taken into account for computation of income tax, but the corresponding amount of withholding tax is creditable against the income tax liability. In this case (or if other French-source income is generated), the non-resident must file a tax return with the French revenue authorities.

Non-residents who have the use and enjoyment of one or more residences in France (DOMs inclusive) may be charged to income tax on a notional income equal to three times the annual fair market rental value of the residences.[2] This rule does not apply if the non-resident is a resident of a country which has entered into a tax treaty with France.

III. TAXATION OF COMPANIES

A. *General*

Under French law, enterprises are commonly classified into two groups: *sociétés de personnes* (companies of persons) and *sociétés de capitaux* (capital companies). Other undertakings may be carried out as economic interest groups or joint ventures. "Sociétés de personnes" are generally treated as partnerships although they are not always completely transparent for tax purposes. "Sociétés de capitaux" are limited companies subject to corporation tax.

B. *Sociétés de personnes*

As a rule (unless they have elected to be liable to corporation tax) general partnerships and similar entities are not subject to income tax, although they generally enjoy legal capacity. However, such entities must file a return for information purposes. The partners are subject according to their status to income tax or corporation tax, as the case may be, on their respective shares, whether or not income is distributed.

C. *Sociétés de capitaux*

Stock companies (*société anonyme, société en commandite par actions*) and limited liability companies (known as SARLs or EURLs) are subject to corporation tax.

1. Principles

Corporation tax is levied on income generated by "enterprises operating in France" or on income the taxation of which is attributed to France by virtue of a tax treaty. Consequently,

2. Under certain circumstances, this taxation is waived, notably for the benefit of residents of treaty countries.

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French corporations are not taxable on a worldwide basis but rather according to the results they generate in France, meaning that no credit system generally exists in France (except where a treaty so provides or for Section 209 B purposes, see below). The crucial term, "enterprise operating in France", is not specifically defined in the French tax code (CGI), and in the absence of a tax treaty, the case law of the Conseil d'Etat provides the only valid guidance. This court has generally defined the term as meaning the habitual exercise of a commercial activity in France, i.e.:

- when a business activity is conducted through an "establishment", i.e. a fixed place of business, a fixed installation operating with some degree of autonomy (e.g. a branch, sales bureau, etc.). Tax practitioners generally believe that the scope of this definition is broader than that of a permanent establishment (PE) as used in the OECD model;
- when, in the absence of an establishment as defined above, business is conducted in France by a "dependent agent". This definition may be co-extensive with the OECD model treaty definition of this example of a PE;
- when, in the absence of an establishment or a dependent agent, the potential taxpayer performs a complete commercial cycle in France. Thus, a one-time business transaction involving both the purchase and sale of a product in France may fall within the French taxing jurisdiction.

These rules apply only in the absence of a tax treaty. When a tax treaty applies the foreign corporation usually will not have to pay tax in France unless it has a PE there (or it derives French-source income). The French tax treaties all use the notion of PE (as set forth in the OECD model) to determine when a taxpayer falls within the French taxing jurisdiction.

The territorial scope of France for tax purposes includes French, European and Overseas Departments, but excludes the *Territoires d'Outre-Mer*, i.e. New Caledonia, French Polynesia and other territories. The three French departments of the Caribbean region are considered France for tax purposes.

For corporation tax purposes, taxable income is broadly defined as the net profits arising from all operations. Net profit is equal to the difference between the net worth at the end of the accounting period and the net worth at the beginning of the period as reduced by capital contributions made during the period and increased by distributions to shareholders.

Losses may be carried forward for five years. Companies may also carry back losses three years. Losses corresponding to the annual capital allowance (so-called ART) may be carried forward for an unlimited period of time. In the case of a reorganization such losses may be converted into ordinary losses retroactively to the time they were generated. In addition, operating losses or annual capital allowances (ART) may be disregarded in the event of a change of activity.

Upon request, the headquarters of foreign companies may be subject to corporate income tax at the normal rate but on a reduced base, generally equal to between eight and ten percent of expenses.[3]

2. Special rules concerning the computation of taxable income

Capital allowances are permitted on depreciable tangible assets. The straight-line method may be applied without any limitation. Conversely, the use of the declining balance method is subject to limitations.[4]

Reserves may be booked against potential subsequent losses or expenses provided the loss or expense is deductible and clearly defined.

Capital gains are part of taxable income. Short-term capital gains are taxable at the standard rate (33.33 percent). This regime applies to gains realized on assets held for less than two years and depreciable assets held for at least two years, to the extent of the capital allowance. Long-term capital gains are taxable at a reduced rate of 18 percent, provided the balance, i.e. the capital gain less the tax paid, is posted and maintained in a specific reserve of long-term capital gains.[5]

Long-term capital gains generally are gains realized on the transfer of assets owned for more than two years (but such gains are taxed as ordinary business income in respect of any recouped depreciation). Long-term capital gains may be offset by any long-term capital losses realized during the fiscal year. In the event the balance generates capital losses, the latter may be carried forward for ten years.[6]

3. Computation of corporation tax

The corporation tax rate is fixed at 33.33 percent. Nevertheless, until 31 December 2001, companies established in a DOM or in continental France are subject to tax on only two-thirds of the income accruing from their DOM-situated establishments in the following economic sectors: industry, tourism, hotel industry, agriculture, fisheries, new energies, construction and public works, transport and handicrafts, and from 1 January 1993 on maintenance activities for the industry as well as television and film activities and broadcasting. This reduction of the tax base also applies to long-term capital gains taxed at the reduced rate of 18 percent (resulting in a rate of 12 percent). As a result long-term capital losses may be carried forward for only two-thirds of their amount. Losses derived from a DOM-sourced activity may be set off against the profits of a continental French company only within the two-thirds limit.

Branches of non-resident companies are subject to corporation tax under the same conditions. In addition, branch profits are deemed to be distributed to non-resident persons and

3. The special tax regime for headquarters of foreign groups is granted if:
- the legal entity (French subsidiary or more frequently branch of a foreign company) is owned by an international group;
- it provides exclusively passive services to the members of the group (e.g. coordination, control, audit, etc.);
- its activity is limited to a certain area (e.g. Western Europe, the EC, etc.).

4. This method is applicable only for new equipment depreciable at least over three years.

5. This rule does not apply, however, in the case of a winding up of the company.

6. Capital gains on certain portfolio securities – mainly investment securities – may not benefit from the special capital gains regime and are therefore includable in taxable income.

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are therefore subject to a 25 percent branch tax. However, this rate may be reduced by tax treaties, or the tax may be refunded under certain circumstances (mainly if the shareholders are residents of France or if the foreign company has not distributed dividends and provides evidence of this); the application for refund is subject to a time limit.

An annual minimum lump sum tax based on the company's turnover is also payable.

4. Tax treatment of distributions

Distributions from companies resident of France are not subject to withholding tax if paid to residents. A tax credit (*avoir fiscal*) equal to 50 percent of the dividend received is attached to any distribution by French limited companies. Distributions to non-residents are generally subject to a 25 percent withholding tax and are not entitled to the benefits of the avoir fiscal, although tax treaties may reduce the rate to five, ten or 15 percent, or may extend the benefit of the avoir fiscal to non-residents.

If the avoir fiscal is granted to non-residents, it is also subject to the relevant withholding tax. As far as distributions between qualifying EC companies are concerned, the domestic withholding tax may be eliminated if certain tests are met (see "6" below).

Unless exempt under the affiliation privilege (see "5" below), French parent companies which receive dividends from a French or foreign source are charged to corporation tax on the aggregate of the dividend, and as the case may be, the avoir fiscal or any tax credit. They may credit the avoir fiscal against their own tax liability but any credit in excess over the tax burden is definitively lost.

Dividends distributed out of income which has not been subject to corporation tax at the standard rate (e.g. received under the affiliation privilege or derived from an activity carried on outside the territorial scope of France for tax purposes) or paid out of income realized more than five years before distribution are subject to an equalization tax (*précompte mobilier*)[7] equal to 50 percent of the net dividend.[8] Consequently, where dividends are paid out of income derived from a DOM and only partially subject to corporation tax because of the two-thirds rule (see above), the "précompte" is due on the distribution of the exempt one-third.

5. Affiliation privilege

Under the affiliation privilege, dividends received by a resident parent company from a subsidiary, whether or not resident, in which it has at least a ten percent share or a participation of at least Ffrs. 150 million, are 100 percent exempt (Finance Bill for 1993). French PEs of non-resident companies may generally qualify for the affiliation privilege.

The affiliation privilege regime is optional; in other words, the recipient company may elect whether or not to take advantage of it. As from 1993, there is no particular advantage in electing the regime, particularly as far as domestic-source dividends are concerned, because the corporation tax has been reduced to 33.33 percent. For example:

If a French corporation receives a dividend of 100 from a domestic corporate subsidiary, the taxation is as follows:

Dividends received	100	
Avoir fiscal (AF) attached	50	(50% of dividends distributed)
Taxable income	150	
Theoretical corporation tax 33.33%	50	
Offset of the AF	(50)	
French corporation tax due	0	

This regime is still available for dividends derived from non-resident companies.

A special regime also applies to holding companies whose income received in the form of dividends from foreign subsidiaries qualifying for the normal participation exemption regime represents at least two-thirds by value of their total income, and whose participation in such foreign subsidiaries represents at least two-thirds by value of the total assets' value. Then, dividends received from qualifying subsidiaries are exempt under the affiliation privilege outlined above. Redistribution by the holding company does not entitle the recipient to the avoir fiscal and does not result in the levying of the précompte. The 25 percent withholding tax on dividends paid to non-residents is increased to 50 percent, this rate being reduced by most tax treaties, and to nil for EC countries under certain circumstances (see below).

6. Parent-subsidiary directive

The withholding tax on dividends paid by French companies to qualifying EC parents is reduced to nil as from 1 January 1992. To qualify, the parent company, as a beneficial owner, must provide evidence that the following conditions are satisfied:

- it is organized in one of the forms listed in the schedule to the directive (mainly limited liability companies);
- it has its effective place of management within the EC and may not be regarded as having its residence outside the EC under a double tax treaty with a non-EC member state;
- at least 25 percent of its shares have been held continuously for two years before the date of the distribution;
- it must be subject to and not eligible for exemption from corporation tax in the state of its effective place of management;
- it must not be entitled to a payment of avoir fiscal;
- it must be the actual beneficiary of the dividend.

This provision does not apply if the dividends are enjoyed by a person controlled directly or indirectly by non-EC members unless evidence is provided that the chain or participation does not have as it main goal (or one of its main goals) the avoidance of withholding tax. The provision, derived from an EC directive, applies to companies set up in the DOMs.

7. This does not apply under certain circumstances if the domestic tax unity system (*intégration fiscale*) is applicable.
8. That is, it is equal to the avoir fiscal.

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7. Other

If a non-resident company does not have a PE, a 33.33 percent withholding tax is levied on the market value of certain French- source income such as property transfers, professional income (if the activity is realized in France) and royalties.

IV. SPECIAL REGULATIONS ISSUED TO PREVENT INTERNATIONAL TAX EVASION

A. *CGI Article 209 B*

Resident companies may be subject to additional assessment for a proportional share of income deemed received from a subsidiary organized in any form and established in a low-tax jurisdiction in which they, directly or indirectly, hold at least a ten percent interest. This also applies to foreign PEs owned by French corporations. This provision does not apply where the foreign entity has an effective industrial or commercial activity primarily carried out in its home market. Generally, a low tax jurisdiction is defined as a jurisdiction in which the subsidiary is subject to a tax burden lower by at least one-third than the tax burden it would have borne in France.[9]

In any event, the question of Section 209 B compatibility with tax treaties applies, as well as the scope of the privileged tax regime.

B. *CGI Article 238 A*

Payments made by a debtor (corporate or individual) established in France to foreign entities or individuals established in a low-tax jurisdiction are not deductible from French taxable income unless the taxpayer provides evidence that the payments are being made in consideration of actual and fair activities and the amount of the payments are neither exaggerated nor abnormal. This provision applies to interest, royalties and services. It also applies if payments are made into a bank account situated in a low-tax jurisdiction.

C. *CGI Article 57*

Profits indirectly transferred by way of transfer pricing from a company resident in France to another related entity which is not resident in France may be recaptured into the profits taxable in France. For purposes of this article, the term "related entity" means a company that controls the French company or is controlled by it. Both companies may also be deemed related if they are controlled by a same third company.

This test of related parties is not compulsory if payments are made to a non-treaty country.

D. *CGI Article 990 D*

A three percent tax is levied on the market value of real estate situated in France owned by French or foreign legal entities. However, the CGI provides for exemptions concerning namely:

- French legal entities or foreign legal entities situated in a country which has concluded with France a treaty containing a non-discrimination or administrative assistance clause, provided they file, or commit themselves to file, an annual tax return, including a description of the real estate and the identity of their shareholders or partners;
- entities in which the value of the French real estate, excluding real estate used for their business activity, represents less than 50 percent by value of their French assets;
- companies, the shares of which are listed on an official stock exchange;
- non-profit-making entities and foreign states and international organizations.

According to recent case law, entities resident in countries that have concluded a tax treaty with France, including a clause for non-discrimination based on nationality, are not subject to the tax.

V. TAX TREATY NETWORK

France has concluded tax treaties with more than 80 countries.[10] Those treaties generally apply to residents of DOMs. However, the treaty concluded between the Netherlands and France excludes the Netherlands Antilles. In the same way, the treaties entered into with the United States and the United Kingdom do not apply to the US and UK territories situated therein.

VI. OTHER TAXES

A. *Value added tax (VAT)*

The scope of VAT was extended to the DOMs in 1946. The introduction of VAT into Guyane, however, was deferred and VAT remains, until further notice, not applicable in that DOM. Conversely, VAT applies – with certain mitigations – to Martinique and Guadeloupe.[11]

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9. A recent report of the French Senate lists the following Caribbean jurisdictions as offering privileged tax treatment, particularly to offshore companies:

Antigua and Barbuda	Montserrat
Barbados	Netherlands Antilles
Belize	Saint Lucia
British Virgin Islands	Saint Vincent and the Grenadines
Saint Kitts and Nevis	Turks and Caicos Islands
Grenada	

The Tax Administration has also issued a list of countries in which companies benefit from a low-tax liability. The list includes:

Cayman Islands	Netherlands Antilles
Bahamas	Barbados
Bermuda	Grenada
Turks and Caicos	British Virgin Islands
Panama	Jamaica
Venezuela	Montserrat
Antigua	Saint Vincent

These lists are not exhaustive and the Tax Administration may determine whether or not the foreign company benefits from a low-tax liability on a case-by-case basis.

10. Tax treaties have been concluded with Ecuador (in force) and Mexico (not yet in force). Negotiations have been finalized with Venezuela and are to start with Cuba.
A treaty with Trinidad and Tobago entered into force on 1 January 1990. This is the only treaty concluded with another Caribbean State applicable thus far.

11. EC rules substantially apply to VAT but not all rules apply to Guadeloupe and Martinique.

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For purposes of VAT, Guadeloupe and Martinique are regarded as import and export territories distinct from continental France and from the other DOMs. Consequently, imports from continental France into Guadeloupe and Martinique are exempt in France (with the possibility for the exporter to deduct his input tax) but taxable in the relevant DOM at the lower rate applicable therein.

The generally applicable rates are as follows:
- lower rate (staple commodities, etc.): 2.1 percent (5.5 percent in continental France);
- standard rate: 7.5 percent (18.6 percent in continental France);
- higher (luxury) rate: 14 percent (22 percent in continental France) (the "luxury" rate was abolished on 1 January 1993).

Substantial VAT exemptions are available in connection with the importation into the DOMs of equipment and materials for tourism and the hotel industry, as well as products, construction materials, fertilizers and industrial and agricultural tools listed in the tax code.

B. *Octroi de mer*

The "octroi de mer" is a tax on imports (CIF value) from all destinations (including EC countries, continental France and other DOMs) levied in the DOMs (Guadeloupe, Martinique and Guyane).[12] The rates are set by the local authorities and the proceeds are used to finance the budget of local administrations. Prevailing rates are as follows: 12 percent in Martinique and Guyane, and 13 percent in Guadeloupe.

In 1992 the European Court of Justice held that this tax represents a customs duty or a tax of equivalent effect and is therefore forbidden under the Treaty of Rome. In 1989 the European Commission issued guidelines for a reform of the octroi de mer, and a French law issued in July 1992 provides for a large-scale reform of the tax. At this time it is impossible to ascertain whether or not the new tax regime will comply with EC law. Nevertheless, the main features of the new octroi de mer are described below.

Taxable operations include import of goods into a DOM; production of goods in a DOM (except for real estate and services); and sale and purchase activities (upon election).

Exemptions from the tax are available for export of local products out of the DOM, and a special regime applies to exchanges between DOMS.

Certain products are exempt because of their nature (tourism equipment, materials for agriculture and construction business, raw materials for local production activities, equipment for local authorities and State administration, sanitary and medical equipment, etc.).

The determination of the rates remains in the discretion of the local authorities (maximum 30 percent).

C. *Custom duties*

Customs duties are levied in accordance with the common external tariffs of the EC with preferential treatment for certain associated countries.

D. *Import/export duties*

A 1986 law provided for the creation of free zones in the DOMs in which enterprises would benefit from a suspension of customs duties, VAT and indirect taxes, but this provision has not yet entered into force. However, enterprises may benefit from an EC regulation which provides for a suspension of VAT where the product to be obtained is destined for re-export.

VII. INCENTIVES AND TAX PLANNING IN THE FRENCH WEST INDIES

A. *Residents of France*

French DOMs benefit from special incentives regimes to favour their economic development.

1. Companies

Companies subject to French corporation or income tax may deduct from their taxable income the total amount of investments made in the DOMs until 31 December 2001.[13] Investment which exceeds Ffrs. 30 million requires a prior administrative agreement. The deduction only applies to investments in the following activities:
- industry
- hotel industry (including camping facilities)
- fisheries
- tourism (holiday resorts/leisure activities, lodging and tourist services (local tour operators, car and boat renting, etc.)
- new energies
- agriculture
- construction and public works
- transportation
- handicraft
- TV and film activities, equipment maintenance and production and broadcasting (under conditions unknown at this time).

A prior administrative agreement is compulsory for investments in the hotel industry, tourism, transportation and TV/film production, unless they are under Ffrs. 30 million.

To qualify the investment must be in the form of the purchase or production of new assets which normally benefit from capital allowances according to their nature. In certain limited cases, land and second-hand materials may also benefit from the deduction regime. Investments made after 1 January 1992 must be in qualifying activities for five years (movable property) or nine years (immovable property), failing which the deduction may be recaptured into taxable income.

12. The octroi de mer does not apply to the Islands of Saint-Martin and Saint-Barthélémy.
13. Note that for both direct or indirect investments, the deduction from taxable income is limited to 75% in respect of the following activities: hotel industry, tourism, transportation and audio-visual and cinematographic production. The deduction is also limited to 75% when the qualifying company is not liable to corporation tax (sociétés de personnes - partnerships, etc.).

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It is also possible to deduct cash contributions made to the following companies from taxable income:
- *Sociétés de Développement Régional* (SDR): companies involved in the DOM's regional development;
- companies whose activities are conducted exclusively overseas (i.e. not in continental France) and fall under one of the above-listed activities. These companies must be subject to corporation tax and 90 percent of their assets must be assigned to qualifying activities.

The investing company must hold its participation for at least five years. Where the investment deduction is set off against personal income tax (the investor is an individual or he invests through a partnership, this deduction is limited to 75 percent of the investment amount.

2. Individuals

Until 2001, individuals resident in France (DOMs included) may benefit from a tax credit provided they:
- purchase or build on real estate to be used as their home or their tenant's home;
- make contributions to the capital of companies which:
  - have the building of houses as their exclusive purpose, or
  - are investing in various listed activities, or
  - are Regional Development Companies.

Prior administrative authorization is required for investments over Ffrs. 30 million. The list of qualifying activities is the same as for companies making indirect investments. The shareholding period, or the period during which the house is being used as a home, must be at least five years. The tax credit is equal to 25 percent of the investment. One-fifth of the tax credit may be set off against the individual's tax liability each year for five years.

Since the incentives provided for corporations are more favourable than those provided for individuals (the amount of the investment may be deducted from the first year's income), many taxpayers invest in the DOMS through a partnership which qualifies for the corporation tax incentives. A specialized entity is therefore appointed as *gérant* (non-member manager) so that the investors can remain passive investors.

B. *Non-residents of France*

Provided certain conditions are met, newly created enterprises having an industrial, commercial or handicraft activity may benefit from a total and then partial tax exemption (exemption from corporation tax or income tax depending on the form of entity). This regime applies all over the French tax territory and not only the DOMs. The law provides for a 100 percent exemption on gains realized during the first 23 months after the creation of the enterprise, and after that for 75 percent, 50 percent and 25 percent exemptions on gains realized during the following three periods of 12 months. The exemption also applies to the annual minimum lump sum tax.

If the enterprise is in the legal form of a corporation or a partnership, its equity capital should not be more than 50 percent controlled, directly or indirectly, by other legal entities.

In case of distribution of exempted gains to the shareholders, the equalization tax (précompte mobilier) is due.

This exemption regime is compatible with the one-third reduction of the tax base applicable in the DOMs.

1. Special middle-term tax regime (Article 208 quater)

A middle-term tax regime applies to approved new corporation tax entities established in the DOMs before 31 December 1996, and to approved existing corporation tax entities which undertake new activities. Income accruing to enterprises under this regime may be totally or partially exempt from corporation tax and minimum tax for a period of ten years.[14]

Prior approval must be given by a local commission and the revenue authorities (in many cases the Central Administration in Paris). In deciding whether to grant approval the authorities look at the nature of the proposed activity, the potential benefits to the local economy and the number of jobs created.

The authorities may impose certain requirements on the qualifying company. Failure to fulfil these requirements or if the activity varies from the proposed activity, the authorities may claim the payment of taxes corresponding to the period during which the company did not qualify.

2. Special long-term tax regimes (Article 1655 bis)

A "long-term" tax regime applies to corporate tax entities whose purpose is the exploration and exploitation of mines in the DOMs. This regime also applies:
- in Martinique and Guadeloupe to corporate tax entities whose industrial activity is regarded as essential to the economic development of these DOMs and which invest more than Ffrs. 20 million in the region;
- in Guyane to corporate tax entities and simple general partnerships conducting agricultural, forestry or industrial activities provided prior approval is granted.

Applications for prior approval must be submitted to the central tax authorities in Paris before 31 December 1996.

For a maximum period of 25 years, approved enterprises are subject to corporation tax in accordance with the rules and rates applicable as at 1 January of the year in which approval was granted, but may benefit from any favourable modification introduced subsequently. Income accruing to such enterprises is exempt from corporation tax for the term agreed if reinvested in the enterprise or in enterprises carrying out similar activities in the DOMs.

14. However, the regime does not apply to the tax due on capital gains on fixed assets and portfolio investments.

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DOUBLE TAXATION AGREEMENTS OF CARICOM: A REVIEW OF EXISTING PRACTICE AND PROSPECTIVE POLICY OPTIONS*

Bruce Zagaris**

I. INTRODUCTION

This article discusses the Commonwealth Caribbean double tax agreements and their effect on trade, commerce and investment. In particular the article considers the principal double taxation agreements to which the countries of the region are parties and explains the legal effects of these agreements or the absence of these agreements. The advantages and disadvantages of such agreements are discussed, with particular reference to access to commercial opportunities in the United States. The article also discusses and considers the adequacy, for serving the usual objectives of such agreements, of the Commonwealth double taxation arrangements in local tax legislation.

The article examines the substantive aspects of the tax treaties and related mechanisms, and provides proposed policy recommendations.

Part II discusses the principal models utilized by CARICOM members. Part III looks at tax information exchange agreements (TIEAs). Part IV then considers the adequacy of local tax legislation for serving the usual objectives of tax treaties. Although tax administration is not an essential part of the model tax conventions of the OECD or the UN model conventions, tax administration is discussed since the issue is considered an essential element of development in CARICOM, and CARICOM itself has committed substantial resources towards tax administration. Fortunately, in recent years tax conventions have begun to embrace tax administration. Hence, the provisions of these conventions are discussed. The tax impacts of non-tax treaties (i.e. investment and trade agreements) are next considered in Part VI, especially since the explosion of free trade agreements has resulted in increased investment and trade agreements that have tax implications and have stimulated the conclusion of double tax agreements. Part VII examines taxation within CARICOM in the context of accelerated integration. It considers the two agreements relating to tax within CARICOM, namely the 1973 Tax Convention between the more and less developed countries of CARICOM, and the 1973 Agreement on the Harmonization of Fiscal Incentives. This section also looks at the developments within the EC on tax harmonization and the potential of these models being emulated by CARICOM (or at least the potential emulation by CARICOM) in a process of tax harmonization. Part VIII focuses on the principal effects of different treaty approaches. Taxation within CARICOM in the context of accelerated integration, especially within the Hemisphere, is then discussed. The final part offers some options for tax treaty policy.

Contents

I. Introduction
II. Principal Double Taxation Agreements to Which CARICOM Members Belong
III. Tax Information Exchange Agreements
IV. Adequacy of Local Tax Legislation for Serving the Usual Objectives of Tax Treaties
V. Tax Administration
  A. The international component of tax compliance and tax administration in the Caribbean
  B. Prospects for improving tax administration in the Caribbean
  C. Agreements with assistance to tax administration provisions
VI. Tax Impact of Non-Tax Treaties
VII. Taxation Within CARICOM in the Context of Accelerated Integration
  A. Tax treaty arrangements within CARICOM
  B. European Community
  C. The Western Hemisphere
VIII. Principal Effects of Different Treaty Approaches
IX. Options

II. PRINCIPAL DOUBLE TAXATION AGREEMENTS TO WHICH CARICOM MEMBERS BELONG

The most important general observation about the tax treaty policy of CARICOM and its members is that the majority of CARICOM member countries are not signatories to any double tax agreements. A few countries, namely Jamaica, Trinidad & Tobago, Barbados, and to a lesser extent Guyana, have each concluded a few treaties. Most of the treaties tend to be with the United States, Canada, the United Kingdom, and to a lesser extent Germany, the Nordic countries and Switzerland.

An interesting trend is that until the last two years Latin American governments with the exception of countries such as Brazil have not had serious tax treaty programmes. However, a major departure has been made in the last two years. Mexico and Venezuela have begun concluding a series of income tax treaties. Mexico has also concluded two TIEAs.

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Chile has scheduled tax treaty negotiations with the United States in January 1993. Brazil and the United States have had a round of negotiations. Other Latin American countries, such as Argentina and Bolivia, have commenced discussions with the United States about starting formal negotiations.

One difficulty that CARICOM members face is that within CARICOM there are no academic or continuing education programmes that discuss methodically and comprehensively the technical aspects of international taxation or tax treaty policy. A new development has been the initiation of continuing education programmes by the local branches of the International Fiscal Association (IFA), particularly the Barbados branch, in conjunction with Caribbean Law Institute (CLI). An additional difficulty is that the CARICOM governments do not have a ready body of human or technical resources with which to develop an international tax policy and particularly a tax treaty policy. Even in the larger CARICOM member countries it is difficult to find more than two or three professionals in public service who spend the bulk of their time concentrating on tax treaty policy. Many of the CARICOM governments do not invest in sending their officials to obtain regular training on international taxation and tax treaty policy. Since international tax and treaty policies change rapidly, governments must spend enough resources to provide for a basic level of training on tax and then international tax policy, and additionally on tax treaty policy. An additional commitment of resources is then necessary to enable the professionals with enough training to understand tax treaty policy to maintain the level of training required to be effective in designing and implementing tax treaty policy. Some training programmes are available externally although these are costly and it sometimes may be difficult to sufficiently match the CARICOM professional to the proper external programme so that the expenditure of resources is worthwhile.

The countries that have no tax treaties are likely to face the following economic and investment impacts: investors have less certainty about the tax impact of their investments compared to the opportunities to invest in countries with tax treaties; investors tend to incur substantially higher withholding taxes than they would in an investment in a treaty jurisdiction since a treaty will provide for reduced withholding rates; investors have no treaty competent authority procedure by which to resolve any disputes over taxation that may arise between the investor and the host and/or home countries; and investors cannot take advantage of the tax sparing provisions that most developed countries other than the United States offer.

The CARICOM countries that have tax treaties follow four principal models. The first model is the old UK extension treaty that results from the colonial relationship between CARICOM members and the United Kingdom. These treaties were concluded either between the United Kingdom and another developed country or between the United Kingdom and one of the CARICOM countries as they were becoming independent. They follow some of the principles contained in an older OECD classical model treaty for the developed countries. They do not cover as many subjects as the newer treaties. For instance, there are extensions of the tax treaties between the United Kingdom on the one hand and Switzerland and Denmark on the other hand. Some of these treaties have been extended to Antigua,[1] Dominica,[2] Grenada,[3] Jamaica,[4] Montserrat,[5] St. Lucia[6] and St. Vincent.[7] These treaties follow to some extent the 1963 OECD model convention although several of them even precede by almost a decade the 1963 OECD model.[8]

Although they do not reflect in many cases the economic, political and juridical circumstances between the CARICOM contracting parties on the one hand and Switzerland and Denmark on the other hand, they do provide some utility to private investors and the signatory parties. In most cases it would be preferable for CARICOM members to maintain these treaty relationships until they can establish a new treaty policy and revise them.

The second and perhaps most-often used model is the UN model treaty between developed and developing countries.[9] The model emphasizes, *inter alia*: source-based principles to expand whenever possible the jurisdiction of the source (i.e. developing) country; higher withholding tax rates to attempt to increase source country revenue; and lower thresholds for imposing a permanent establishment (PE) whereby the source country has jurisdiction to tax. The treaties have variations on the UN model treaty. Examples of these treaties are the treaties of Trinidad and Tobago,[10] Jamaica,[11] Guyana[12] and the earlier treaties of Barbados.[13]

1. See, e.g. the Antigua/UK treaty signed in 1947, as amended in 1968, or the Antigua/Switzerland treaty, signed on 26 August 1973, Switzerland/UK treaty and extended on 30 September 1954 to Antigua.
2. See e.g. the Dominica/UK treaty, signed 7 March 1968, amending the 1949 treaty; the Dominica/Denmark treaty of 22 December 1954, extending the UK/Denmark treaty, signed 27 March 1950.
3. See, e.g. the Grenada/UK treaty, signed 3 and 25 April 1968, amending the 1949 tax treaty; the Grenada/Swiss treaty of 26 August 19653, extending the 30 September 1954 treaty.
4. See, e.g. the Jamaica/Denmark treaty. An extension was signed on 22 December 1954 of the earlier Jamaica/Denmark treaty.
5. See, e.g. the Montserrat/UK treaty, signed 8 April 1968 amending the treaty of 1947; the Montserrat/Denmark treaty of 22 December 1954, extending the UK/Denmark treaty of 27 March 1950; the Montserrat/Japan treaty, signed 25 September 1970, extending the treaty signed 4 September 1962; and the Montserrat/Switzerland treaty, signed 265 August 1963, extending the UK/Switzerland, signed 30 September 1954.
6. See, e.g. the St. Lucia/UK treaty, signed 5 April 1968, amending the treaty of 1949; the St. Lucia/Denmark treaty, signed 22 December 1954, extending the UK/Switzerland treaty, signed 26 August 1963, extending the UK/Switzerland treaty, signed 30 September 1954.
7. See, e.g. the St. Vincent/UK treaty, signed 1 April 1969, amending the treaty of 1949; the St. Vincent/Denmark treaty, signed 22 December 1954, extending the UK/Denmark treaty, signed 27 March 1950; the St. Vincent/Switzerland treaty, signed 26 August 1964, extending the UK/Switzerland treaty, signed 30 September 1954.
8. For a discussion and the text of the 1963 and 1977 OECD model treaties, see *Model Double Taxation Convention on Income and Capital* (Report of the OECD Committee on Fiscal Affairs, OECD: Paris, 1977).
9. For a discussion and the text of the UN model tax convention, see, e.g. UN Dept. of International Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (United Nations: NY, 1980, ST/ESA/102).
10. See, e.g. the treaties between Trinidad & Tobago and Switzerland, signed 1 February 1973; the United Kingdom, signed 29 December 1966, amended 10 December 1969; Italy, signed 26 March 1971; Denmark, signed 17 May 1971; France, signed 5 August 1987; and Italy, signed 26 March 1971.
11. See, e.g. Jamaican tax treaties with the United States, signed 21 May 1980; Sweden, signed 17 February 1985; the Federal Republic of Germany, signed 8 October 1974; and Canada, signed 4 January 1971.
12. See, e.g. the Guyana/Canada treaty.
13. See, e.g. the treaties between Barbados and Sweden, signed 13 March 1949

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These treaties have a PE provision based in part on the UN model tax convention. For instance, they provide that a building site or construction assembly, installation or dredging project, or a drilling rig or ship used for exploration of natural resources within a Contracting State for one or more periods totalling 183 days in a 12-month period will constitute a PE.[14] The treaties contain many provisions that are designed to broaden the host country's jurisdiction to tax. This is a means to enable the host country jurisdiction, typically the Caribbean country, to be able to raise revenue through the employment of its ability to tax.

A common feature of these models is higher withholding taxes than is common in tax treaties between OECD countries. For instance, withholding rates on dividends range typically from ten to 25 percent rather than five to 15 percent as in the case of treaties between OECD countries. Withholding rates on interest are typically around from ten to 25 percent rather than ten percent as in the case of treaties between OECD countries (in many cases five percent is the rate). Withholding rates on royalties and management fees are typically ten to 20 percent rather than five percent as in the case of treaties between OECD countries.

A third model is the one previously used by Barbados. Its model has evolved more from a strict application of the UN model in the 1970s to a hybrid model that blended some aspects of the UN and OECD models. For instance, in its 1983 income tax treaty with the United States, Barbados emulated the OECD treaty in the sense that it agreed to relatively low withholding rates of five and 15 percent on dividends and 12.5 percent on royalties and interest.[15] The treaty also contained a liberal limitation on benefits article that allows some offshore activities to benefit from the treaty.[16] The treaty also has a broad non-discrimination provision that enabled Barbados offshore companies to obtain tax benefits in the United States on an equal basis with US persons. This provision enabled Barbados to attract, for instance, international business companies (IBC) when the United States partially terminated its income tax treaty with the Netherlands Antilles. Barbados also succeeded in obtaining exemptions on US insurance premium excise taxes.[17] As a result Barbados has become the second largest jurisdiction for hosting captive insurance companies (after Bermuda). However, the United States terminated the treaty, resulting in some small dislocation and slow-down in the growth of this new industry. A unique feature of the Barbados/US treaty is that slightly before the conclusion of an income tax treaty in December 1983, the two governments concluded a TIEA, thereby making Barbados eligible for hosting foreign sales corporations (FSCs).[18] Barbados has become the second largest host of FSCs after the British Virgin Islands.

A fourth model is the current Barbados model. Starting a few years ago when Barbados began to diversify its tax treaty network and negotiated with three Nordic countries and then Germany, its model evolved to provisions more similar to those of a 1977 OECD-type model. It eliminated the expansion of the source country's ability to tax by using PE and provisions analogous to those in the 1977 OECD model convention. It lowered the withholding rates for interest and royalties to as low as five percent.

The reason that Barbados has done this is twofold. On the one hand, its offshore sector has begun to grow and, in order to prosper, it is preferable to have low withholding rates and the ability to use tax treaties. Barbados has also decided to revert to the OECD model treaty for purposes of the jurisdiction of the source country. In order for the Barbados offshore sector, say IBCs, to be able to invest in and trade into the other country at a minimal tax rate, such Barbados entities need to be able to take advantage of a high threshold before the source country can impose tax on such investment/trade so that they can avoid the possibility of being taxed in countries such as the United States. With a UN model PE provision, it becomes more difficult for a Barbados IBC to provide services ancillary to trading into the United States and yet avoid US tax on such activities. For instance, in the proposed protocol between Barbados and the United States, the combination of the PE article (which is analogous to the 1977 OECD model convention) and the limitation of benefits article, enables a Barbados IBC to assist a foreign company that wants to begin exporting or consolidate existing exports to the Western Hemisphere, especially the United States. By establishing a Barbadian IBC and by having an active trade or business in Barbados relative to its US activities, the Barbadian company can conduct activities ancillary to marketing and selling goods into the United States without any imposition of tax. There are other examples, but the key point is that Barbados can attract investment to its offshore sector through emulating the OECD model convention. Barbados also believes that, in the competitive market in which it must try to attract investment, a very low threshold by which the source country can impose tax and then high withholding rates does not necessarily increase revenue. In fact, since Barbados is a high-cost jurisdiction, the combination of high taxes and high operating costs (i.e. comparatively higher wages) may preclude attracting new investment.

III. TAX INFORMATION EXCHANGE AGREEMENTS

Another variant of a double tax treaty has been the TIEA, which is a part of the Caribbean Basin Economic Recovery

(as concluded with the United Kingdom and extended to Barbados), subsequently modified and no longer in force; Denmark, signed 27 March 1950 (as concluded with the United Kingdom and extended to Barbados and no longer in force); Norway, signed 2 May 1951 (as concluded with the United Kingdom and extended to Barbados and no longer in force); Switzerland, signed 30 September 1954 (as concluded with the United Kingdom and extended to Barbados); United Kingdom, signed 26 March 1970; Canada, 22 January 1980; and United States, signed 31 December 1984.

14. This contrasts with the periods of 12 months in the OECD model and 24 months in the US model.

15. See, e.g. Barbados treaties with Finland signed, 15 June 1989, Norway, signed 15 November 1989, and Sweden.

16. A limitation on benefits or anti-treaty shopping article is an article directed at limiting the benefits arising from the treaty to those persons that are intended beneficiaries. Such provisions define the intended beneficiaries normally as nationals, residents, holders of minimum amounts of equity, publicly held companies and so forth.

17. Another aspect of the 1983 Barbados/US income tax treaty is that it emulated the UN model in that it has low thresholds to impose a PE.

18. For background on foreign sales corporations, see Bruce and Lieberman, *Foreign Sales Corporations* (Tax Mgmt. Portfolio 264-4th BNA 1988).

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Act of 1983.[19] There are approximately 11 TIEAs, including the one with Mexico[20] and excluding three TIEAs with US possessions. Others are awaiting ratification (i.e. Canada/Mexico and Peru/US).

These agreements expand on the obligations of signatory countries to exchange information pursuant to Article 26 of the OECD model treaty. Specifically, TIEAs override bank secrecy and bearer share provisions. They provide more specificity as to the methods by which the requesting state may request information.

From an economic policy perspective the result of TIEAs seems clear. Some investors, particularly those interested in anonymity and confidentiality or concerned about an eventual audit by the Internal Revenue Service, will invest in other countries in which their preference for anonymity can be satisfied.

The TIEA makes CARICOM signatory parties eligible for three benefits: Americans attending conventions in CBI countries with TIEAs can more easily deduct their expenses, thereby facilitating convention business in those CBI countries; eligibility to host FSCs;[21] and Section 936 financing. Each benefit is quite marginal. Even together, all the benefits are marginal. Convention deductions are important only if the Caribbean country has a substantial convention infrastructure, and most countries do not have the ability to attract large conventions. The few that have the facility, such as the Bahamas, have concluded that the benefits of the convention business would be outweighed by the loss of offshore business, especially because most investors using the Bahamas depend in part on confidentiality, many for legitimate reasons. The second benefit, eligibility to host FSCs, is no longer viable. For instance, only the United States, Virgin Islands, Barbados, and to a small degree Jamaica, have any FSCs. The bulk of opportunities were in the first year. The market for hosting such entities is now full and there is no room for newcomers to host FSCs. In any event, the fees and business derived from FSCs are not in themselves significant. Rather the business of hosting FSCs is only valuable as part of a broader portfolio of offshore business. The third benefit, the Section 936 financing, has been the most attractive. However, the projects for Section 936 have been rather narrow. The prospective life of Section 936 is indeed quite limited, regardless of the outcome of the evolution of Puerto Rico's status.[22]

Clearly one of the goals of the CARICOM member states should be to only conclude TIEAs as an ancillary mechanism and complementary to an income tax treaty. Although TIEAs are useful, tax treaties are clearly more important, compared to TIEAs, in attracting and facilitating transnational investment. TIEAs assist CARICOM governments in their own tax compliance efforts as well as their efforts to prosecute crimes that may include tax and related crimes (currency exchange violations that may be tax crimes).

The most usual answer of the United States to the reason why it does not negotiate income tax treaties with most CARICOM governments is that it does not have time to negotiate with so many small countries. This can be solved either by increasing the staffing of the officials in the US Government, concluding some multilateral treaties, and/or assisting the small countries in their knowledge of international taxation and especially the negotiation of tax treaties.[23]

A regional trend has been that some developing countries, led by Mexico, have begun negotiating TIEAs in order to raise revenue, especially from flight capital (residents and nationals with investments outside the country) and from investments by multinational companies.[24] There is also a regional TIEA model that has been concluded with the Inter-American Center of Tax Administrators (CIAT).[25]

IV. ADEQUACY OF LOCAL TAX LEGISLATION FOR SERVING THE USUAL OBJECTIVES OF TAX TREATIES

One element of a tax treaty which local legislation cannot accomplish is the revision or elimination of barriers to investment and trade in other countries. For instance, US investment in Barbados captive insurance companies was primarily desirable after 1984 due to the elimination under the Barbados/US treaty of the insurance premium excise tax. Similarly, the US Virgin Islands, Barbados and Jamaica only received FSCs because of the TIEA they concluded with the United States. As noted above convention deduction and Section 936 tax benefits are only available in the context of a TIEA. Reciprocal recognition of deductions made to foreign charitable organizations may sometimes only be available in the form of a treaty.

In connection with inbound investment tax treaties are required to either obtain a lower threshold for the host country's assertion of jurisdiction and lowering or eliminating the rate of withholding tax.

In most CARICOM countries, where there is no tax treaty and the foreign income is subject to income tax in a British Com-

19. For background on TIEAs, see Zagaris, *Selected Developments of New Tax Information Exchange Agreements and Their Relatives*, 19th Annual International Tax Conference (1 January 1991); for the text of the TIEAs, see R. Rhoades and M. Langer, 3-4 *Income Taxation of Foreign Related Transactions* (1985). For additional discussion of the TIEA programme at its inception, see Foster & Penick, "Barbados Signs the First Exchange of Information Agreement under the Caribbean Basin Initiative", 114 *Tax Management International Journal* (1985), at 100; Sharp and Steel, "The Caribbean Basin Exchange of Information Draft Agreement - A technical Analysis", 19 *International Lawyer* (1985), at 949; Zagaris, "The Caribbean Basin Initiative", 28 *Tax Notes*, at 102.

20. For a discussion of the Mexico/US TIEA, see Karlin & Breger, "Exchange of Tax Information Between the United States and Mexico", 6 *International Enforcement Law Rptr.* (February 1990), at 69; Zagaris, "US and Mexico Conclude Tax Information Exchange Agreement", 5 *International Enforcement Law Rptr.* (November 1989), at 413.

21. See *supra* note 18.

22. For a critical look at the TIEAs, see Zagaris, "The Caribbean Basin Tax Information Exchange Agreements Program of the United States: Eat Softly and Carry a Big Stick", 43 *Bulletin for International Fiscal Documentation* (March 1989), at 115.

23. However, lobbying is needed to persuade the United States to invest some resources in negotiating tax treaties.

24. For a discussion of the tax compliance emphasis in the region, see Zagaris, "International and Comparative Tax Trends in a Caribbean Integration Perspective" (9th Caribbean Conference of Accountants 20-22 June 1991 unpublished).

25. For a discussion of the CIAT model TIEA, see Zagaris, "CIAT Adopts Model Tax Information Exchange Agreement", 6 *International Enforcement Law Rptr.* (March 1990), at 105.

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monwealth country that provides similar relief, a partial credit for such foreign country taxes paid can be claimed in the CARICOM country. For instance, in Barbados relief is limited to 50 percent of the lower of the Barbados or foreign country income tax paid on the same income. In the event the foreign taxes paid surpass the credit granted by Barbados, the excess foreign taxes are deductible for Barbados tax purposes.

The operation of unilateral relief of double taxation in the CARICOM can be illustrated by reviewing the Antigua legislation. Unilateral relief of double taxation is primarily given for British Commonwealth taxes. Relief within limits may be provided to residents of Antigua against Antiguan income tax for the income taxes of British Commonwealth countries as listed in the Income Tax Act, assessed on or deducted at source from income taxed both in the Commonwealth country and in Antigua. However, Antigua does not give unilateral relief for the income taxes of a country with which Antigua has a double tax agreement, which is limited to the United Kingdom at present, unless the agreement allows such unilateral relief. In the case of the United Kingdom it does not. Antigua only gives unilateral relief if the country of source of the relevant income grants similar relief to its residents for Antiguan income tax.

For an eligible Commonwealth income tax unilateral relief is effectively half the Antigua rate, and hence 20 percent since only resident companies would normally be eligible for the relief. Unilateral relief is given on a per country basis. Claims for unilateral relief should be made within two years of the end of the relevant year of assessment, as for relief under double taxation agreements, but the legislation does not expressly so state.

Unilateral relief can be given to a non-resident of Antigua. Such relief is conditional on similar relief being available in the other Commonwealth country, a rare occurrence since other countries normally do not provide relief for foreign taxes to non-residents.

Foreign taxes on income derived from non-Commonwealth countries or Commonwealth countries that do not provide a similar credit for Antigua tax may not be credited against the Antiguan income tax or business tax. One issue is, whether such taxes may be deducted in computing taxable income. Concerning UK taxes, the tax act precludes the deduction of UK income taxes completely as an outgoing or expense wholly and exclusively incurred in producing the chargeable income. The prohibition seems to also extend to UK corporate tax.

For taxes of other countries, the question is difficult to answer. If foreign taxes that are not Commonwealth taxes could be regarded as outgoings or expenses which are wholly and exclusively incurred in producing the chargeable income according to the tax authorities, then they should be deductible.

V. TAX ADMINISTRATION

One element of tax cooperation that can be incorporated in a double tax treaty and/or a TIEA is to provide for technical and financial assistance in tax administration. Before reviewing some provisions of tax administration within treaties, it is useful to review tax administration in the Caribbean.[26]

The regionalization of tax administration is in its infant stage. One of the principal organizations for regional tax administration is the CIAT, which is based in Panama. Three CARICOM countries (Barbados, Trinidad & Tobago and Jamaica) as well as Bermuda are members. Several developed countries, such as the United States, Germany, Spain and Canada also participate in CIAT. CIAT holds courses on tax administration; for instance, in 1985, it held a comprehensive course on planning and control in tax administration.[27] CIAT also has a bimonthly newsletter that provides an update on CIAT activities, developments in tax administration in the member countries (i.e. new laws, administrative regulations, policy initiatives and changes in personnel), and other information, such as developments and publications of interest to its members. CIAT has been trying to assist CARICOM to develop more programmes on a sub-regional level.

The principal sub-regional organization in the Caribbean is the Caribbean Organization of Tax Administrators (COTA), which is composed of the tax administrators within CARICOM. At its annual meetings tax administrators present papers which are published.

Some of the improvements in tax administration are obtained through bilateral technical assistance with the United States. The US Agency for International Development (AID) funds projects that the Office for Tax Administration Advisory Services (TAAS) assists. The assistance may be training, or may be furnished by automated data processing. The Inter-American Development Bank (IDB) serves as a major source of financing tax administration.

A. *The international component of tax compliance and tax administration in the Caribbean*

In February 1990, the adoption by the CIAT of a draft TIEA cements the legitimacy of TIEAs throughout the region.[28]

With the increasing conclusion of TIEAs agreements that include implementation programmes, the role of technical assistance in the implementation of such programmes and technical assistance in tax matters, generally to developing countries, is becoming increasingly important. In the United States this role is performed by the Office of TAAS.

26. For further information on tax administration in the region within the context of overall tax policy, see Zagaris, "The Potential Role of Barbados in Strengthening Tax Policy and Tax Administration in the Caribbean", 4-9 (Paper prepared for programme on CARICOM Tax Treaties sponsored by the Barbados Branch of the IFA and the CLI 2-3 November 1990), from which this section is taken almost verbatim; for additional background on the conference, see Zagaris, "IFA Barbados Branch Considers CARICOM Tax Treaty and Tax Issues", 43 *Bulletin for International Fiscal Documentation* (April 1991), at 186.

27. For the papers on the programme, see *Planning and Control in Tax Administration* (Amsterdam: International Bureau of Fiscal Documentation No. 39, 1987).

28. This discussion is taken largely from "Tax Information Exchange Agreement Point to Increasing Importance of Technical Assistance", 6 *International Enforcement Law Rptr.* (April 1990), at 146.

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The TAAS of the IRS provides technical assistance in tax administration to foreign, state, local, commonwealth and territorial governments, US possessions and institutions of higher education. Generally, its goal is to give advice and assistance to governments which ask for help in modernizing and strengthening the administration of their internal tax programmes. Its overall goal is to motivate and assist governments in developing an independent capability to carry out continuing improvements in their tax administration management, organizations and technical programmes. TAAS provides assistance on a short or long-term basis extending up to several years and covers all major functions of tax administration. TAAS services cover the functional areas of tax administration, including activities such as training and management, but do not include assistance in tax policy or customs matters.

IRS/TAAS started its overseas advisory assistance programme in 1963. This programme has included a broad range of activities to more than 54 countries throughout the world. TAAS provides two types of technical assistance: general comprehensive assistance, and a more limited specialized assistance. For both types, the donee country completes a pre-survey request (questionnaire), after which TAAS provides a report of findings and submits a work plan based on the request from the donee country and the pre-survey.[29]

TAAS also sponsors two categories of tax administration for managers. The first category is a six-week Middle Management INTAX Seminar for tax administrators. The second category of training concerns various types of short courses, including the following: basic instructor training; executive development seminar; financial investigative techniques; middle management INTAX seminar; training for trainers; analyst training; and technical training. TAAS also has a course on international issues, which covers basic areas of international taxation including foreign corporations, foreign tax credits and transfer pricing. Its special agent investigative techniques course covers basic income tax investigative techniques, proving income, and computer applications.

The TAAS financial investigative course has especially been in demand, including from European countries. The one-week course is an orientation to financial investigative techniques, and is particularly useful to persons working in criminal investigation and examination. Through discussions, participants learn of sources and means for obtaining financial evidence and examine techniques that can be applied in their country. Among the topics covered are: financial interviewing, indirect methods of tracing funds and effective communications.

IRS/TAAS has made the formation and activities of intergovernmental association of tax administrators a priority. It is a charter member of CIAT, and has attended all of CIAT's general assemblies and most of its technical seminars. For instance, TAAS actively participated in the preparation and adoption of the CIAT model TIEA.[30] It has provided technical and logistical advice to CIAT when needed. Albeit not a member, the IRS has played an active role in the COTA, participated in annual assemblies and supported its training projects.

The INTAX course has been held in Brazil in conjunction with the CIAT. It is possible to hold the INTAX course in other regional areas, such as the Commonwealth Caribbean where COTA operates and where discussion has already focused for many years on having a common regional tax scheme for the Eastern Caribbean in the context of the Organization of East Caribbean States (OECS). In fact, one possibility for regional tax approaches on training, management and systems is in the context of the Administration of Justice Project (AOJ) for the Commonwealth Caribbean and the CLI. The AOJ Project is a project whereby the US AID is providing $ 10 million to the University of the West Indies Law Faculty for on-lending to the East Caribbean national legal committees for, *inter alia*: strengthening law libraries, training judges and practitioners and developing textbooks.[31] The CLI is a joint venture between Florida State University and the University of the West Indies, funded by the US Congress.[32] Its purpose is to unify and harmonize the commercial and other laws of the Commonwealth Caribbean, especially to assist in attracting investment.[33] More uniformity in tax administration and management would help all investors, especially foreign investors, since the region's tax system would become more predictable. However, newly independent countries jealously guard their tax and customs regimes and are initially reluctant to surrender power over them.

In the discussions on the establishment of new legal systems and mechanisms in Central Europe, technical assistance and a common regional tax approach may well be useful. With the United States leading most of the rest of the world in its aggressive posture towards international tax compliance, the technical assistance, in conjunction with similar compliance trends in the rest of the world, will produce transfer of technology and more uniformity of approaches in international tax compliance.[34]

As money laundering becomes increasingly criminalized and laws to identify, trace, freeze, seize and confiscate illegally gained assets become prevalent, you will see developing

29. Normally, this phase costs $ 20,000, which includes the cost of a two-person, two-week survey, the report, the round-trip transportation and per diem. However, if the request is very specific, such as the potential interest by a country in improving automated data processing and/or improving compliance by small mobile merchants, the cost can be cut in half, based on one person and one-half the work.

30. For a discussion of the CIAT model TIEA, see Zagaris, "CIAT Adopts Model Tax Information Exchange Agreement", 6 *International Enforcement Law Rptr.* (March 1990), at 105.

31. For a discussion of the Caribbean AOJ Project, see Zagaris, "Law and Development or Comparative Law and Social Change - The Application of Old Concepts in the Commonwealth Caribbean", 19 *University of Miami Inter-American L.R.* (No.2, June 1988), at 543.

32. For background to the CLI project, see *Id.*, at 590.

33. For a status report on the work of the CLI, see a report prepared by Professor Ralph Carnegie, Commercial Law Survey Seminar (15 January 1990 (unpublished) 57 pp.).

34. In May 1990, the Sub-committee on Compliance, Enforcement and International Tax Law, Committee on International Tax Law, Section of International Law & Practice, American Bar Association chaired by James P. Springer, Special International Tax Counsel, US Dept. of Justice, hosted a programme on technical assistance in tax matters, especially financial investigations, featuring Socorro Velasquez, the director of TAAS, and Leif Muten, a senior attorney at the International Monetary Fund. The author also participated and addressed more general tax policy and tax administration. These types of programmes could and should be held in the Caribbean.

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countries' tax and law enforcement authorities increasingly line up to take courses on financial investigation, and request assistance from the United States in locating records, taxpayers and witnesses.

The beginning of an era of cooperation in tax and money movement has begun. This also is imposing new standards on bankers, accountants, lawyers and all kinds of professionals. Those who do fail to ask enough questions and follow the "know your customer" approach and make criminal referrals when they encounter "suspicious transactions" will encounter civil and even criminal problems.

B. *Prospects for improving tax administration in the Caribbean*

A major initiative to improve tax administration is to provide a regional training center. For instance, the Inter-American Development Bank (IDB) funded a training programme for Latin American tax administrators which is located in Venezuela. There has been a proposal to start such a programme in CARICOM. CIAT would provide much of the technical assistance while the IDB would provide the financing.

For many years discussion of common tax administration and customs (and other, e.g. legal) services have been discussed with the OECS. For many years US AID has offered to fund these common services. Clearly throughout CARICOM and especially in the least developed countries in the OECS, better training is essential to ensure proper tax collection and to bring some equity to the tax system. Repeatedly studies show that the only real and practicable means of improving tax administration in the OECS countries is through regionalization.[35] Unfortunately, the OECS countries and CARICOM have not been able to regionalize tax administration. Instead the more developed CARICOM members obtain assistance from participating in CIAT, occasionally sending tax officials to courses in developed countries (such as the Harvard Tax Program). These courses, while beneficial, are not designed just for the Caribbean and without proper follow-up the training cannot realize its potential.

If the region and if CARICOM members are going to achieve the degree of professionalism required to raise revenue, give the tax system integrity and credibility, the system must have an ongoing programme to train lower and mid-level officials as well as specialized courses for mid and senior-level persons. They also need to set a standard of performance and recognize officials who have achieved high standards. Such an investment would be worthwhile both economically and politically.

In the near future the establishment of the Caribbean Center for Tax Administrators, with technical assistance from CIAT, interested donor governments and private foundations should be started. One potential source of funding could be debt-for-equity swaps. If the Enterprise for the Americas Initiative were expanded slightly, the cancellation of official debt could be used not just for environmental needs, but for fiscal ones as well.[36] In fact, professionalization of tax administration is just one of the structural reforms called for by the Enterprise for the Americas Initiative. Hopefully, the Administration and other developed countries will realize and contribute to such an initiative. However, CARICOM and its member governments and institutions must have the political maturity and foresight to propose the establishment of such a Center. The CARICOM private sector should encourage the development of regional tax administration.[37]

C. *Agreements with assistance to tax administration provisions*

With this background on tax administration in the Caribbean, one mechanism to provide for technical assistance for tax administration is through tax treaties and TIEAs.

The United States and American Samoa have concluded a tax implementation agreement (TIA) (Samoan TIA) that will facilitate information exchanges and mutual assistance in tax matters.[38] The Tax Reform Act of 1986 necessitated the new agreement because the Act allows American Samoa, Guam and the Northern Marinara Islands to enact their own tax laws in place of the Internal Revenue Code.[39] The Samoan TIA is very similar to the TIA concluded by the United States and the Virgin Islands[40] in February 1987. The Samoan TIA provides specifically that the United States will "routinely supply" tax information to American Samoa, including copies of the following: income subject to withholding, partnership return of income, information returns, W-2 combined wage reporting tapes and elections to be treated as an FSC or as a small FSC.[41] American Samoa will routinely supply to the United States audit reports of individual, partnership, corporate and employment changes (with associated reports of experts) that "disclose information relevant to the United States".[42] The specification of the precise documents that will be exchanged is unique to the TIAs and can be explained in part by the identity of the tax systems and even forms of the contracting par-

35. See e.g. Francis and Supersad, "Tax Policy and Tax Administration in the Less Developed Countries of the Caribbean Community", (also contained in Zagaris (ed.), II *International Tax Law Materials* 318 (UWI Extramural course materials, Cave Hill Campus, 1978).

36. For a discussion of broadening the purposes for which debt-for-equity swaps can be used, see Zagaris, "Swap Debts for Education", *The Journal of Commerce* (31 August 1990).

37. A recent example of this was the hosting by the Barbados IFA branch and the CLI of a programme on international tax and tax administration.

38. See "Tax Implementation Agreement Between the United States of America and American Samoa", 7 January 1988, (Hereinafter Samoan TIA) reprinted in *Tax Notes International*, 7 June 1989, at 54; *BNA Daily Tax Reporter* No. 10 (5 January 1988), at L-9. According to the Treasury Department, the Samoan TIA replaces and expands upon prior tax agreements between the two jurisdictions. See Treasury News Release B-1257 (14 January 1988).

39. Tax reform Act of 1986, Pub. L. 99-514, §§ 1271, 1277, 100 Stat. 2593 (codified at 26 USC §§ 931 (Supp. V 1987).

40. See *Tax Notes International*, supra note 312; Treasury News Release B 889 (2 March 1987) (explaining that the Virgin Islands TIA will be used as a model for other tax agreements); Zagaris, "US/USVI Tax Exchange Agreement Analyzed", 3 *International Enforcement Law Reporter* (1987), at 301.

41. Samoan TIA, *supra* note 38, Art. 4(2)(a)(i)-(vii).

42. *Id.* Art. 4(2)(b)(i). The information supplied will also include the following reports about: any taxpayer who is a citizen of the United States or has been a resident alien of the United States; files an income tax return with American Samoa that discloses non-American Samoa source of income; and claims for the first time to be an American Samoa resident; all corporate information about ownership interests in any FSC established in American Samoa; and such information about corporations electing application of Sec. 936 of the Internal Revenue Code as agreed upon by the competent authorities. *Id.* Art 4(2)(b)(ii)-(iv).

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ties. Under the agreement, the parties will develop a simultaneous examination programme for both civil and criminal investigations.[43] In addition, the United States will assist in collecting taxes, interest and additions to tax owed by American Samoa taxpayers present in the United States.[44]

The Samoan TIA indicates a new type of momentum behind the tax information exchange programme. This TIA is more significant than a TIEA since it provides for technical assistance by the United States in addition to joint tax collection.[45] Technical assistance gives developing country governments, many of which are in dire need of revenue, an incentive to acquire the technical know-how to close the revenue gap and apply their tax laws in a more equitable fashion.[46] Practically speaking, the inclusion of such incentives also makes conclusion of such agreements much more likely even though the emphasis is still on enforcement. However, the confidentiality desired by foreign investors is adversely affected by TIAs that contain provisions enabling exchange of tax- related information. Accordingly, the TIAs between the United States and its possessions and protectorates may have a significant impact on amounts and types of inbound investment.

CARICOM members would benefit by incorporating the tax administration assistance provisions and programmes in TIAs into their own TIEAs and tax treaties with the United States, provided of course that they can persuade the United States of their efficacy. To persuade the United States would require lobbying because Treasury does not have statutory authorization and funds to undertake this effort at present.

VI. TAX IMPACT OF NON-TAX TREATIES

CARICOM countries will want to be aware of and sometimes take advantage of investment and trade agreements that impact on tax treaties. Increasingly, as the services round of the GATT progresses, the services sector and even taxes may be affected. For instance, already three Caribbean jurisdictions have profited from the decision of the GATT panel that the US Domestic International Sales Corporation (DISC) provisions were illegal and contrary to the GATT. As a result, the United States had to enact new legislation, known as the Foreign Sales Corporation Act, which required US corporations wanting to take advantage of the tax preference to establish a subsidiary overseas. Among the leading FSC jurisdictions have been the US Virgin Islands, Barbados, and to a lesser extent Jamaica.

Increasingly, successful foreign direct investment and international trade require taking advantage of provisions for national or most-favoured-nation treatment on a range of related matters, only one of which involves taxation. Important aspects of investment and trade decisions involve bringing employees of the investor's choice, from whichever country the employer chooses, the right of establishment, the right to freely repatriate profits and a host of other rights that may or may not involve taxation.[47]

Bilateral investment treaties (BITs) have been successfully used to gain tax benefits. In particular, the national treatment provisions that require a host signatory country to accord investors from the home signatory country the same treatment as nationals that are similarly situated has been utilized for tax purposes. For instance, after the US Government partially terminated its double tax treaty with the Netherlands Antilles, many entities moved the entities holding their US real estate operations to Barbados in order to take advantage of the election under the tax code that only a US tax resident or a person to whom the national treatment provisions of a tax treaty or BIT applied. Although the Barbados provisions were part of its income tax treaty with the United States, it could also have utilized a BIT. For instance, after the partial cancellation of the income tax treaty, Antillean companies for a while were able to use the national treatment provisions of its Friendship Commerce and Navigation Treaty for tax benefits.

The other area in which trade provisions are impacting on international tax and must be taken into consideration are the dynamic area of regional integration treaties, such as the European Economic Community. This area is discussed below.

VII. TAXATION WITHIN CARICOM IN THE CONTEXT OF ACCELERATED INTEGRATION

Increasingly, regional integration and free trade initiatives are propelling tax changes. Some of the changes are effected by legislation and regulations promulgated by a regional body. The treaty giving the regional bodies authority must be scrutinized for its provisions with respect to taxation. Sometimes, treaties are made to implement policies of regional bodies, such as the Council of Europe/OECD convention on mutual administrative assistance in tax matters.

A. *Tax treaty arrangements within CARICOM*

1. 1973 regional double tax convention

In 1973, the members of CARICOM concluded a unique tax agreement. Similar to the OECD and the UN model treaties the CARICOM treaty has the purposes of encouraging international trade and investment and preventing fiscal evasion

43. *Id.* Art. 7(6). The object of the examination programme is to avoid redundancy in examination coverage. *Id.*
44. *Id.* Art. 7(8). Such tax collection efforts by the United States are subject to the availability of enforcement resources and allowed only to the extent permitted by law. *Id.*, Art. 7(8), 1. The Agreement provides that the competent authorities will discuss appropriate procedures for facilitating such collections. *Id.*, Art. 7(8). Any taxes collected are to be remitted to American Samoa, after deducting the reasonable costs of collection. *Id.*
45. *Id.* Art. 7(9).
46. See Zagaris, "Inter-American Center of Tax Administrators Holds Session on Ways to Discourage Tax Evasion and Avoidance", 4 *International Enforcement Law Reporter* (1988), at 264 (discussing technical assistance issue). For example, developing countries often rely on the inequitable device of indirect taxes in their adminstration of tax laws. See Wallschutzsky, "Achieving Compliance in Developing Countries", 43 *Bulletin for International Fiscal Documentation* (May 1989), at 234.
47. For a useful discussion of how BITs are useful mechanisms to attract investment, offering both tax and non-tax incentives to nationals of the treaty country, and in many cases to third country nationals willing to establish joint ventures in one of the treaty countries with a view to further activities in the other treaty country, see Gantz "The Use of Non-Tax Treaties for Encouraging Investment and Economic Development", 45 *Bulletin for International Fiscal Documentation* (April 1991) at 190.

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with respect to taxes on income and profits.[48] Unfortunately, the agreement seems to have for many years fallen into disuse and is virtually ignored by all tax professionals.

Commentators also express doubt as to whether the treaty or at least various parts of the treaty are used or have succeeded in accomplishing any of its principal purposes.[49]

One unique feature of the treaty is that it is between the more developed countries within CARICOM, which are designated in Schedule 1 as Barbados, Guyana, Jamaica and Trinidad & Tobago, and the less developed countries within CARICOM, which are listed as Antigua, Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent and St. Kitts, Nevis & Anguilla.

The reduced withholding rates of ten percent in the case of interest and five percent in the case of royalties only apply to the more developed countries within CARICOM. The less developed countries may tax these amounts according to their laws. For dividends, varying reduced withholding rates apply to three of the more developed countries. Barbados and the less developed countries can apply the rate of tax chargeable in respect of the profits or income of the company paying the dividend. The lack of reduced withholding rates when capital flows from the more developed countries to the less developed countries is unique and does not, compared with other tax treaties around the world, assist in providing tax incentives to stimulate investment flows. Perhaps most importantly, the classification of Guyana as a less developed country is deemed anachronistic.

Unless the treaty is actually being used and unless it is succeeding in the purposes of encouraging the flows of investment and reducing tax evasion, it would be better to either conclude a protocol to modernize the treaty or terminate it.

On 7 July 1992, the CARICOM Secretariat circulated for comments a proposed CARICOM double taxation agreement for investment and trade among CARICOM members to replace the 1973 double tax convention. Unfortunately, it is based closely on the source taxation conventions of the Andean group conventions for the avoidance of double taxation.[50] The latter conventions apply both internally among Andean members and externally in tax treaties between Andean and non-Andean members. However, because the global trend is towards the OECD model, even among many developing countries, Andean countries such as Venezuela have abandoned the Andean tax convention in their negotiations with countries such as the United States. The adoption of the source taxation convention would be quite harmful to the stimulation or even facilitation of trade and investment among CARICOM members and even *vis à vis* extra-regional trade and investment. The purposes of the source taxation model, revenue raising and the prevention of tax evasion, can be solved in part by consumption taxes and in part by strengthened enforcement arrangements (discussed below).

An alternative to having the current or the proposed treaty would be to revise the Treaty of Chaguaramas and give the CARICOM institutions more authority to promulgate tax laws to facilitate and encourage investment flows. Such an approach would emulate the tax legislative capability of the EC. This may be unrealistic at present unless CARICOM is restructured and allowed taxing powers. It may be premature at the historical development of integration within CARICOM for the members to cede such power.

Another alternative for facilitating and encouraging investment within CARICOM would be for CARICOM to prepare model double tax convention(s) for use by the CARICOM members that want to use such models for encouraging investment and/or reducing tax evasion. It is important for the new model to be based on current global tax treaty policy, i.e. the OECD model or at least a model emulating a mix of the OECD and UN models. This arrangement would be normal. For instance, in the context of European integration, its members have maintained standard income tax treaties that reflect the OECD models. EC tax policy is gradually interacting with and superseding treaties, to the extent that the treaties may conflict with the Treaty of Rome and its amendments.

To prevent tax evasion and to raise revenue (one of the obvious purposes of the proposed CARICOM double taxation convention), CARICOM members should conclude an expanded and modern version of a multilateral convention on mutual assistance in tax matters. The Council of Europe/OECD Convention is the best model that can be adopted to CARICOM purposes. Alternatively, the model TIEA of the CIAT could be adopted for CARICOM purposes. Such a treaty could be a multilateral one to which all member states should participate or could be used as a prototype for bilateral TIEAs between interested CARICOM members. Clearly, a multilateral mutual assistance treaty that embraces, inter alia, assistance in administration and information, service of documents and assistance in collection are preferable. Because of the relative newness of the achievement of independence by each of the CARICOM members, the relative newness and frangibility of CARICOM's institutions, and the political importance to the countries and the principal taxpayers of revenue, such a treaty may be controversial. A potentially critical component in the CARICOM convention could and should be assistance for tax administration. Each of the CARICOM members has important elements of tax administration in which it needs assistance. The ability to earn revenue, the fairness and integrity of the tax system, and of course the nexus between the tax system and investment depends on the ability to administer the tax laws. One of CARICOM's goals is to provide some of these services to the region. Lack of resources has impeded achievement of some of its goals.

The linkage between budget and trade deficits, political and economic stability and overall development has interested some developed countries and international financial organizations. In particular, the IDB has discussed with CARICOM

48. For a useful discussion of the CARICOM tax treaty, see the paper given by Mr. Panniah Karalasingham, "An Examination of the Permanent Establishment and Residence in the CARICOM and other Treaties", prepared for the seminar on the CARICOM Tax Treaty and Tax Issues within CARICOM sponsored by the IFA, Barbados Chapter in association with the CLI (2-3 November 1990) (unpublished).

49. See e.g. the discussion by Mr. Karalasingham about Art. 25 on exchange of information at *Id.*

50. Andean Group Doc. No. 14, adopted by the Commission of the Cartagena Agreement, 16 November 1971, entered into force 1 January 1981.

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regional resources for tax administration and training. Other key players are the CIAT, the IMF and major donor countries, such as the United States, Canada, Germany and Spain. Until now the European countries have been the most far-sighted and innovative in providing tax assistance to regional bodies. At times when donors such as the US Government have offered assistance in tax administration on a regional basis, donees, such as the OECS countries, have not deemed the offer appropriate for consideration.

One trend within the international financial organizations, such as the World Bank Group, has been to emphasize tax compliance and maximizing potential for local revenue as a condition to structural adjustment programmes. Recent examples of these programmes are Mexico and Argentina. The technical assistance given to Mexico for tax administration has been a major success. The Argentine programme is still in a design phase and its implementation has not proceeded far enough yet to make any appraisals. More than likely, a conditionality of structural adjustments programmes in the future within CARICOM may be programmes to improve tax administration.

Assuming CARICOM members want to undertake a regional programme of tax administration in the context of a regional convention, the best models seem to be in the tax information exchange and implementation conventions between the United States and its territories. Some provisions of those conventions would serve as appropriate models for use.

2. Agreement on the Harmonization of Fiscal Incentives to Industry

Another convention on taxes *vis-à-vis* countries outside of CARICOM is the Agreement on the Harmonization of Fiscal Incentives to Industry. This Agreement was concluded in 1973 at the formation of CARICOM due to the need for promoting the balanced and harmonious development of CARICOM by conferring incentives to industry. It covers several important types of tax: relief from tonnage tax and customs duties on plant, equipment, machinery, spare parts and raw materials; relief from tax liability on export profits; depreciation allowances; carry-forward of losses; dividends and other distributions; and interest. Although the purpose is laudable – to coordinate fiscal incentives so that CARICOM members do not have highly divergent regimes *vis-à-vis* foreign investment – this Agreement has fallen into disuse and is not observed.[51]

It appears that the provisions of the Agreement already may conflict in some cases with national legislation, actual investment concessions to individual projects, double tax treaties and BITs. Pressure exists from multilateral development banks and governments outside CARICOM for CARICOM members to revise their treatment of foreign investment (e.g. Enterprise for Americas Initiative). The pressure is on the individual members rather than on the Agreement even though liberalization of national regimes would be in breach of the Agreement. The overlap of tax and investment regimes is becoming more common in the evolution of economic integration and free trade organizations. It creates both opportunities and problems. The problems spring from lack of agreement and coordination of the substantive and procedural provisions.

Any tax treaty models adopted should be coordinated with the Agreement or it should be cancelled. Otherwise there will be conflicting obligations among the double tax treaties, BITs and the Agreement. The conflicts will create confusion and lead to a lack of respect for the rule of law.[52]

B. *European Community*

1. Tax harmonization

The tax developments for the completion of a single European market exemplify this phenomenon.[53]

Until 1990, most of the progress concerning harmonization or approximation of tax rules within the EC occurred in the area of indirect taxation. Several value added tax (VAT) measures were taken. The Sixth VAT Directive produced a substantial body of VAT law. An extensive jurisprudence on VAT has emerged, both at the level of the European Court of Justice and in many of the EC member state tribunals in interpreting various aspects of VAT legislation. However, an impasse has occurred concerning further steps towards VAT harmonization.[54] A fundamental issue is how to combat fraudulent transactions designed to avoid VAT liability. Business is arguing against imposing too great a burden on taxpayers. However, the EC recognizes the need to promote a system which does not overly distort purchases (i.e. trade) between EC member states.

Substantial progress has been achieved in the area of excise duties on tobacco products, alcoholic beverages and mineral oils and fats.

The EC has harmonized capital duties within narrow bands, which have been consistently moved downwards. Currently, the rates are between zero and one percent. The EC Commission wants to abolish capital duties completely in the near future.

In 1990, the most important progress occurred in the area of direct corporate taxation. Three corporate tax directives were finally passed by the ECOFIN Council of 23 July 1990. The parent-subsidiary directive will, inter alia, exempt dividends (1) from EC-based subsidiaries owned 25 percent or more by an EC member state company from withholding tax, as well as (2) from 95 or 100 percent of the corporate tax otherwise due in the hands of that corporate shareholder (unless the

51. Some senior practitioners in the Caribbean and government officials have told the author that they had not even heard of it.
52. There is a project within CARICOM to revise and modernize the Agreement. It was to become operative in January 1991, but amendments were still being proposed in October 1990 and the new Agreement may not yet be in force.
53. For a discussion of the tax developments in the context of EC 92, see Liebman, "Summary of Tax Developments for the Completion of a Single European Market", *Materials of the Annual Spring Meeting American Bar Association Section of International Law and Practice* (1991), at 667, from which the discussion in this section relies heavily.
54. Proposals to approximate rates within two bands and to establish a clearing-house mechanism have been opposed. The EC Commission has proposed a transitional plan that would temporarily table the proposal to eliminate the VAT exemption for exports (i.e. retaining the destination principle) until 1996.

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recipient is instead accorded a tax credit in its home country for underlying mainstream taxes). The merger directive will permit a deferral of taxation on the cross-border transfer of assets occurring as a part of a qualified merger, division (split-up) or contribution of a branch of activities. The arbitration directive provides the basic tenets of a convention to provide for the mandatory resolution of transfer pricing disputes between EC member states. A number of items remain to be clarified, particularly concerning the details of such a tax arbitration procedure.

The EC Commission has stated that it wants to make a number of other proposals, such as the elimination of intra-group withholding taxes on interest and royalties and group consolidation of tax losses.

Other initiatives are the existing information exchange provisions and the proposals to strengthen them, and a 1984 proposal to establish and harmonize the corporate tax base.[55]

These tax and other directives and changes derived from the establishment of a single internal market in Europe are expected to reduce the operational need for establishing redundant sales subsidiaries and distribution operations in each EC member state. As a result, group reorganization and restructuring will be required for many multinationals.

2. Conflicts between tax treaties and European integration in the context of the Single European Market

A problem that has arisen in the context of the realization of the Single European Market is the challenge made to the tax treaty policy of member states, namely Germany. The possible effects of such a potential conflict, in the realization of Caribbean accelerated integration, bears consideration here.

(a) *Article 28 of the German/US tax treaty*

In particular the new income tax convention between Germany and the United States, which was signed on 29 August 1989, and which has now been ratified by both countries, contains a "treaty shopping" clause that is consistent with US treaty shopping policy.[56] The purpose of Article 28 is to prevent taking advantage of the treaty's privileges by interposing only a person that is resident in one of the contracting states. A person that is a resident of a contracting state and derives income from the other contracting state is entitled to the benefits of the treaty only if such person is: (a) an individual; (b) a contracting state or one of its public bodies; (c) an active "company" as defined in the treaty; (d) a company quoted and traded on a stock exchange; (e) a person beneficially owned more than 50 percent by persons which for their part are entitled to the benefits of the treaty or are US citizens, and using not more than 50 percent of its gross income to meet liabilities to persons not entitled to the benefits of the treaty; or (f) a not-for-profit organization.

Article 28(2) of the treaty entitles the competent authorities of the source state to concede the benefits of the treaty in individual cases even to a person that does not comply with the above-mentioned conditions.

(b) *EC treaty requirements*

Article 52 of the EC Treaty provides that each resident of an EC member state has the unconditional right to establish and manage undertakings in another member state of the EC, including the incorporation of subsidiaries. This is referred to as the "right of establishment". Companies that are established pursuant to the laws of an EC member state and that have their registered office, place of management or principal office within the EC can also benefit from this right under Article 58 of the EC Treaty. The European Court of Justice has held that discrimination of residents from another EC member state can occur through disadvantageous taxation.[57]

(c) *Compatibility of Article 28 and EC law*

The issue of the compatibility of Article 28 with EC law arises in the context of Article 28(1)(e) in the case of a German resident company when the majority of shares is held by persons qualified under the treaty or by citizens of the United States. By this restriction, German companies with a majority of shareholders that are residents from other EC member states are excluded from the benefits of the treaty.

The argument of discrimination of EC residents cannot be solved by referring to the "activity clause" in Article 28(1)(c), especially since the US tax treaties with Italy and France do not have such "activity clauses", or the competent authority discretion according to Article 28(2).

Pure holding companies are of course excluded from the treaty benefits by the activity provisions. Article 52 of the EC Treaty safeguards the unconditional right of establishment and freedom of capital movements to all companies of the EC without any discriminating restrictions. The subjection of companies to conditions regarding the persons participating in the company violates Article 52 in connection with Articles 58 and 67 of the EC Treaty.

Many commenters believe that Article 28 of the US/German income tax treaty injures European integration and tends to separate the national markets rather than facilitate their amalgamation into an internal market. Some commenters believe that the introduction of "treaty shopping clauses" contributes to the isolation of national markets. If the EC Commission also concludes that Article 28 of the US/German treaty infringes basic EC law, it would introduce a formal infringement procedure under Article 169 of the EC Treaty. A company affected by Article 28 could also bring the case before a national tax court for submission to the European Court of Justice pursuant to Article 177 of the EC Treaty.

Several potential solutions can be foreseen if the EC Commission rules that Article 28 infringes EC law. The United

55. The 1975 proposal to harmonize corporate tax rates and establish a common imputation tax credit system was temporarily withdrawn in 1990 and this initiative awaits the result of a study to be conducted by a "committee of experts".

56. For a useful discussion of the application of the treaty shopping problem to the US/German treaty and the EC challenge, see Becker and Thömmes, "Treaty Shopping and EC Law Critical Notes to Article 28 of the New German–U.S. Double Taxation Convention", *European Taxation* (June 1991), at 173.

57. Case 270/84 *Commission vs. France* of 28 January 1986, ECR (1986) at 273, 302.

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States and Germany can try to renegotiate the treaty. This would be extremely difficult and cumbersome. To assist, they could try to refer to secondary Community law, such as the 1990 parent-subsidiary Directive. Another approach would be to bring the member states' tax treaties in line with EC law by negotiating a common EC model treaty. The EC Commission would prepare it and the EC Council would then have binding effects for further treaty negotiations between an EC member state and any third country.

C. *The Western Hemisphere*

The free trade developments in the Western Hemisphere are having a catalytic impact on international tax developments.

As a result of the free trade agreement between the United States and Canada, withholding rates are being lowered significantly with several business groups demanding their complete abolition, so that capital may flow more freely. In the context of free trade, cooperation between the United States and Canada in tax enforcement is extremely close. Canada is the only government with which the United States automatically and regularly provides information on bank accounts. Simultaneous audits between the two countries are up.

A few years ago Mexico had no income tax treaties. Now it has an income tax treaty with Canada and TIEAs with both Canada and the United States. Soon Mexico and the United States will have a fourth round of negotiations and are about to conclude an income tax treaty. Again US business groups are requesting that, concomitant with the pledge to conclude a North American Free Trade Agreement, the tax treaty should not be the standard treaty with moderate rates of withholding taxes, but rather that the rates should be extremely low, so that the flow of goods is facilitated.

Propelling the tax aspects of free trade arrangements is competition. As long as corporations and other entities in Europe can make tax-free reorganizations and as long as dividends between parents and subsidiaries must be tax-free, other free trade arrangements will need to have tax provisions that are as conducive to international trade and business.

In the context of free trade arrangements, CARICOM governments would be wise to have a treaty programme. There are several components to such a programme. In the context of the Enterprise for Americas Initiative, framework agreements on trade have been concluded. Unfortunately, the Bush Administration did not make the conclusion of tax treaties a part of the Enterprise for Americas Initiative. A similar oversight occurred in the Reagan Administration when income tax treaties were omitted from the CBI. To compound the omission, Congress overruled the Reagan Administration's proposal for a tax credit (as the alternative to tax sparing) and then imposed the TIEA.[58] While TIEAs have the laudable objective of strengthening tax enforcement, they do not provide tax incentives and probably discourage some potential foreign investors. In practice, countries such as Mexico, Venezuela and Chile are beginning to start negotiating income tax treaties because of a reevaluation of their trade and investment infrastructure due to the explosion of free trade and economic integration in the Hemisphere.

Why should CARICOM or other governments of free trade agreements have a tax treaty programme? A tax treaty programme would eliminate double taxation, provide a more stable environment governing the rules for transnational investment and reduce withholding rates on items such as dividends, interest and royalties, thereby encouraging investment. A tax treaty programme would encourage foreign investors to the Caribbean and it would increase the use of those Caribbean countries for operations for investment and trade into their treaty partners.

VIII. PRINCIPAL EFFECTS OF DIFFERENT TREATY APPROACHES

Most importantly, CARICOM countries without tax treaties are disadvantaged when they compete for foreign investment with CARICOM and non-CARICOM countries with tax treaties. In addition, they have less ability to export goods and services than countries with tax treaties because when natural and artificial persons from their country trade and invest abroad, they will not be able to compete as well economically with persons from other countries. To the extent a CARICOM country has an international financial or services sector, a tax treaty programme may be able to attract foreign investment into that sector partly due to an advantageous treaty. One example has been the use of Barbados IBCs and the non-discrimination provisions in the 1983 tax treaty with the United States. It has resulted in substantial foreign investors in US real estate using Barbados in order to take advantage of the election under Section 897(i) of the US Internal Revenue Code.

The principal effect of having a treaty is that foreign investment will increase in CARICOM countries. A potential impact of a treaty is that the reduced withholding taxes may deprive the host (e.g. CARICOM) country of revenue that it would otherwise have received. To try to increase its revenue, developing countries have decided not to conclude tax treaties, whereby the withholding rates and perhaps even jurisdiction to tax would be reduced. When they decided to conclude tax treaties, they also utilized the UN model. Recently, developing countries, led by Mexico, have revised their policy. Mexico and Venezuela have decided to start negotiating tax treaties. Mexico has decided to utilize an OECD model. The past belief that a country would lose revenue if it concluded tax treaties or used the OECD model probably requires reexamination.

From the perspective of a private investor, a treaty provides assurance about the tax treatment that will apply. Many investors have difficulty finding or understanding the law of a foreign country. This problem is exacerbated in some Caribbean countries because codification has not occurred for many years and the laws and tax regulations are not easily located outside the Caribbean. An additional problem is that foreign investors do not know or understand the formulation and application of regulations. A treaty thus offers

58. For background on the development and other policy aspects of the TIEAs, see Zagaris, *supra* note 22 ; Zagaris, "The Caribbean Basin Initiative", 28 *Tax Notes* (1985), at 1021.

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more certainty for investors. Investors also can resort to the competent authority procedures in the treaty if a problem or dispute arises. Hence, there is a known procedure that can be utilized.

There is widespread agreement that treaties will increase flows of investment internationally.[59]

The use of the UN model approach will expand the opportunities for the host CARICOM government to raise revenue, provided the level of foreign investment is maintained or increases. If the tax regime, either because of another treaty or because of national laws within CARICOM, in combination with other economic factors, is more favourable in another CARICOM or non-CARICOM country, then foreign investment may not increase in the country trying to raise revenue and the policy may prove unsuccessful.

Use of the OECD model has the advantage of providing a more favourable tax regime to a foreign investor and also to the extent CARICOM countries can attract investors to use a tax treaty to export services (e.g. through an international financial sector). If an OECD model treaty is used in conjunction with BITs and other investment mechanisms, the increase in foreign investment, especially if they have a multiplier effect, may produce more revenue and development than the UN model.

Many different experts have argued for both the OECD and UN approaches. CARICOM and non-CARICOM countries have even combined these approaches in one treaty.

IX. OPTIONS

The recommended option is for the region to prepare a model tax treaty or perhaps two models, along the lines discussed above. The models would have an explanation of their purposes and variations, so that CARICOM countries could refer to it in negotiating. The model(s) should be periodically reviewed and revised.

Some issues and recommendations may be acceptable regardless of which model is followed. For instance, each CARICOM country wants to attract funds abroad for charitable organizations. Since the laws and policies of some governments, such as the United States, do not favour contributions to foreign charitable organizations, one of the ways to overcome these laws and policies is through the negotiation of tax treaties. Such provisions would provide a reciprocal deduction when citizens and residents of one treaty country make contributions to charitable organizations recognized in the other treaty country. Since the flow of contributions will normally and predominantly be from the developed to CARICOM countries, such a provision would be favourable to all CARICOM countries, notwithstanding their choice of a model.

Many CARICOM members may want more comprehensive provisions to prevent tax evasion and/or avoidance (i.e. tax information exchange and mutual assistance in tax matters and anti-treaty shopping provisions).

CARICOM members should consider the model(s) and tax treaty goals. Wherever possible, they should consider having multilateral negotiations. This would solve the problem of countries having to spend an inordinate amount of time concluding treaties with tiny countries with very limited markets. Unless the CARICOM members find a way to minimize the time and resources that a treaty negotiation consumes, most countries will continue to take the position that they do not have time and resources to negotiate with so many small countries.

One requirement for an effective tax treaty programme is for CARICOM as an organization, CARICOM members and the interested private sectors (i.e. within CARICOM and in external donor countries)[60] to invest sufficient resources to have the material and human resources to design and implement policies. One of the most economical ways this can be achieved is for one of the regional institutions to undertake the investment.[61]

With respect to TIEAs, CARICOM as a whole and CARICOM members should try to obtain more benefits from the United States in exchange for concluding TIEAs. The provisions to stimulate investment by US persons in the Caribbean, the investment tax credits, were removed from the initial proposal of the Reagan Administration. Without substantial mechanisms to motivate US persons to invest in the CBI countries that have signed the TIEA, the TIEAs benefit the United States much more than the CBI countries with TIEAs. Unless the United States clearly distinguishes in the US persons eligible for benefits, such as tax credits and deferral and makes eligibility contingent on the existence of a TIEA, the CARICOM members will not be realizing the potential benefits that could flow from assisting the United States in enforcement cooperation. Among CARICOM members, a convention on international assistance in tax matters modeled on the Council of Europe/OECD Convention, would be useful to tax enforcement cooperation.

As accelerated integration proceeds, CARICOM institutions may well have to consider whether treaty shopping and other provisions of such treaties comply with CARICOM law, and take steps accordingly.

CLI and/or CARICOM may want to make recommendations on a model CARICOM TIEA or a type of convention for administration assistance in tax matters. The tax exchange of information and implementation agreements between the United States and its territories provide examples of the types of agreements that have tax administration provisions.

59. A comprehensive macroeconomic review of the principal effects of different treaty approaches is beyond the scope of the paper.

60. In Europe, Germany and Spain are among the major donors to tax administration through their contributions to the CIAT.

61. For instance, the University of the West Indies, in cooperation with the Caribbean Association of Industry and Commerce, the Caribbean Development Bank and initially one or two external institutions, could provide the instruction. Courses and practical research and development could occur as part of the regular curriculum and as part of an associated organization, such as a Caribbean Institute of Services. Technical and financial assistance is available through the European Development Fund and the provisions of the Lomé IV Convention, provided it is a regional project. For additional background on this idea and for the precise proposal, see Zagaris, "Application of the Lomé IV Convention to Services and the Potential Opportunities for the Barbados International Financial Sector", 45 *Bulletin for International Fiscal Documentation* (June 1991), at 289.

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CLI and/or CARICOM may want to make suggestions on non-tax treaties that are useful, and model provisions for such treaties. In particular BITs would serve this purpose. CARICOM or CLI may want to assist in providing a model or alternative model BITs.

To remain competitive, CARICOM must reconsider and revise its internal tax treaties. For instance, there is both a fiscal harmonization agreement entered into by the CARICOM members in the mid-1970s and the 1973 CARICOM double taxation treaty between the most developed and the less developed countries. The CARICOM double taxation treaty is based for the most part on the old (1964) OECD model treaty. Tax incentive legislation in individual member country chapters follows this harmonization agreement. The double tax treaty is in need of revision. Alternatively, if the 1973 CARICOM double taxation treaty is not revised in the near future, it may be preferable to some countries, after receiving CARICOM's approval, to negotiate their own arrangements. Eventually, CARICOM itself may want to follow the EC model of making legislation that controls tax relations among member countries within the Community and eventually, at least to some extent, outside the Community.

Similarly, the Agreement to Harmonize Investment Incentives has fallen into disuse and may well conflict with national laws and agreements of CARICOM members. Hence, if not already done, it needs to be revised or scrapped.

As CARICOM starts achieving substantial progress towards realizing the free and unrestricted movement of people, goods and capital, it will need to consider harmonizing its tax systems. In that regard, it may want to consider providing more authority to the ministers in charge of finance to study and propose means of achieving tax cooperation and harmonization in the context of accelerated economic integration. In the short-term it may want to facilitate or commission some studies and try to strengthen CARICOM institutions, such as the COTA and the tax policy resources within CARICOM, and initiate tax policy research capability within CARICOM (i.e. University of the West Indies, CAIC, and the proposed Caribbean Institute on Services).

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FINANCIAL SERVICES IN THE BRITISH VIRGIN ISLANDS

Michael Riegels

Michael Riegels *was born in Tanzania and educated in Kenya and at Oxford University. He is a member of Grays Inn and was called to the Bar in England in 1961. He was admitted as an Advocate in Tanzania in 1962. After practising for ten years in Dar-es-Salaam he settled in the BVI in 1973 where he joined the law firm which is now known as Harney, Westwood & Riegels, of which he is the Senior Partner.*

Until I read the conference papers I thought that the British Virgin Islands (BVI) was unusual although probably not unique in that it offers investors a choice of low tax or no tax, but from the table of tax rates in the Caribbean[1] it is clear that several Caribbean countries offer such a dual tax regime. However, when you look at the actual rates of tax offered by other jurisdictions it would probably be more correct to say that they offer the choice of "no tax" or "not very high tax". Our nearest competitor appears to be Montserrat which offers no tax or a 20 percent tax, followed by Jamaica with no tax or a 33.3 percent tax, but the Netherlands Antilles is in there fighting with an alternative tax rate of between 27-34 percent. And again if I have read my papers correctly Aruba should also be included amongst those countries offering a zero rate in certain circumstances, and a rate of between 27-34 percent in other circumstances.

Traditionally, the BVI has always been a low tax jurisdiction. For many years the top rate of income tax was 12 percent but it has crept up over the years so that the top rate for individuals is now 20 percent whilst the rate for companies is a flat 15 percent (with some lower rates for special circumstances).

BVI tax is very simple – there are no personal allowances – and except for certain categories of income which are exempted (such as domestic servants), tax is payable from the first dollar earned. For the individual taxpayer the rates are as follows:

$	0	– $ 2,500	3%
	2,501	– 7,500	6%
	7,501	– 15,000	10%
	15,001	– 25,000	15%
over	25,000		20%

One somewhat unusual feature of BVI tax is that the top rate – and for most purposes the only rate – of tax for companies is lower than the top rate for individuals but there is no tax on dividends. Thus for an individual earning in excess of about $ 28,000 it is sensible to form a company which will then employ the individual and pay only 15 percent tax on net income over and above the individual's salary which can be distributed to the individual tax free.

The international investor, however, is unlikely to reside in the BVI and thus his interest in BVI tax would normally be with a view to minimizing his tax elsewhere, and to achieve this objective he would invariably want to use a BVI company. For many years, like our friends in the Netherlands Antilles, the BVI prospered from the extension of tax treaties negotiated between the United Kingdom and other high tax areas.

At the height of the golden era of double tax treaties the BVI had double tax treaties with the United States, Canada, New Zealand, Denmark, Norway, Sweden, Switzerland and Japan. Most of these treaties allowed for reduced withholding taxes on dividends and interest and in most cases allowed royalties and commercial profits where there was no permanent establishment (PE), to leave the high tax areas without suffering any tax at all.

Slowly but surely these treaties were curtailed and cancelled, but two treaties remain in force, i.e. the treaties with Japan and Switzerland.[2] In my experience the Swiss treaty, which was extended to the BVI on 1 January 1961, is very little used and is somewhat limited in that its principal benefits are that it exempts from tax, royalties (which includes rent for films and for the use of commercial, industrial or scientific equipment) and, subject to the PE test also exempts from Swiss tax, capital gains and industrial and commercial profits. There are also exemptions arising from the operation of ships and aircraft. The operation of aircraft I can understand but I cannot believe that there is much scope for shipping activities in Switzerland.

1. See A. Johnson, "Recent Tax and Foreign Investment Developments in the Caribbean" in this issue, at 109.

2. Again I am indebted to the very interesting analysis of treaties prepared by Annette Johnson, which shows that several Caribbean jurisdictions enjoy the benefit of the extension of UK treaty with Switzerland.

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The interesting treaty is of course the one with Japan with which country I see no other Caribbean jurisdiction has a treaty. The treaty is quite a good one. It is an extension of a UK treaty and was extended to the BVI with effect from 1 January 1963. It features the following:

- the usual commercial and industrial profits exemption otherwise than from a PE, and the ships and aircraft exemption;
- in the case of dividends paid by a Japanese company the withholding tax is reduced to 15 percent, and where more than 50 percent of the Japanese company is owned by a BVI company, to ten percent;
- dividends paid by a BVI company out of income derived from Japanese sources are free of Japanese tax if paid to non-residents of Japan;
- withholding tax on interest payments to a BVI company is ten percent;
- withholding tax for use of copyrights, patents, film rentals and for use of industrial, commercial or scientific equipment is limited to ten percent as is tax on capital sums derived from the sale of patents and royalty rights to a BVI company.

As mentioned earlier, BVI corporate tax is levied at the rate of 15 percent. Taxable income is computed after taking all the normal deductions properly incurred in earning the income, and management fees are an acceptable form of deduction. Thus if BVI tax is not offset by tax credits it can be reduced by management fees paid to a suitable advisor situated in a zero tax area, but in such cases it is advisable to discuss the effect and scope of the management fee beforehand with the BVI tax authorities because although it is not possible to negotiate tax rates in the BVI, the tax authorities will usually advise whether or not a management fee is acceptable in given circumstances.

There are also generous tax credits available in the BVI. Any foreign tax paid on the same income is available by way of tax credit and where appropriate provisions are obtained in double tax treaties, in the case of dividend income, tax on the underlying profits from which the dividend was paid is also available by way of tax credit. Thus where a BVI company owns more than 50 percent of a Japanese company the reduced withholding tax of ten percent in Japan is a direct credit against BVI tax, and in most cases the Japanese taxes levied on the income from which the dividend is paid may also be claimed as a credit leaving no BVI tax to be paid.

There are no capital gains taxes in the BVI and no inheritance taxes or estate duties. In order to take advantage of tax treaties, however, the company must be incorporated under the Companies Act and must be a resident company, i.e. it must be controlled and managed in the BVI. It will be deemed for tax purposes to be so controlled and managed if a majority of its directors are resident in the BVI.

The BVI/US treaty was certainly the most widely used treaty and with its cancellation in the early 1980s, the BVI decided in 1984 that in addition to being a low tax jurisdiction, it would join the ranks of the no tax jurisdictions, and for this purpose the International Business Companies Ordinance was enacted which created the International Business Company (IBC), a company which is prohibited by law from carrying on business with residents and therefore can only do business with non-residents. The name IBC is not very original and our friends from Barbados will assert that they were using this name and concept long before it dropped anchor in the BVI. It has now become so popular, however, that it has been taken on board by the Bahamas and other jurisdictions as well. What we did in the BVI was to combine no tax with a very modern and streamlined company law and the result has been very successful. There are now more than 60,000 IBCs in the BVI – that is more than four companies for every man, woman and child in the Territory and the rate of new incorporations runs at about 1,000 a month.

It is difficult to say too much about companies which are exempt from tax at a tax conference. It is a bit like comparing different brands of whisky at a convention of teetotallers, but suffice it to say that zero tax entities have a place in any tax planning structure, besides which IBCs are very useful tax planning tools in that:

- they can redeem shares and reduce capital with a minimum of formalities;
- they have the utmost flexibility in the distribution of assets by way of dividend. Before making any distribution directors are required, bona fide, to satisfy themselves as to the solvency of the company and that the company can meet its liabilities in the ordinary course of its business. For such purpose the directors may take into account unrealized gains, but having made such a determination the company may distribute all assets in excess of the company's liabilities as established by its accounts and its capital;
- dividends can be distributed to certain classes of shares and not others;
- there is no minimum capital requirement;
- there are no requirements for specific debt-to-equity ratios;
- assets can be allocated to different classes of shares;
- IBCs can exist without any shareholders although in such circumstances the directors will be personally liable for the company's debts.

Most of the features upon which I have dwelt so far are features that could well be attractive to the international tax planner, but there are other attractive features which make an IBC popular to those who have exchange control problems.

A selection of such features would be the following:

(1) Registered and bearer shares can be issued and holders of either can convert such shares into the other type.
(2) Shares may be issued with or without par value and need not be numbered.
(3) An IBC may purchase and own its shares.
(4) A company incorporated under the Companies Act may be converted into ("continue as") an IBC.
(5) A foreign company may continue as an IBC without any reciprocal arrangement in the jurisdiction of incorporation.

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(6) A foreign company may provisionally continue as an IBC subject to instructions for the continuation being given to the Registry by a nominated third party.
(7) An IBC may continue itself in another jurisdiction.
(8) An IBC may fully indemnify officers and agents from corporate funds.
(9) An IBC may merge, consolidate or enter into arrangements with other IBCs, with companies incorporated under the Companies Act or with foreign companies.
(10) The directors may protect the assets of the IBC for the benefit of the IBC, its creditors and its members and for any person having a direct or indirect interest in the IBC by transferring the assets of the IBC to another company or legal entity in trust for the IBC, its members, creditors and persons having other direct or indirect interests in the IBC.[3]
(11) Where a foreign government expropriates or imposes confiscatory taxes upon the shares or other interests in an IBC, the IBC or any person holding shares or other interest may apply to the court for an order that the IBC disregard the action of the foreign government and continue to treat as members or interest holders those persons whose shares or interests were subject to action by the foreign government.
(12) Minority shareholders have the power to dissent from certain transactions and to obtain fair value for their shares.
(13) The power to amend the Memorandum and Articles may be given to the directors.
(14) An expeditious and simple form of voluntary winding up is available for solvent companies.
(15) An IBC may rescind voluntary winding up proceedings after the commencement thereof.
(16) An IBC may apply to a judge in chambers, without the necessity of joining any other party, for a declaration on any question of interpretation of the IBC Act or the Memorandum or Articles of an IBC.

These companies can be formed cheaply and quickly. The Companies Registry is extremely efficient which is important if certified copies of documents or certificates of good standing are required, or if mergers need to be accomplished within tight deadlines. Annual Government fees for most companies are $ 300, and for companies with large capital, $ 1,000 per annum.

The IBC is popular because it is many things to many people. It can do things which other more conventional companies cannot do and can thereby step around the tax laws in other jurisdictions which cannot imagine the existence of such a creature.

Before concluding I would like to dwell very briefly on two other points: the exchange of information and recent developments in BVI laws to broaden the scope of the financial services which we offer.

As regards the exchange of information the BVI always has and I believe always will adhere robustly to the principle that except where we have tax treaties in force we will not act as tax collectors or assistant tax collectors for any other jurisdiction. The United States chose to cancel its treaty with the BVI and quite frankly neither the carrots nor the stick are such as to cause us to change our mind. That does not mean, however, that in the BVI anything goes and I feel it would be remiss of me if I did not make the point that the steady growth of international crime and fraud is a matter of great concern.[4]

It is my belief that concerns over international fraud and international crime will soon eclipse the problem of mere tax evasion and the financial centres will have to make a choice as to how they wish to conduct their affairs. Will they be a haven for criminals or will they recognize the fact that offering financial services also means offering responsibility? As far as the BVI is concerned there is no question but that we want no truck with those bent on crime or fraud and we have reached this conclusion without any carrots or sticks from the United States.

The BVI recently embarked on a new and far-reaching regulatory regime where we seek not so much to regulate the people doing business with the BVI but more to regulate those who handle their business in the BVI. Any form of regulation is an inconvenience but "no regulation" is as great a peril as "over-regulation". There is no foolproof method of detecting criminals or potential criminals and not even the most sophisticated regulatory mechanism will achieve this. However, the dangers of the criminals moving in can be minimized by demanding high standards of those who operate in the offshore business, and trying to eliminate negligence, laziness and the "couldn't-care-less" attitude.

That is one way to tackle the problem, but that in itself is insufficient. Any jurisdiction which wishes to enjoy a good reputation must decide how and where to differentiate between a legitimate desire for confidentiality and an illegitimate desire to conceal the proceeds of fraud and crime from the innocent victims thereof. We in the BVI are trying to tackle this problem because we are determined to keep our jurisdiction as clean as possible.

So if anything, I think you can expect from the BVI a tightening up on such things as bearer shares, the total anonymity of directors, and the absence of any statutory framework requiring disclosure of information in the event of established fraud or crime. For the legitimate businessman the BVI will continue to be a helpful and useful jurisdiction, but for the international criminal the welcome mat is definitely not on the floor.

Finally, I would like to dwell on two recent developments in our law which are intended to keep the BVI in the forefront of the financial services business. There is presently passing through our legislative assembly, some amendments to our trust law which are long overdue. These amendments in brief:

3. This may appear to be a very esoteric benefit but advantage was taken of this provision during the Gulf War.
4. The subject is very much in the news at the moment, first with Barlow Clowes involving tens of millions of dollars, then with Robert Maxwell involving hundreds of millions, and finally to the largest international fraud ever – so far – the BCCI, involving thousands of millions of dollars.

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- introduce a fixed perpetuity period of 100 years;
- introduce the so-called "wait and see" rules;
- clarify the tax-exempt status of trusts for non-residents;
- eliminate registration requirements for trust deeds;
- introduce the concept of the purpose trust, i.e. a trust with a business purpose would be possible.

The second piece of legislation which will shortly be enacted will regulate partnerships and introduce the concept of limited partnerships into BVI law. This is a definite lacuna in our law since limited partnerships are a very effective tax planning tool in the United States and elsewhere, and there is a definite perceived need to have limited partnerships as part of BVI law. BVI law will follow very closely the law in Delaware.

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FINANCIAL SERVICES IN THE NETHERLANDS ANTILLES

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INTRODUCTION

Like Aruba, the Netherlands Antilles (NA) is an autonomous part of the Kingdom of the Netherlands. It is an associate member of the EC. The head of state is Queen Beatrix, who is represented in the NA by a Governor General. The NA has its own legislation and monetary system. The currency is the NA guilder which is maintained at a fixed rate versus the US dollar.[1]

The NA consists of five islands: Curaçao, Bonaire, Sint Maarten, Sint Eustatius and Saba.[2] Curaçao is the largest with approximately 150,000 inhabitants. The central government of the NA and Parliament reside in Curaçao. The NA is governed by a Cabinet of Ministers headed by the Prime Minister. The Parliament is democratically elected every four years. Each island has its own government and parliament, and certain responsibilities are delegated by the central government to the respective island governments, but most taxes are imposed by NA law (Central Government).

The main pillars of the economy are trading and distribution (Free Zone and container terminal), oil refining, tourism, transshipment, ship repair and the financial offshore industry. For the financial offshore industry Curaçao is the most important island which houses some 35 trust companies and about 50 offshore banks. In addition, there are some 20 trust companies which have been established to serve selected interests. The offshore industry in its present form dates from the early 1950s, and directly employs over 1,200 individuals. According to the commercial register there are nearly 20,000 offshore companies.

COMPANIES

The NA limited liability company (NV) is the most common type of legal entity in the NA. An NV may be formed by one or more persons, either individual or legal entites, and may be either a public or a closely held company.

Once an NV is incorporated it must be registered with the Commercial Registry of the Chamber of Commerce and Industry.

The minimum authorized capital of an NV is US$ 30,000 (or the equivalent in another currency). At least 20 percent (or US$ 6,000) must be paid up and must be outstanding at all times. An NA company may repurchase its own shares so long as they are fully paid up and provided that 20 percent of the authorized share capital remains outstanding.

If provided by the Articles of Incorporation shares may be common shares, preference shares, non-voting shares or shares with limited voting rights. Shares may be registered or bearer, they must have a par value, and if registered, may be partly paid to a minimum of ten percent of par value. The names of the shareholders are not registered in any public record.

An NV is managed by a board of managing directors, consisting of at least one individual or corporate managing director, and at least one managing director must be resident in the NA. An NV may have a supervisory board to advise and supervise the board of managing directors but this is not mandatory.

The annual general meeting of the shareholders must be held within nine months of the company's financial year end. The managing directors must present the financial statements[3] and a report of the managing directors at the annual meeting. An audit of the financial reports is not mandatory unless so mandated by the articles of incorporation or the shareholders.

1. The last time the Netherlands Antilles changed the parity of its guilder was 20 years ago.
2. Aruba was part of the NA until 1 January 1986 when it obtained *status aparte*, as a separate part of the Kingdom of the Netherlands.
3. The financial statements are comprised of a balance sheet and a profit and loss account and notes.

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To protect the rights of creditors, NA legislation contains rather extensive provisions regarding the dissolution of limited liability companies. The liquidation process must be initiated by the shareholders by a resolution at the general meeting. Once in liquidation the company's affairs are managed only by the liquidator. The company continues in existence but only to the extent that this is necessary to wind up its affairs.

Notice of the liquidation must be published in the Official Gazette and the plan for liquidation must be filed at the Commercial Registry for public inspection. Creditors may object to the plan within two months after filing. After expiration of the two-month moratorium and after the creditors have been paid the liquidator can make the final distribution of assets to the shareholders. A final account is then filed with the Chamber of Commerce; if no objections are filed within three months the liquidation procedure is completed and the company stricken from the Commercial Registry. After liquidation, the company books must be kept in custody for 30 years.

TAX SYSTEM

Broadly, resident companies and other taxable entities are subject to profit tax on their worldwide income.[4] The tax rates vary depending on whether the company is an onshore or an offshore company. An onshore company mainly carries on business activities in the NA. The purpose of an offshore company is to derive income from investment or trading activities outside the NA and its shares are held only by non-residents; such companies, which include trading companies, finance companies, investment/holding companies, intellectual property and patent-holding companies and shipping companies, are deemed resident companies for NA tax purposes. Certain of the individual types of offshore companies are discussed below.

The tax rate for onshore companies, which is progressive, ranges from 37-40 percent, including the 15 percent island surcharge. Investment, holding, finance and intellectual property and patent-holding companies, however, qualify for concessionary tax treatment under Articles 14 and 14A of the Profit Tax Ordinance, i.e. they are subject to tax at the rate of 2.4% on net income of US$ 56,000 and three percent on the balance.[5] For companies engaged in other activities a special advance ruling must be obtained in order to be treated under the advantageous tax regime.

Non-resident companies (both on and offshore) are taxed to the extent that they engage in business in the NA through a permanent establishment, on profits derived from real estate in the NA and on profits derived from claims whose principal amount is secured by a mortgage on real estate situated in the NA.

Capital gains derived by onshore companies are included in the taxable income and taxed at the usual rates. Capital gains derived by companies which qualify under Article 14 or 14A (i.e. offshore companies) are exempt from tax, and capital losses are not deductible. There are no withholding taxes on interest, royalties or any profit distributions. No capital tax, sales tax or inheritance or gift tax is imposed on non-NA resident private individuals in the NA.

A tax return must be filed annually with the Inspectorate of Taxes, together with the company's financial statements. The return must generally be filed within six months of the financial year end.

Investment/holding companies and finance companies

Portfolio investment/holding companies are companies established to invest in securities such as shares, bonds, etc. Finance companies engage exclusively in borrowing and lending activities, i.e. to borrow sums from third parties which are then used to furnish loans to affiliated companies. All of the above companies are eligible for the reduced rate of profit tax (i.e. 2.4/3 percent) upon application to the tax inspector.

Patent-holding companies

Patent-holding companies are offshore companies whose principal object is the receipt of royalties and technical service payments from sources outside the NA. These companies are subject to the reduced rate of profit tax on the net amount of royalty income received.

OTHER TYPES OF COMPANIES

Offshore banks

As mentioned above the NA hosts about 50 offshore banks which are licensed to conduct international banking transactions with offshore companies and with non-resident individuals.[6] Investment and interest income qualifying under Article 14 of the Profit Tax Ordinance is subject to the reduced rate of tax. Other types of foreign-source income will be taxed at the rates of 24-30 percent unless reduced by a ruling of the tax inspector.

Captive insurance companies

Special rules apply to captive insurance companies, i.e. companies whose activities only consist of insuring the risks of other companies. The profits of qualified companies which do not receive any treaty related income will be set at NAFl. 100,000 and taxed at the rate of 2.4 percent, thus limiting the amount of tax payable to NAFl. 2,400.

Real estate companies

Resident companies and NA offshore companies carrying on business in the NA through a permanent establishment are

4. A company is deemed resident in the NA if it is established under the laws of the NA or if its effective management and control is located in the NA.
5. According to the Guaranty Ordinance of 1976, the reduced taxation regime will apply to the offshore sector through to the financial year commencing 1 July 1999.
6. Many offshore banks have been established by Dutch banks, but countries such as Canada, France, Germany, Italy, Saudi Arabia, Switzerland and the United States are also represented.

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exempt from tax in respect of profits derived from real estate situated outside the NA.[7]

Mutual funds

Certain countries allow foreign mutual funds to operate directly in their domestic markets, or as the case may be, allow them to be marketed locally if supervised or regulated by a recognized foreign authority. There is no supervision of mutual funds in the NA, although they may be regulated by the Central Bank in the Netherlands; therefore mutual funds may be marketed in foreign countries and may operate in foreign financial markets.

As from 1 January 1988, mutual funds incorporated in the NA are exempt from profit tax on non-treaty related income provided they meet certain criteria, i.e. the fund should have either at least US$ 50,000,000 in net assets, a participation of at least 50 shareholders and four local employees or minimum net assets of US$ 300,000,000 and two local employees. Mutual funds that do not meet this criterion will be taxed on non-treaty related income at the rates of 2.4 to 3 percent with a minimum charge of US$ 1,000 and a maximum of US$ 10,000.

TAX TREATIES

The NA currently has a tax treaty with Norway.[8] The 1955 treaty with the United States was terminated as of 31 December 1987, except for Article VIII, which provides for an exemption of US withholding tax on interest paid by US sources to a resident of the NA if the NA recipient waives the right to be taxed under the low rates, i.e. the exemption only applies if the NA company is subject to the tax rates of 24-30 percent on its net taxable income.

TAX REGULATION OF THE KINGDOM OF THE NETHERLANDS

The 1964 (as amended) Tax Regulation of the Kingdom of the Netherlands governs double taxation issues between the NA, Aruba and the Netherlands. The principal benefit offered by the Regulation relates to the tax treatment of dividends received from the Netherlands by NA companies. Withholding tax on dividends paid by a Netherlands source to a NA party is 15 percent; however, if the NA company has a participation of at least 25 percent of the capital of the Dutch company, the withholding tax is further reduced to 7.5 percent. The rate is reduced to five percent if the NA company elects to be taxed in the NA at a rate of at least 5.5 percent.[9]

7. The exemption extends to real estate profits distributed to the NA by a subsidiary which carries on business through a permanent establishment in the Netherlands or Aruba.
8. The NA formerly had treaties with the United Kingdom and the United States. The Norway and UK treaties have been terminated in full, and the US treaty has been terminated except for Art. 8 dealing with the treatment of withholding tax on interest. Negotiations are taking currently place with Austria, Belgium, Italy and Sweden.
9. Tax Regulation for the Kingdom of the Netherlands, Art. 11(3).

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 53-56 of the January 1993 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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  release 65
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CUMULATIVE INDEX – 1993 Nos. 1-2

I. ARTICLES

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Hong Kong:
Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

John Prebble:
100 Years of Income Tax 59

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

United States:
Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

United States/Netherlands:
Wim Wijnen
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96

IV. CONFERENCE DIARY 39

V. BIBLIOGRAPHY

– Books 49, 100
– Loose-leaf services 51, 103
– List of addresses of the major publishing houses appearing in the Bibliography 53

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CONTENTS

VOL. 47 NO. 4 **APRIL 1993**

LIMITATIONS ON BENEFITS UNDER THE NEW US–NETHERLANDS INCOME TAX TREATY — 159 — *Philip H. Spector*

The limitations on benefits provision in the new US–Netherlands income tax treaty is the most detailed and probably the most heavily negotiated limitations on benefits article in the history of bilateral tax agreements. Mr Spector first looks at the reasons why the Netherlands is an attractive location for holding companies and finance subsidiaries for international groups. He then overviews the US response to treaty shopping since 1981. The remainder of the article describes in detail the requirements of the various categories of treaty entitlement.

TREATY SHOPPING UNDER THE NEW US–NETHERLANDS TREATY — 175 — *Philip T. Kaplan*

The new US–Netherlands tax treaty carries anti-treaty shopping provisions to new heights – some 23 pages of text under the limitation on benefits provision and a memorandum consisting of 30 numbered sections of which 15 concern the limitation on benefits article. By using diagrams and charts Mr Kaplan sets out the limitation on benefits provisions in such a way to make them comprehensible to all.

INTERNATIONAL: INDICATIONS OF FUTURE POLICY IN THE LATEST OECD TASK FORCE REPORT — 181 — *Jill C. Pagan*

The primary objective of the Committee on Fiscal Affairs Report on the proposed IRC Section 482 regulations was to reinforce the various representations to the US Treasury by governments and international commercial and trading associations. The full Report was made available by the OECD in January 1993 (the report appears in the January issue of the *Bulletin*), the month in which the United States issued its new regulations. Jill Pagan takes a critical look at the Report, concluding that it is a hastily produced response the proposed regulations which fell prey to an over-preoccupation with tax avoidance.

UNITED STATES: TRANSFER PRICING REGULATIONS ISSUED — 187 — *Stanley C. Ruchelman*

The temporary and proposed Section 482 regulations issued on 13 January 1993 revise the rules under which cross-border transactions between controlled parties are examined to determine whether they have been carried out at arm's length. The substantive regulations were accompanied by two sets of proposed regulations: one to limit the impact of foreign law on the ability of the IRS to make an adjustment, and the other set addresses the reasonable cause exception to the accuracy related penalty in transfer pricing matters.

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The International Guide to Mergers and Acquisitions

European Tax Handbook 1993

and

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Now Weekly!

JAPAN: TAXATION OF DIVIDENDS AND INTEREST — 202 — *Alum Bati*

This article discusses the taxation of dividends and interest paid to, or received from, non-Japanese companies. The focus is on the new thin capitalization rules as well as withholding taxes and the method of giving tax credit for foreign taxes.

DENMARK: TAX STATUS OF EXPATRIATES — 211 — *Bente Moll Pedersen*

Denmark recently adopted a new tax regime for foreign employees transferred to the country for a period of six to 36 months, i.e. under certain conditions such employees may opt to be taxed at a flat rate of 30 percent of the monetary payments under a service agreement.

FRANCE: MAJOR MEASURES CONCERNING INTERNATIONAL TAXATION: THE FINANCE ACT 1993 AND TRANSFER OF ASSETS ABROAD — 214 — *Pierre-Jean Douvier*

The Finance Act 1993 contains a number of important measures for corporations, including reduction of the corporate tax rate, abolition of the surtax due on distributions of income and abolition of the "five percent rule" so that dividends received under the affiliation privilege will be completely exempt from tax. Additionally, the CFC provisions of Section 209 B have been tightened and the three percent tax on French real estate owned by certain foreign companies has been modified. Finally, a measure has been introduced affecting French companies which transfer assets abroad to a third person or trustee for certain purposes.

EUROPEAN COMMUNITY: CORPORATE INCOME TAX HARMONIZATION IN THE NINETIES — 220 — *Dr. George Mavraganis*

The establishment of the single market, the conclusion of the Treaty on European Union, the Ruding Report and the EC Commission's reaction to that Report will influence the development of the harmonization of corporate tax law of the EC member states. This article examines the implications of these events for corporate tax harmonization.

IFA NEWS — 219

BIBLIOGRAPHY — 226
- Books 226
- Loose-leaf services 231

CONFERENCE DIARY — 186

CUMULATIVE INDEX — 225

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LIMITATIONS ON BENEFITS UNDER THE NEW US–NETHERLANDS INCOME TAX TREATY

Philip H. Spector

Philip Spector is a US tax partner with the New York office of the international law firm Watson, Farley & Williams. Mr Spector specializes in cross-border transactions and has published numerous articles in US tax and financing journals. He is a graduate of Columbia University (B.A., 1978), the University of Pennsylvania Law School (J.D., 1981) and New York University School of Law (LL.M. in Taxation, 1986).

I. INTRODUCTION

The eagerly anticipated new income tax convention between the United States and the Netherlands (the "Treaty"), together with an accompanying Memorandum of Understanding (the "Memorandum") was signed on 18 December 1992. The signing concludes protracted negotiations that began a decade ago. When it becomes effective, the Treaty will replace the current convention, which was concluded in 1948 and supplemented in 1965.

The Treaty's provisions generally have precedents in the US and OECD model treaties and recent US treaties with developed countries (e.g. the US–Germany treaty concluded in 1989). However, one clear and significant departure from precedent is the Treaty's long and complex limitation on benefits provision. This is the most detailed and probably the most heavily negotiated limitation on benefits article in the history of bilateral tax agreements. The length and detail is due in large part to the United States' interest in preventing "treaty shopping" (third party use of the Treaty), and the Netherlands' competing desire to retain its status as an attractive location for holding companies and finance subsidiaries for international groups. The result of these competing interests is a provision that seeks to define with unprecedented precision who is eligible for Treaty benefits and who is not.

A. *The attraction of the Netherlands*

The Netherlands generally imposes a corporate income tax at rates up to 40 percent, but the "substantial holding privilege" or "participation exemption" can completely exempt from tax dividends received from domestic and foreign corporate affiliates and capital gains from the sale of affiliate stock. Thus, a Netherlands corporation may be completely free from Netherlands tax if its sole activity is to act as a vehicle for receiving and distributing subsidiary earnings and for the acquiring and disposing of subsidiary stock. The Netherlands is also an attractive home for holding companies because the comprehensive Dutch tax treaty network can substantially reduce (often to zero) withholding taxes levied at source on dividends received from subsidiaries and Dutch withholding taxes on dividends paid to the Dutch holding company's parent or shareholders.

Netherlands companies have also been used as finance companies for multinational corporate groups. Such a company borrows from within or outside the group and onlends the funds to affiliates. Under Dutch tax practice, the Dutch company is required to earn a marginal "spread" on its borrowing and lending activities, and this spread is subject to the corporate income tax. However, the Netherlands imposes no withholding taxes on interest payments made by a Dutch company and most tax treaties with the Netherlands substantially reduce (often to zero) any withholding taxes levied by the countries where the funds are used.

The Netherlands has tax treaties with many countries that either do not have an income tax treaty with the United States, or whose treaty with the United States is less favourable than the US–Netherlands treaty. Residents of such countries, and residents of countries that do not have a tax treaty with either the United States or the Netherlands, have utilized Netherlands holding companies and financing companies in order to take advantage of the existing US–Netherlands tax treaty. For example, a large amount of Canadian investment in the United States is structured through Netherlands holding companies in order to reduce the US withholding taxes on interest and dividends from 15 and 10 percent (under the US–Canada

Contents

I. Introduction
A. The attraction of the Netherlands
B. Responses to treaty shopping
II. Description of Article 26
A. Qualified persons
1. Individuals
2. Governments
3. Not-for-profit organizations
4. Publicly-traded companies
5. Subsidiaries of publicly-traded companies
6. Netherlands/EC controlled company
7. Beneficial interests/base reduction test
8. Conduit companies
B. Active trade or business test
1. Income derived in connection with a trade or business
2. Business "substantial" in relation to income-producing activity
3. Income "incidental" to Netherlands business
4. Attribution of business assets and activities
5. Election to treat related EC business activity as Netherlands business activity
C. Headquarter companies
D. Limited benefits for Netherlands companies
E. Income from operation of ships or aircraft in international traffic
F. Benefits granted in the discretion of the competent authority
1. Factors to be considered
2. Changes in circumstances
3. Post-acquisition reorganization
4. Companies trading in stocks and securities
G. Proof of eligibility for benefits
H. Entry into force
III. Conclusion

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treaty) to zero and five percent (under the US–Netherlands treaty). As another example, foreign persons from countries that do not have a tax treaty with either the United States or the Netherlands have used the so-called "Dutch sandwich" structure to make investments in US real property and other US investments.[1]

Use of a tax treaty by persons not resident of either of the treaty countries, sometimes called "treaty shopping", is not an uncommon practice in structuring international operations and transactions. Typically, the multinational corporation that uses a Netherlands holding or finance company is merely trying to avoid double taxation by reducing its foreign withholding tax burden and avoiding excess foreign tax credits in its home country. At one time, the Internal Revenue Service (IRS) did not consider treaty shopping under the existing US–Netherlands tax treaty (and other US treaties) an abusive practice.[2] However, the IRS' position on treaty shopping has changed.

B. *Responses to treaty shopping*

Since 1981 there has been a concerted effort on the part of the IRS, the Treasury Department and Congress to reduce or eliminate treaty shopping, including treaty shopping using the existing US–Netherlands tax treaty.[3] These efforts have been, in part, unilateral. That is, in US legislation, regulations, official rulings and litigating positions, the US lawmaking and taxing authorities have prescribed conditions that must be met before a treaty can operate to reduce or eliminate a US tax. These conditions have been imposed without prior negotiation with treaty partners.[4] To date, unilateral limitations on treaty benefits have been imposed on a selective rather than broad-based approach, and do not apply, for example, to limit treaty relief from US withholding taxes. However, legislation proposed in 1992, and which is expected to be proposed again in 1993, would unilaterally import limitation on benefits provisions into every US tax treaty, and these treaty limitations would apply with respect to all US taxes.[5]

Certainly a more diplomatic way of imposing limitations on treaty benefits is by bilateral negotiation with treaty partners. The United States began this process in 1981 with the inclusion of a limitation on benefits provision in the 1981 draft US model income tax treaty. Its limitation on benefits provision lay the groundwork for subsequent treaty negotiations, including the negotiations with the Netherlands.[6] The principle underlying these provisions is that, in order for an entity to qualify for treaty benefits, it is not sufficient that the entity be organized under the laws of, or treated as a resident of, the treaty partner country. The entity and/or its owners must establish additional substantial nexus with that country. Under the 1981 US model treaty provision, a treaty country resident other than an individual or a publicly-held company is not entitled to any treaty benefits unless it satisfies a beneficial interests/base erosion test: more than 75 percent of its beneficial interest must be directly or indirectly owned by individual residents of the treaty country, and its income cannot be used in substantial part to meet liabilities to residents of third countries ("base erosion"). Alternatively, benefits are available if the treaty resident establishes the lack of a principal purpose of obtaining treaty benefits.

Since 1981, limitation on benefits provisions have entered into force in treaties with several US treaty partners (either in new treaties or in protocols to existing treaties).[7] These provisions reflect, in various modified forms, the basic thrust of the 1981 US model and include, in most cases, a beneficial interests/base erosion requirement, a publicly-traded exception and a principal purpose exception.

Several post-1980 US treaties also contain limited exceptions to loss of benefits for treaty country residents conducting active business operations in the treaty country.[8] The "active trade or business" principle extends treaty benefits in situations where the entity is owned by non-treaty country residents, but has a sufficient active business nexus with the treaty country to justify the availability of benefits.

The "derivative benefit" concept extends treaty benefits to a treaty country resident if its beneficial owners reside in a third country that also has a tax treaty with the United States that provides similar treaty benefits. The concept of derivative benefits is not present in the 1981 US model but appears in the Jamaica treaty and more predominantly in the treaty with Mexico. The US–Mexico treaty's limitation on benefits article has derivative benefits provisions that are keyed in part to the North America Free Trade Agreement ("NAFTA"). Under these provisions, for example, a Mexican company is eligible for benefits if its stock is owned in a prescribed quantities and combinations by certain residents of the United States, Canada and Mexico.[9]

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1. The foreign person would establish and own a Netherlands Antilles company which would organize a wholly-owned Netherlands company which would make an investment in the United States (typically through a US subsidiary). This has remained a viable structure despite the substantial termination of the income tax treaty between the United States and the Netherlands Antilles.
2. See e.g. Private Letter Rulings 7723035, 7739080, 7746046 and 7751023.
3. See generally, R. Rhoades & M. Langer, "Limitations on Treaty Shopping", in *Income Taxation of Foreign Related Transactions* (Matthew Bender, 1992), ch. 12A.
4. The branch profits tax is a good example of unilateral treaty limitation by legislation. Sec. 884(e) and (f)(3) of the Internal Revenue Code (the "Code") and the regulations thereunder precondition treaty relief from the branch profits tax and branch-level interest taxes on satisfaction by the treaty partner resident of one of a number of alternative tests, based in large part on the 1981 US model income tax treaty limitation on benefits provisions.
5. See Sec. 302 of H.R. 5270, 102nd Cong., 2d Sess. (1992).
6. See Kramer, "Attempts to Curb Treaty Shopping in US–Dutch Treaty Negotiations", 37 *Bulletin for International Fiscal Documentation* (March 1983), at 107. The United States is not the only country that has negotiated anti-treaty shopping provisions with the Netherlands. For example, both the UK–Netherlands tax treaty (Art. 9(3)(d)) and the Switzerland–Netherlands tax treaty (Art. 9(2)(a)) have provisions of this nature, but they are more limited in scope than either the 1981 US model's or the Treaty's provisions.
7. See, e.g. Jamaica (Art. 17); Australia (Art. 16); New Zealand (Art. 16); Canada (Art. XXIX(6)); Italy (1984 Protocol, Art. 2); Cyprus (Arts. 4 and 26); Barbados (Art. 22); China (1984 Protocol ¶7; 1986 Protocol ¶¶1-4); Bermuda (Art. 4); Belgium (Art. 12A); Indonesia (Art 28); Finland (Art 16); France (Art. 24A); Germany (Art. 28); India (Art. 24); Tunisia (Art. 24); Spain (Art. 17; Protocol ¶13); Mexico (Art. 17).
8. These include the treaties with Barbados, Jamaica, Belgium, Germany and Mexico.
9. See US–Mexico tax treaty (Art. 17(1)(d)(iii) and (g)). These provisions of the treaty take effect only when (and if) NAFTA enters into force. See US–Mexico tax treaty (Protocol, Art. 15(d)).

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II. DESCRIPTION OF ARTICLE 26

The new Treaty's limitation on benefits provisions are contained in Article 26, and are elaborated in the Memorandum that accompanies the Treaty. Article 26 incorporates elements of the 1981 US model provisions and limitation on benefits provisions from other treaties in force. Depending on how one attempts to arrange them, Article 26 describes approximately 13 different categories into which a resident of the United States or the Netherlands may fall and thereby become entitled to Treaty benefits. Several of these categories have precedents in prior treaties (the treaties with Germany and Mexico in particular), but in Article 26 the categories are described with greater precision and detail than in any other US treaty.

The volume of alternative categories and the descriptive detail is likely due to the desire of the Netherlands negotiators to provide as many options for third-party benefits as would be acceptable to the United States, and to ensure that these options were described with sufficient clarity to allow third country residents to structure new investments and restructure existing holdings with relative certainty.

In summary, Article 26 describes six broad categories of persons entitled to Treaty benefits, as follows:

• *Qualified person* is a term of art that itself includes eight categories of persons who are eligible for benefits generally as a result of their status as residents of, or ownership by residents of the United States and/or the Netherlands. These include corporations and other entities that satisfy one of several publicly-traded or beneficial interests/base erosion tests. Special rules apply to "conduit companies" that receive and pay out interest and royalties (e.g. finance subsidiaries). Derivative benefits for Netherlands corporations with EC ownership are available in some circumstances.

• The *active trade or business test* affords Treaty benefits to residents of one country that earn income from the other country if the resident carries on an active trade or business in its home country that is related to and substantial in relation to income-producing activity in the other country, or if the income is incidental to the home country business. A formulary non-exclusive safe harbour is available to establish "substantiality". In certain cases, business activities can be attributed to a Netherlands resident from related parties, and certain activities performed in other EC countries by affiliates of a Netherlands resident can be treated as conducted by the Netherlands resident in the Netherlands.

• *Headquarter companies*, i.e. Netherlands or US residents that perform supervisory and administrative functions for a multinational corporate group, and that satisfy various requirements, are entitled to Treaty benefits.

• *Limited Treaty benefits* (relief from US withholding and branch profits taxes) are available to Netherlands companies that satisfy certain stock ownership and base reduction tests.

• *Income from international transportation operations* is eligible for benefits if certain ownership tests are met.

• Finally, Treaty benefits may be granted to a treaty country resident in the *discretion of the competent authority* of the source country if obtaining Treaty benefits was not a principal purpose of the resident's establishment and operations.

Eligibility for benefits is determined on an annual basis, and each of the categories of persons eligible for Treaty benefits is an alternative category. Thus, a person may qualify for Treaty benefits under one category in one year, and then qualify for benefits under a different category in the following year, and so on.

The remainder of this article describes in detail the requirements of the various categories of Treaty entitlement. As with all complex tax provisions, a number of technical questions are unanswered by Article 26 and the Memorandum, and hopefully will be resolved in the Treasury Department's official explanation of the Treaty.

For purposes of consistency and clarity, the discussion below generally assumes that the person seeking Treaty benefits is a resident of the Netherlands that derives income in the United States. However, except as noted otherwise, the limitation on benefits provisions of Article 26 apply equally in the reciprocal case of a US resident seeking Treaty benefits.

A. *Qualified persons*

A person that is a resident[10] of the Netherlands and derives income from the United States is entitled to all the benefits of the Treaty if the person is a "qualified person".[11] As described more fully below, there are eight categories of qualified persons.

1. Individuals

An individual who is a resident of the Netherlands is a qualified person entitled to all the benefits of the Treaty.[12]

2. Governments

The Government of the Netherlands, and any political subdivision or local authority thereof, is a qualified person, entitled to all benefits under the Treaty.[13]

3. Not-for-profit organizations

Generally, a not-for-profit organization that, by virtue of that status, is generally exempt from taxation in its country of residence, is a "qualified person", entitled to all benefits under

10. The term "resident" is defined in the Treaty. Generally, for purposes of the Treaty, and as used in this article, a "resident of the Netherlands" means any person who, under the laws of the Netherlands, is liable to tax in the Netherlands by reason of the person's domicile, residence, place of management or place of incorporation (but not persons liable to tax only on income from Netherlands sources). Partnerships, trusts and estates are treated as Netherlands (or US) residents only to the extent that the income derived by the entity is subject to tax in the Netherlands (or United States) in the hands of the entity or in the hands of the partner or beneficiary. "Tie-breaker" rules apply for individuals who would be treated as residents of both the United States and the Netherlands under the general rules.
11. Treaty Art. 26(1) and 26(8)(g).
12. Treaty Art. 26(1)(a).
13. Treaty Art. 26(1)(b).

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the Treaty, provided that more than 50 percent of the beneficiaries, members or participants (if any) in such organization are qualified persons.[14]

However, a pension fund, pension trust or similar entity organized for the purpose of providing retirement, disability or other employee benefits is entitled to Treaty benefits if (1) it is organized under the laws of the United States or the Netherlands, and (2) the organization sponsoring the fund, trust or entity is entitled to Treaty benefits.[15] Thus, for example, a pension plan sponsored by a Netherlands or US corporation that meets the publicly-traded test would qualify for Treaty benefits.

4. Publicly-traded companies

A corporation that is a resident of the Netherlands is a qualified person, entitled to all Treaty benefits, if it satisfies the following test (the "publicly-traded test"): the principal class of its shares is (1) listed on a recognized stock exchange located in either the Netherlands or the United States, and (2) substantially and regularly traded on one or more recognized stock exchanges.

(a) *Principal class of shares*

The "principal class" of a company's shares is the company's common shares if those shares represent the majority of the company's voting power and value. If no single class represents the majority of vote and value, the "principal class" includes each of those classes of shares that in the aggregate represent more than 50 percent of the vote and value.[16] In addition, the "principal class of shares" also includes any class (a so-called "disproportionate class") that entitles the holder to disproportionately higher participation in the earnings generated in the United States as a result of particular assets or activities of the Netherlands company in the United States.[17]

> *Example 1*: NL, a Netherlands corporation, has three classes of stock outstanding: common stock, non-voting preferred stock and a "tracking" stock that entitles the holder to disproportionately higher participation in earnings from the operations of NL's subsidiaries doing business in the United States. The common stock possesses 100 percent of the voting power and 45 percent of the value of NL. The preferred stock represents none of the voting power and 50 percent of the value of NL. The "principal class" of NL's shares includes all three classes. Accordingly, NL will meet the publicly-traded test only if each class is listed on a recognized stock exchange in either the Netherlands or the United States and is substantially and regularly traded on a recognized stock exchange.

(b) *Recognized stock exchange*

A "recognized stock exchange" includes the Amsterdam Stock Exchange, and exchanges registered with the US Securities and Exchange Commission as a national securities exchange.[18] The competent authorities have agreed to include the stock exchanges of Frankfurt, London and Paris, and may agree to include others.[19] The US NASDAQ ("over-the counter") system and the parallel over-the-counter market in Amsterdam are also recognized stock exchanges, except with respect to shares of a "closely-held company", i.e. any company 50 percent or more of whose principal class of shares is owned by persons other than "qualified persons" or "residents of a member state of the European Communities", each of whom beneficially owns, directly or indirectly, alone or together with related persons, more than 50 percent of such shares for more than 30 days during a taxable year.[20]

(c) *Substantial and regular trading*

The shares in a class of shares are "substantially and regularly traded" on one or more recognized stock exchanges in a taxable year if (1) more than a de minimis quantity of shares of that class are traded on such recognized stock exchanges during every month, and (2) the aggregate number of shares of that class traded on such exchanges during the previous taxable year is at least six percent of the average number of shares outstanding in that class during that year.[21] Any pattern of trades conducted for the purpose of meeting the "substantial and regular trading" test are disregarded. A person can be required to rebut evidence that it has engaged in such trading.[22]

5. Subsidiaries of publicly-traded companies

A company is a qualified person eligible for all benefits under the Treaty if (1) more than 50 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies ("parents") which are residents of either the United States or the Netherlands, (2) each parent satisfies the "publicly-traded" test, and (3) the company is not a "conduit company".[23]

For purposes of this test, to establish "indirect" ownership through a chain of companies, each company in the chain must itself qualify as a subsidiary of a publicly-traded company.[24]

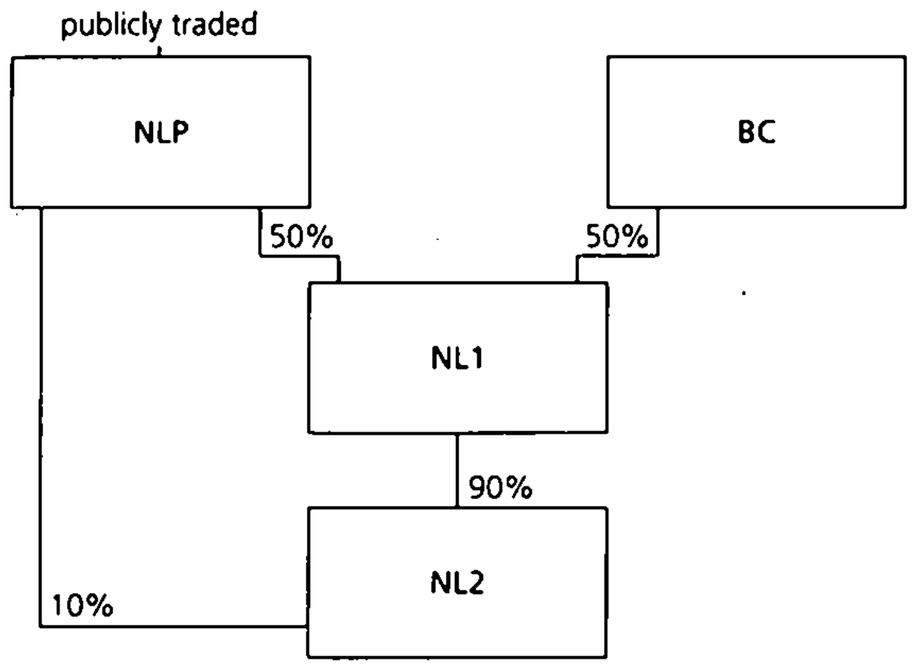
> *Example 2*: NLP is a Netherlands corporation that meets the publicly-traded test. NL1 is a Netherlands corporation whose stock is owned 50 percent by NLP and 50 percent by BC, a Bermuda corporation. NL2 is a Netherlands corporation ten percent of whose stock is owned by NLP and 90 percent of whose stock is owned by NL1. In determining whether NL2 qualifies for Treaty benefits as a subsidiary of NLP, NLP is not treated as owning any stock of NL2 indirectly through NL1 because NLP does not own more than

14. Treaty Art. 26(1)(e). Not-for-profit organizations include charitable, educational and scientific organizations, and also include pension funds, pension trusts, private foundations, trade unions, trade associations and similar organizations.
15. Treaty Art. 26(8)(j).
16. Treaty Art. 26(8)(a). In determining voting power, authorized but unissued shares are taken into account. The competent authorities may mutually agree upon the impact of restrictions or limitations on voting rights of issued shares. *Id.*
17. Treaty Art. 26(1)(c)(i).
18. These include the New York Stock Exchange and the American Stock Exchange, among others.
19. Treaty Art. 26(8)(d)(iv) and Memorandum Art. XXII.
20. Treaty Art. 26(8)(d) and (e). The competent authorities can agree to disqualify other exchanges as "recognized stock exchanges" with respect to the stock of such companies. The term "resident of a member state of European Communities" is defined in the text at II.A.6.(a).
21. Treaty Art. 26(8)(f).
22. *Id.*; Memorandum Art. XXIV.
23. Treaty Art. 26(1)(c)(ii).
24. Treaty Art. 26(8)(k).

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50 percent of NL1's stock. Therefore, NL2 is not a qualified person under the subsidiary test. If NLP owned 51 percent of NL1's stock, then NLP would be treated as owning 51 percent of NL1's 90 percent interest in NL2, or 45.9 percent. Assuming that it is not a "conduit company," NL2 would be a qualified resident because NLP's combined direct and indirect ownership of NL2 would be 55.9 percent.

Example 2



"Conduit companies", and the circumstances under which they may qualify for benefits, are described below at II.A.8.

6. Netherlands/EC controlled company

A corporation that is resident in the Netherlands is a qualified person, entitled to all Treaty benefits, if its stock is owned principally by prescribed combinations of publicly-traded companies that are residents of the United States, the Netherlands and member states of the EC (US corporations are not eligible to qualify as qualified persons under this test.) Specifically, this test is satisfied if (1) the corporation is resident in the Netherlands, (2) the corporation is not a conduit company, (3) at least 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer corporations that are residents of the Netherlands, each of which meets the publicly-traded test, and (4) at least 70 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are residents of the United States or residents of an EC member state, each of which companies satisfies the publicly-traded test (other than the listing requirement of that test).[25]

For purposes of this test, "indirect" ownership through a chain of companies can be utilized to meet either the 30 percent or the 70 percent part of the test only if each company in the chain itself satisfies ownership requirements of the 30 percent test or the 70 percent test, as the case may be.[26]

(a) *Resident of an EC member state*

A company (or any other person) qualifies as a resident of an EC member state[27] if (1) the company would be considered a resident of an EC member state under the principles of the definition of "resident" in the Treaty, (2) the company is entitled to the benefits of the particular income tax convention between the company's EC state of residence and the United States, and (3) the company would be a "qualified person" under the provisions described in II.A., applied as though the parties to the Treaty were the United States and the relevant EC member state.[28]

Example 3: NL, a Netherlands corporation, has one class of stock outstanding, which is owned as follows: 20 percent by FC, a French corporation; 20 percent by PC, a corporation that is a resident of Portugal; 35 percent by NLP, a Netherlands corporation; and 25 percent by USCO, a US corporation. Assume that NLP and USCO each meets the publicly-traded test.

(a) Assume that the principal class of FC's stock is substantially and regularly traded on the Paris stock exchange. FC qualifies as a "resident of an EC member state" for Treaty purposes because (i) FC would be considered a "resident" of France under the Treaty's residence principles, (ii) FC would be a "qualified person" under the principles of the Treaty (applied as though the Treaty were between France and the United States) because FC would meet the publicly-traded test, and (iii) FC is entitled to benefits under the US-France income tax treaty.[29]

(b) In determining whether NL is a qualified person under the 30/70 percent test, the 30 percent test is met because NLP, a Netherlands resident corporation that meets the publicly-traded test, owns directly 35 percent of NL's stock. The 70 percent test is met because 80 percent of NL's stock is owned by residents of EC member states or the United States (NLP, FC and USCO), each of which meets the publicly-traded test. Assuming that NL is not a conduit company, NL is a qualified person. Note that Portugal is not an "EC member state" for purposes of the Treaty because Portugal does not have comprehensive income tax conventions with the United States and the Netherlands. Accordingly, PC's 20 percent interest in NL is not counted for the 70 percent test.

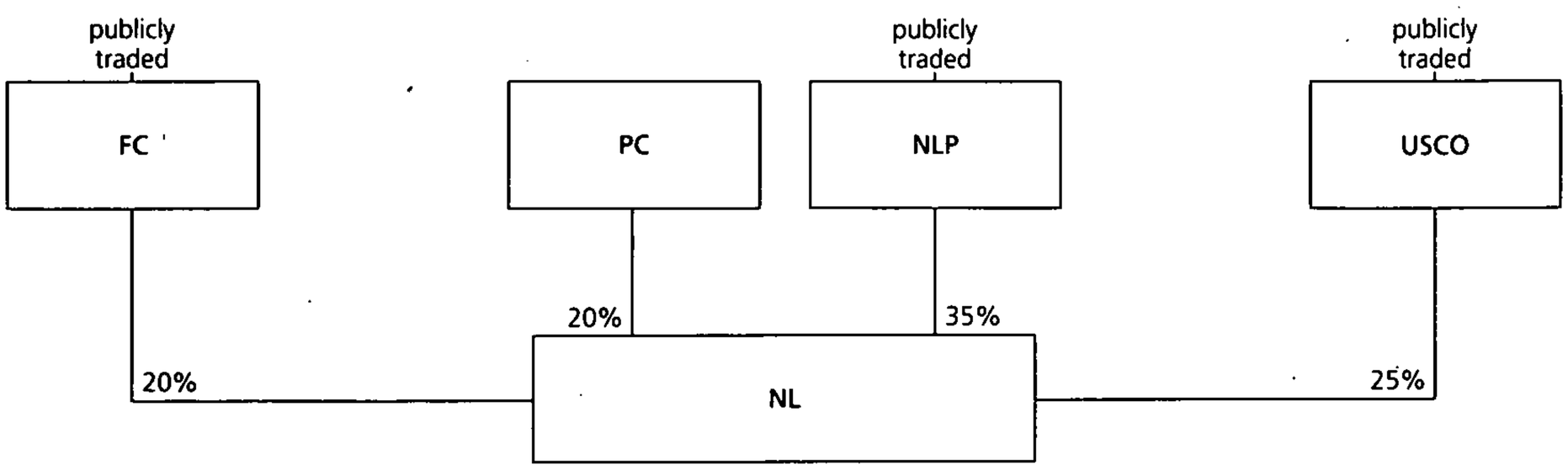
Example 3A: Assume the same facts as in Example 3, except that FC does not own its 20 percent interest in NL directly. Instead, FC owns 70 percent of the stock of NA, a Netherlands Antilles corporation, which in turn owns 20 percent of NL's stock. In this case, the 70 percent test will be met only if FC's 14 percent indirect interest in NL (70 percent of NA's 20 percent interest) can be combined with the 60 percent held by NLP and USCO. Indirect ownership through NA can be taken into account only if NA itself is at least 70 percent owned by a resident of an EC member state. Here, NA is 70 percent owned by FC, which is a resident of an EC member state for Treaty purposes. Accordingly, FC's indirect 14 percent interest may be counted for the 70 percent test. Assuming that NL is not a conduit, NL is a qualified person entitled to Treaty benefits because the 30/70 percent test is met.

Note that, in Example 3A, in determining whether FC's indirect ownership through NA may be taken into account for

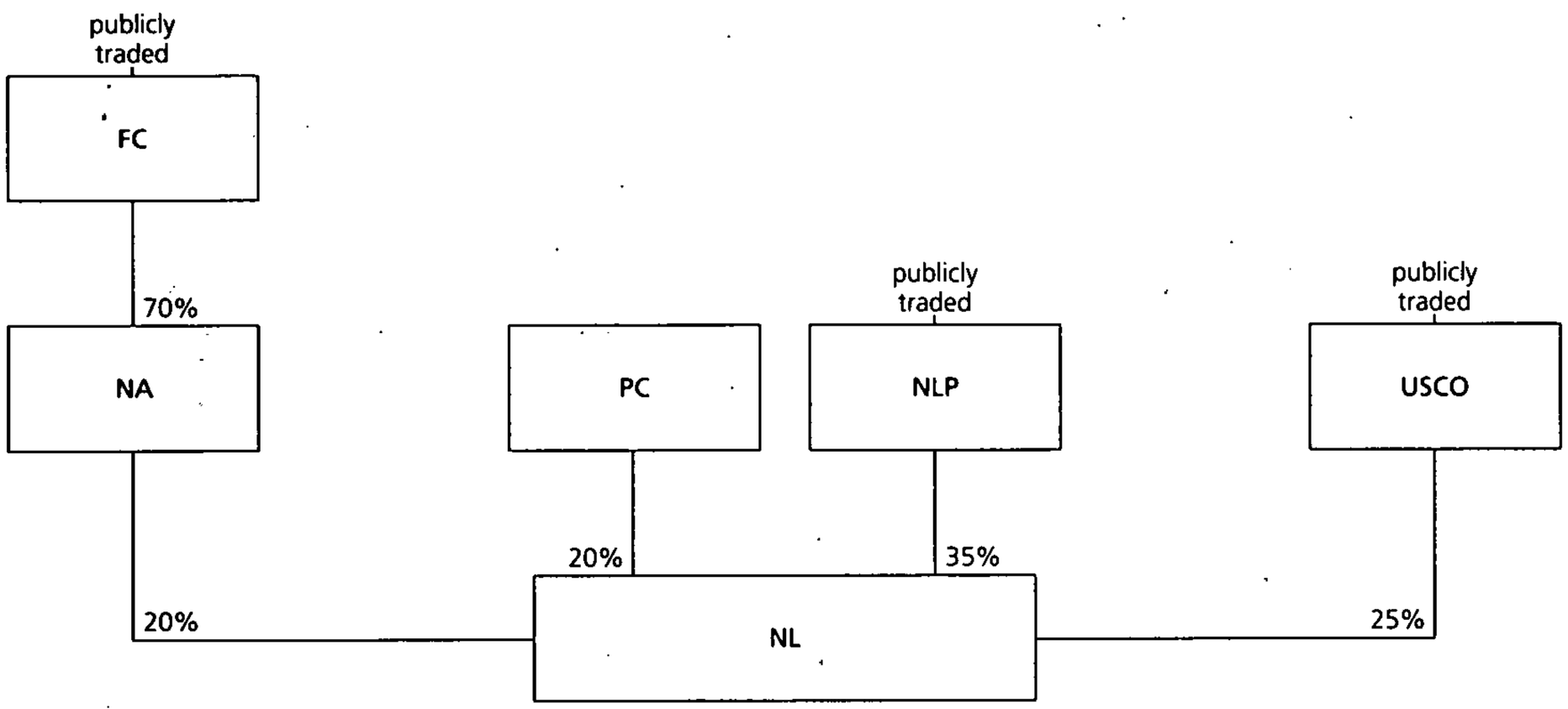
25. Treaty Art. 26(1)(c)(iii).
26. Treaty Art. 26(8)(k).
27. For purposes of the Convention, "EC member states" include the Netherlands and the other member states of the EC with which both the United States and the Netherlands have in effect a comprehensive income tax convention. These other EC member states are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Spain and the United Kingdom. Portugal is a member state of the EC but is not an "EC member state" for Treaty purposes because it does not have tax treaties with the United States and the Netherlands.
28. In the remainder of this article, references to a person that qualifies as a resident of an EC member state denote a person that satisfies these three requirements.
29. FC would qualify for benefits under the US–France tax treaty because it would satisfy the publicly traded test in that treaty's limitation on benefits provisions. See US–France tax treaty (Art. 24A(3)).

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Example 3



Example 3A



purposes of the 70 percent test, the determinative factor is whether the intermediary (NA) itself meets the 70 percent ownership requirement. The intermediary's country of residence is not controlling, nor is the fact that the intermediary does not satisfy the 30 percent test.[30] Thus, for example, the result in Example 3A is not changed if the other 30 percent of NA's stock is owned by non-EC, non-US persons.

7. Beneficial interests/base reduction test

A person is a "qualified person" eligible for all benefits under the Treaty if (1) more than 50 percent of the beneficial interests in the person is owned, directly or indirectly, by qualified persons, and (2) the person meets the "base reduction test" described below. For corporations, the beneficial interest part of the test is met if more than 50 percent of the aggregate vote and value of all shares, and more than 50 percent of the shares of any disproportionate class, is owned directly or indirectly by qualified persons.[31]

This two-part ownership and base erosion test has precedents in other US treaties, although the EC element in the base reduction test is new.

(a) *Base reduction test*

The base reduction test is designed to prevent a person from qualifying for Treaty benefits (under this category of "qualified person") when a substantial part of its earnings are paid out in satisfaction of obligations to non-treaty country residents, who would thereby indirectly enjoy the benefits of the Treaty.[32] Thus, even if qualified persons own more than 50 percent of the beneficial interest in a Netherlands company, the company will fail to come within this category of "qualified person" if a substantial portion of its earnings are devoted to certain payments (such as interest expense on indebtedness) to non-qualified persons.

Specifically, a Netherlands resident will satisfy the base reduction test if either:[33]

30. Conversely, in determining whether indirect ownership through an intermediary may be taken into account for purposes of the 30% test, the intermediary's country of residence, and whether the intermediary satisfied the 70% test, would not be determinative. See Treaty Art. 26(8)(k).
31. Treaty Art. 26(1)(d).
32. For example, a third-country resident could lend funds to a Netherlands-owned Netherlands corporation to be reloaned to the United States. The US-source interest income ordinarily would be exempt from US withholding tax under Article 12 (Interest) of the Treaty. Interest payments made by the Netherlands corporation to the third-country resident would not be subject to any Netherlands withholding tax under Netherlands law. Thus, the US Treaty benefit will have flowed to the third-country resident. In addition, the interest payment made by the Netherlands corporation could be deductible and offset the Netherlands corporate income tax on the Netherlands corporation's interest income (thereby "reducing" or "eroding" the Netherlands corporate tax base).
33. Treaty Art. 26(5)(a). A Netherlands resident can satisfy the test by meeting the requirements of clause (1) or (2). A US resident can satisfy the test only by meeting the requirements of clause (1).

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(1) during the current year, the amount of "deductible payments" made, directly or indirectly, to non-qualified persons is less than 50 percent of the greater of (i) the company's gross income for the preceding year, or (ii) the average gross income for the four preceding years;[34] or

(2) both (i) the amount of "deductible payments" made to non-qualified persons is less than 70 percent of such gross income, and (ii) the amount of deductible payments made to persons that are neither qualified persons nor residents of EC member states is less than 30 percent of such gross income. Thus, both prongs of this second alternative test can be satisfied even if as much as 30 percent of a Netherlands company's gross income is used to make deductible payments to qualified persons, and as much as 40 percent is used to make such payments to non-qualified persons that are residents of EC member states.

"Deductible payments" include interest and royalties, but not rent paid for the use of tangible property in the ordinary course of business or payments for services performed in the payor's country of residence.[35] Payments are treated as deductible payments whether or not they generate a deduction or other tax benefit for the payor.

Note that the base reduction test compares the current year's deductible payments to the gross income from the prior year or years. Thus, a company should be able to calculate, in advance, the amount of deductible payments to "bad" recipients it will be able to make during the current year and still satisfy the base reduction test.

8. Conduit companies

"Conduit companies" are not eligible to be qualified persons as either a subsidiary of a publicly-traded company (see II.A.5) or a Netherlands/EC controlled company (see II.A.6). However, as described below, such a company may be entitled to Treaty benefits if it does not pay out substantial amounts of interest or royalties to related parties located in tax havens.

Generally, a company is a "conduit company" if its aggregate "deductible payments" (e.g. interest and royalties) paid by it for the year are 90 percent or more than the aggregate deductible payments it receives during the year.[36]

The "conduit company" concept was probably intended to cover Netherlands financing intermediaries the bulk of whose income and expense is interest or royalties.[37] However, many operating companies may find that they fall within the definition of "conduit". The test does not compare a company's total income and expense with its interest and royalty income and expense. Rather, the test compares interest and royalty income with interest and royalty expense, however small these items may be in relation to the company's overall income and expense. So long as the company pays out an amount of interest and royalties that is 90 percent or more than the amount of interest and royalties it receives, the company is a conduit. Thus, technically, a company with $ 1,000 of interest income and $ 1,000 of interest expense for the year (and no other deductible payments made or received) is a conduit, even if it has $ 1 million of operating income for the year. Such a company may qualify for Treaty benefits as a "qualified conduit" (see discussion below), or may qualify for benefits under other provisions of Article 26.[38]

Almost every bank would be treated as a conduit under the Treaty because most of a bank's income and expense consists of interest. The Treaty addresses this issue with a special exception for active banks and insurance companies. A bank or insurance company is not a conduit if it (i) is engaged in the active conduct of a banking or insurance business, and (ii) is managed and controlled by one or more "associated enterprises" that are qualified persons.[39] For this purpose, a bank will be considered to be engaged in the active conduct of a banking business if it regularly accepts deposits from the public, or makes loans to the public. An insurance company will be considered to be engaged in the active conduct of an insurance business only if its gross income consists primarily of insurance or reinsurance premiums, and investment income attributable to such premiums.[40]

(a) *Qualifying conduit companies*

A "conduit company" that meets the stock ownership and residence tests applicable to a subsidiary of a publicly-traded company (described at II.A.5) or the Netherlands/EC controlled company (described at II.A.6) can be a qualified person if it satisfies a special base reduction test.[41]

The conduit company first must satisfy one of the stock ownership tests described above at II.A.5 and II.A.6. This requirement is met if either (i) more than 50 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies ("parents") which are residents of either the United States or the Netherlands, and each parent satisfies the publicly-traded test, or (ii) at least 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer corporations that are residents of the Netherlands, each of which meets the publicly-traded test, and at least 70 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are residents of the United States or an EC member state, each of which companies satisfies the publicly-traded test (other than the listing requirement of the publicly-traded test).

34. Treaty Art. 26(5)(b).
35. Treaty Art. 26(5)(c). The competent authorities can agree to add or delete other types of payments from the scope of deductible payments.
36. Treaty Art. 26(8)(m).
37. See discussion of the Netherlands as a base for financing companies in the text at I.A.
38. In addition, an operating company that inadvertently falls into the "conduit" definition may be eligible for Treaty relief granted in the discretion of the competent authority. See II.F.
39. Treaty Art. 26(8)(m). "Associated enterprises" are generally defined as two entities where one participates in the management, control or capital of the other, or entities in which the same persons participate in the management, control or capital. Treaty Art. 9 generally allows for the reallocation of income and deductions among associated enterprises of the United States and the Netherlands respecting transactions between them that are not conducted at arm's length. For the purposes of the bank/insurance company exception to the "conduit" definition, the controlling entity can be resident of either the United States or the Netherlands, so long as it is a qualified person.
40. Memorandum Art. XIII.
41. Treaty Art. 26(1)(c)(iv).

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The special conduit base reduction test is similar to the base reduction test described above at II.A.7.(a), except that the test is liberalized in that only deductible payments (i.e. interest and royalties) that are made to related parties and that are subject to a low rate of tax on the payments received are treated as "bad" deductible payments. The current year's "bad" deductible payments are compared with the gross income for the prior year (or years).[42]

Specifically, a conduit company that is a resident of the Netherlands will satisfy this test if either:[43]

(1) an amount equal to less than 50 percent of the conduit's gross income is used, directly or indirectly, to make deductible payments in the current year to related persons[44] that are not qualified persons and that are subject to an aggregate rate of tax on the payments (a "low effective tax rate") that is less than 50 percent of the rate that would be applicable had the payment been received in the conduit's country of residence and subject to the normal taxing regime in that country; or

(2) (i) an amount equal to less than 70 percent of the conduit's gross income is used, directly or indirectly, to make deductible payments in the current year to related persons that are not qualified persons and that are subject to a low effective rate on the payments received, and (ii) an amount equal to less than 30 percent of the conduit's gross income is used, directly or indirectly, to make deductible payments in the current year to related persons that are neither qualified persons nor residents of an EC member state, and that are subject to a low effective tax rate on the payments received.

Example 4: NL is a company resident in the Netherlands all of whose stock is owned by USCO, a US corporation. USCO is a multinational corporation with worldwide operations. USCO's principal class of shares is substantially and regularly traded on the New York Stock Exchange. NL's principal activity is borrowing money and relending money to its corporate affiliates. In the current year, NL makes payments of interest to its lenders in an amount that equals 90 percent of its interest income for the year. Hence, NL is a conduit for the year. NL's gross income for the current year and for each of the preceding four years is $ 1,000 and its deductible payments (interest expense) for the current year are $ 900. Assume that all of NL's interest expense is paid to unrelated lenders. In this case, NL satisfies the conduit base reduction test because none of its deductible payments are made to related persons. NL also satisfies the stock ownership test for qualified conduits because more than 50 percent of its stock is owned by a US corporation that meets the publicly-traded test.

Example 5: The facts are the same as in the previous example except that $ 500 of NL's $ 900 of interest expense is paid to NA, a resident of the Netherlands Antilles and a wholly-owned subsidiary of USCO. NA is subject to a low effective tax rate on the interest payments received from NL. In this case, NL fails the base reduction test because $ 500, the amount of interest expense paid to NA, a related person subject to a low effective rate of tax, is 50 percent or more than NL's gross income for the preceding taxable year ($ 1000), and NA is not a qualified person and is not a resident of an EC member state.

(c) *The "triangular" problem*

The "triangular" problem refers to a situation that does not involve conduit companies *per se*, but does involve a combination of tax base reduction and the tax havens. A typical case is one where a Netherlands corporation receives an interest or royalty payment from US sources, but the income is attributable to a branch or other permanent establishment maintained by the Netherlands corporation in a tax haven (e.g. the Netherlands Antilles). Under current Netherlands law, the interest or royalty payment is not subject to Netherlands tax because it is attributable to an offshore branch.

Article 24(4) of the Treaty provides that, unless the Netherlands law is amended to provide anti-abuse provisions for such situations by the time the US Senate Foreign Relations Committee hearings on the Treaty begin, the competent authorities will address the issue in a future protocol to the Treaty. It appears as though the United States is not willing to give up its source-based withholding tax in this situation unless the interest or royalties are taxed in the Netherlands.

B. *Active trade or business test*

The "qualified person" categories described above focus on objective characteristics of a person (e.g. ownership, residence, "conduit" status) to determine availability of Treaty benefits. The "active trade or business" test focuses on the location of a person's active business activities and the connection between those activities and the income for which Treaty benefits are sought.

A person that is a resident of the Netherlands[45] is entitled to Treaty benefits with respect to income derived from the United States (whether investment income or active business income) if:

(1) the Netherlands resident is engaged in the active conduct of a trade or business in the Netherlands; and

(2) either (i) the income from the United States is derived in connection with the Netherlands trade or business, and that business is substantial in relation to the income-producing activity in the United States, or (ii) the income from the United States is incidental to the trade or business carried on in the Netherlands.[46]

The business of making or managing investments is not considered an active trade or business unless these activities are banking or insurance activities carried on by a bank or insurance company.[47]

The Treaty provides rules and safe harbours for determining when US income is derived "in connection with" an active Netherlands business, when an active Netherlands business is "substantial" in relation to the US income-producing activity, and when the US income is "incidental" to an active Netherlands business. Under several of these rules and safe har-

42. "Gross income" is the greater of (1) the gross income for the preceding taxable year or (2) the average of the gross incomes for the four preceding taxable years.
43. Treaty Art. 26(5)(d).
44. The term "related persons" as used herein has the same meaning as "associated enterprises". See *supra* note 39.
45. This discussion focuses on the active trade or business test in the context of a Netherlands resident, but the test applies equally to US residents that derive income from the Netherlands.
46. Treaty Art. 26(2)(a).
47. *Id.*

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bours, the active business need not be conducted by the Netherlands resident itself; the Treaty permits attribution of active Netherlands business operations of certain affiliates and related parties to the Netherlands resident. In addition, a Netherlands resident may, under certain circumstances, elect to treat business activities conducted in other EC states as though it was conducted by the resident in the Netherlands.

1. Income derived in connection with a trade or business

US income is derived "in connection with" a Netherlands trade or business of a Netherlands resident if the income-producing activity in the United States is a line of business that forms a part of or is complementary to the Netherlands business.[48] If this requirement is satisfied, the active trade or business test is met if the Netherlands business is "substantial" in relation to the US activities.

2. Business "substantial" in relation to income-producing activity

(a) *Substantiality: general rule*

Whether the Netherlands business is "substantial" in relation to the connected US income-producing activity generally is determined by reference to the Netherlands resident's ownership interest in the US income-producing activity, and the quantity and quality of the Netherlands business relative to US activities. The nature of the activities performed and the relative contributions made to the business in both countries are considered.[49]

(b) *Substantiality: non-exclusive safe harbour*

The Treaty provides a non-exclusive safe harbour for the "substantiality" test.[50] If the requirements of the safe harbour are met, the Netherlands business will be deemed substantial in relation to the connected US activities. The requirements focus on the relative contributions of the Netherlands business and the US activities to the common line (or related lines) of business. In particular, the safe harbour involves three ratios:

(i) the ratio of the value of assets used or held for use in the trade or business in the Netherlands to the ratio of assets used or held for use in the business in the United States (the "asset factor");
(ii) the ratio of gross income from the business derived in the Netherlands to the gross income from the business derived in the United States (the "income factor"); and
(iii) the ratio of the payroll expense of the business for services performed in the Netherlands to the payroll expense of the business for services performed in the United States (the "payroll factor").[51]

The substantiality safe harbour is met for a particular year if, for the preceding taxable year, the average of the three factors exceeds ten percent, and each of the three factors exceeds 7.5 percent (or, for any factor that does not exceed 7.5 percent for the preceding year, the average for that factor for the three preceding years exceeds 7.5 percent).

As discussed more fully below, Netherlands residents may also elect to apply a modified version of the safe harbour, under which assets and activities relating to the business conducted in other EC member states by the Netherlands resident or certain related parties or affiliates can be combined with the Netherlands assets and activities (see II.B.5).

3. Income "incidental" to Netherlands business

As an alternative to the "substantiality" test, the active trade or business test can also be met if the US income is "incidental" to the Netherlands business. Income derived from the United States is "incidental" to a business conducted in the Netherlands if the production of the income facilitates the Netherlands business. For example, the investment of the Netherlands business' cash working capital in US stocks and securities facilitates the Netherlands business and the US-source dividend and interest income from those investments would be considered "incidental" to the Netherlands business.[52]

4. Attribution of business assets and activities

For purposes of the "substantiality" and "incidental" tests, the relevant business activity conducted in the Netherlands may be conducted directly by the Netherlands resident seeking Treaty benefits with respect to its US income. Alternatively, the business activity can be carried on in the Netherlands by another person, and that business can be attributed to the Netherlands resident. The Treaty specifies seven situations (described below) in which business activities of another person are attributed to the Netherlands resident. If a specified relationship exists and Netherlands business activity is attributed to the Netherlands resident from another person, (i) the Netherlands resident is deemed to be engaged in the business activity attributed to it, and (ii) the Netherlands resident is deemed to possess a proportionate share of the other person's assets, income and payroll expense for purposes of applying the "substantiality" and "incidental" tests, including the substantiality safe harbour.[53]

(a) *Attribution from a partnership*

A Netherlands resident that is a partner in a partnership is treated as being engaged in the active trade or business conducted by the partnership in the Netherlands, and the Netherlands resident partner is treated as having a proportionate share of the partnership's assets, income and payroll expense for purposes of the active trade or business tests (including the safe harbour).[54] For example, if a Netherlands resident owns a 20 percent interest in a partnership that conducts business in the Netherlands, the Netherlands resident would be treated as engaged in that business, and, for purposes of the

48. Treaty Art. 26(2)(b).
49. Treaty Art. 26(2)(c).
50. *Id.*
51. Treaty Art. 26(2)(c)(i), (ii) and (iii).
52. Treaty Art. 26(2)(d). The "incidental" test is similar in concept to the "asset use" test in Treas. Reg. §1.864-4 for determining whether interest and dividends is effectively connected to a US trade or business.
53. Memorandum Arts. XII and XV.
54. Treaty Art. 26(2)(e)(ii).

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safe harbour, the partner would be treated as owning 20 percent of the partnership's assets, income and payroll expense relating to the Netherlands business.

Example 6: NL, a corporation resident in the Netherlands, is a publishing company. NL licenses copyrighted literary works to and receives royalties from US persons. NL is not a "qualified person". NL is not actively engaged in the publishing business in the Netherlands, but owns a ten percent interest in a partnership ("Partnership") that is so engaged. The Partnership licenses literary works throughout Europe, including the Netherlands. Many of the same works licensed by the Partnership are also licensed by NL in the United States. For the previous taxable year, the asset values, gross income and payroll expenses of NL's US activities and of the Partnership's activities in the Netherlands were as follows:

	NL (US)	*Partnership (Netherlands)*
Assets	240	250
Income	40	50
Payroll	48	50

Under the partnership attribution rule, ten percent of the Partnership's assets, income and payroll are attributed to NL. Accordingly, the values of NL's US activities and attributed Netherlands activities, and the ratios of the Netherlands factors to the US factors, are as follows:

	US	*Netherlands*	*Netherlands as a % of US*
Assets	240	25	10.4% (asset factor)
Income	40	5	12.5% (income factor)
Payroll	48	5	10.4% (payroll factor)

Because each of these percentages exceeds 7.5 percent, and because the average of the three ratios exceeds ten percent, the "substantiality" safe harbour is met and NL is entitled to Treaty benefits with respect to its US-source royalty income.[55]

(b) *Attribution from a controlling shareholder*

Assets and activities of a business conducted in the Netherlands are attributed to a Netherlands resident from any single person that holds a "controlling beneficial interest" in the Netherlands resident.[56]

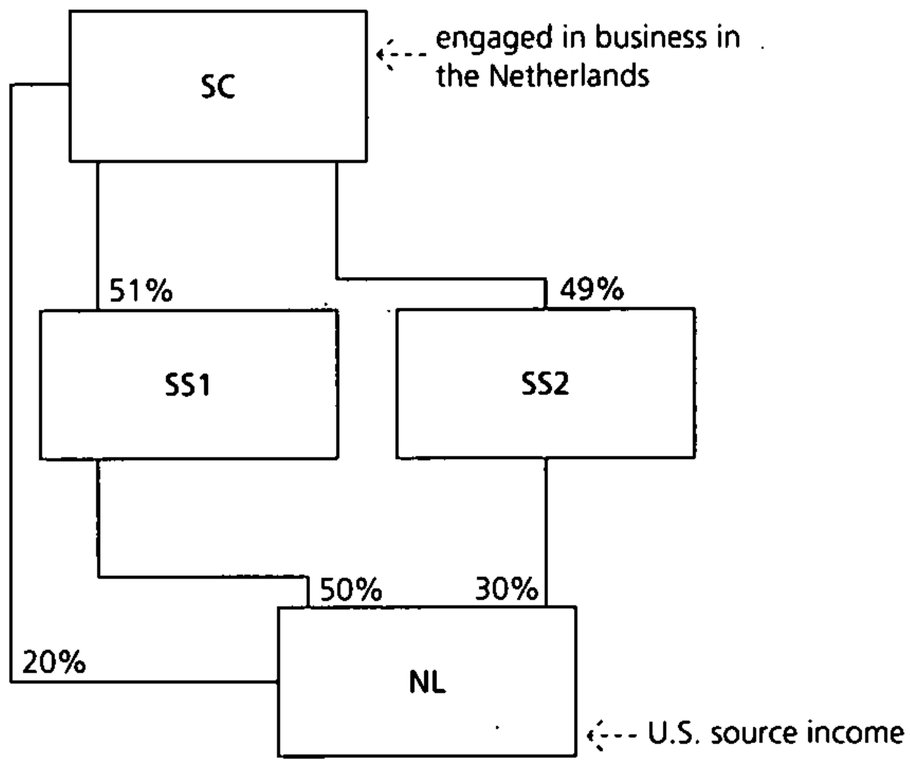
(i) *Controlling beneficial interest*

The concept of "controlling beneficial interest" is used throughout the active business attribution rules. A person holds a "controlling beneficial interest" in another person if it holds directly or indirectly a beneficial interest that represents more than 50 percent of the value and voting power in the other person.[57] This definition is subject to two limitations.

First, indirect ownership is taken into account only through intermediaries in which the controlling person (or other intermediary in the chain) owns more than 50 percent of the value and voting power.[58]

Example 7: NL is a Netherlands resident corporation that derives US-source income from business X. NL is not engaged in business X in the Netherlands. NL's stock is owned 20 percent by SC, a Sweden corporation. NL's remaining stock is owned 50 percent by SS1, a Sweden company whose stock is owned 51 percent by SC, and 30 percent by SS2, a Sweden company 49 percent of whose stock is owned by SC. SC is engaged in business X in the Netherlands. However, SC's Netherlands business activities cannot be attributed to NL because SC does not own a controlling beneficial interest in NL. SC owns, directly and indirectly, only 45.5 percent of NL's stock. SC owns 20 percent of NL directly and owns 25.5 percent indirectly through SS1 (SC owns 51 percent of SS1's 50 percent interest in NL). However, SC is not considered to indirectly own any of SS2's 30 percent interest in NL because SC does not own more than 50 percent of SS2's stock.

Example 7



Second, in determining whether a group of persons together own a controlling beneficial interest in an entity (which is relevant for the remainder of the attribution rules discussed below), a person cannot be a member of the "group" unless the person owns directly at least ten percent of the value and voting power in the entity.[59]

(c) *Attribution from a group of shareholders*

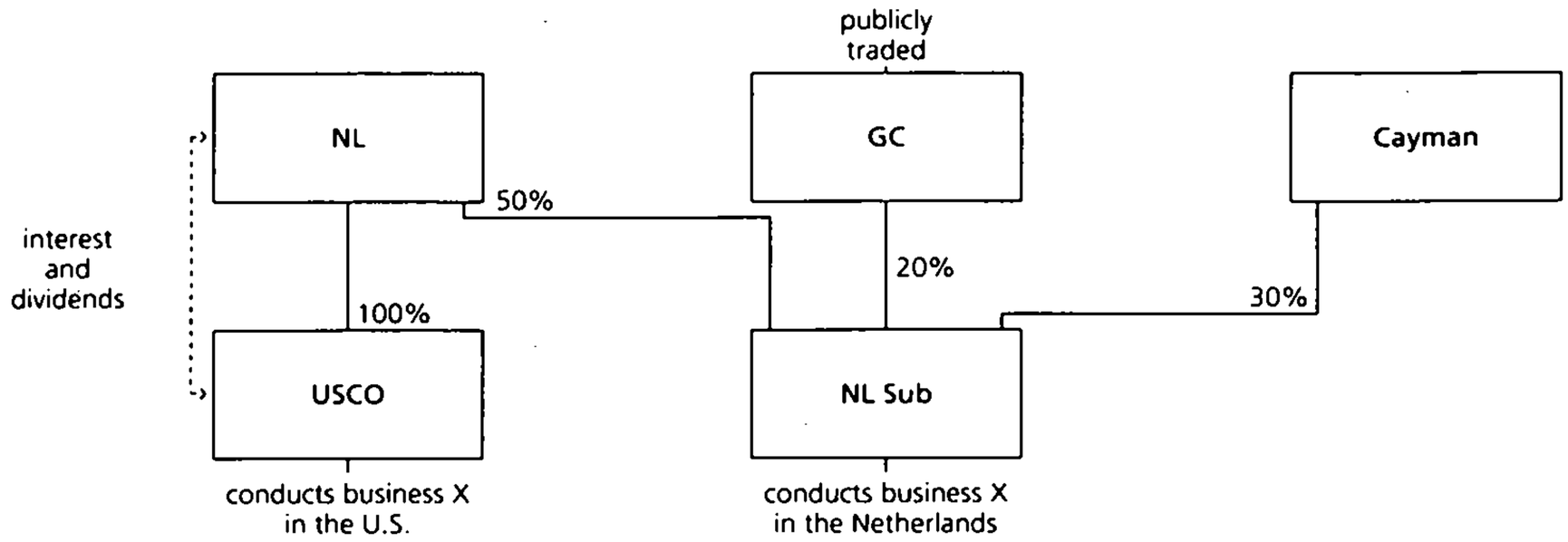
Netherlands business activities are attributed to a Netherlands resident from a group of five or fewer persons (1) that together own a controlling beneficial interest in the Netherlands resident, and (2) each of which is engaged in activity in the Netherlands that is a component part of or directly related to the business in the Netherlands.[60]

Example 8: NL is a Netherlands corporation whose stock is owned by ten shareholders, each of which is a corporation that conducts, in the Netherlands, a component part of a common business activity. One of the shareholders, XCo, owns 45 percent of NL's stock and each of the other nine shareholders owns five percent. None of the Netherlands business activities are attributed to NL because none of the minority shareholders directly owns ten percent of NL

55. It is worth noting, in the context of Example 6, that an active Netherlands business can also prevent the imposition of US withholding tax on royalties *paid by* a Netherlands resident in a "cascading royalties" scenario. For example, assume that NL in Example 6 has licensed its rights from and pays a royalty to X, a resident of the Bahamas. Under US tax principles, that royalty would be treated as US-source income subject to US withholding tax. See Rev. Rul. 80-362, 1980-2 C.B. 208. Art. 13(5)(d) of the Treaty would prevent the imposition of the US withholding tax provided that the use of the copyright by NL in the United States is a component part of or directly related to the active Netherlands business.
56. Treaty Art. 26(2)(e)(iii).
57. Treaty Art. 26(2)(f).
58. Treaty Art. 26(2)(f)(i).
59. Treaty Art. 26(2)(f)(ii).
60. Treaty Art. 26(2)(e)(iv).

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Example 9



and hence cannot be combined with XCo's 45 percent to form a controlling group.

(d) *Attribution from consolidated tax group members*

Netherlands business activities are attributed to a Netherlands resident from any member of a group of companies that form or could form a consolidated group for tax purposes under Netherlands tax law (as applied without regard to the residence of such companies), provided that at least one member of the group is engaged in the active conduct of business in the Netherlands.[61]

(e) *Attribution from subsidiaries and other controlled entities*

Netherlands business activities may be attributed to a Netherlands resident from entities (corporate or non-corporate) in which the resident owns a controlling beneficial interest. The Netherlands resident may own such interest itself. Alternatively, the controlling beneficial interest can be established if the Netherlands resident is one of a group of five or fewer persons that together own a controlling beneficial interest in the entity that has the Netherlands business. To be counted as a group member, each person owning an interest must (i) be either a qualified person, a resident of an EC member state or a resident of an "identified state"; and (ii) own directly at least ten percent of the voting power and value of the entity that has the Netherlands business.[62]

An "identified state" is any country, identified by the competent authorities, that has an exchange of information agreement in effect with the country of residence of the person whose eligibility for Treaty benefits is being tested (the Netherlands in our example).[63]

Example 9: NL, a corporation resident in the Netherlands, owns 100 percent of the stock of USCO, a US corporation, and 50 percent of the stock of NL Sub, a corporation resident in the Netherlands. GC, a German corporation, owns 20 percent of NL Sub's stock. The remaining 30 percent of NL Sub is owned by a Cayman Islands corporation. NL and GC do not directly conduct an active trade or business. However, USCO and NL Sub are engaged in the same active trade or business. USCO conducts that business in the United States and NL Sub conducts the business in the Netherlands. NL receives payments of interest and dividends from USCO. Assume that GC qualifies as a resident of an EC member state for Treaty purposes. Also, assume that NL is not a qualified person.

(a) NL is deemed to be engaged in the Netherlands business activities conducted by NL Sub because NL and GC as a group have a controlling beneficial interest in NL Sub, and GC is a resident of an EC member state. In addition, for purposes of applying the substantiality safe harbour, NL is deemed to own 50 percent of NL Sub's assets, income and payroll expense. (Note that the percentage of NL Sub's business items that are attributed to NL is 50 percent, the amount of NL Sub's stock owned directly or indirectly by NL. Although GC's 20 percent interest is counted in determining whether a qualified group owns a controlling beneficial interest in NL Sub, GC's 20 percent stock interest does not increase the attribution percentage to 70 percent because NL does not own that 20 percent stock interest directly or indirectly.)

(b) Assume that for each of the four most recently concluded taxable years, the asset values, gross income and payroll expenses of USCO and NL Sub attributable to the business are as set forth below. Also shown below is NL's proportionate share (50 percent) of the Netherlands assets, income and payroll attributed to NL from NL Sub, and the asset factor, income factor and payroll factor for purposes of the substantiality safe harbour:

	1 *USCO (US)*	2 *NL Sub (Neth)*	3 *Attribution from NL Sub to NL (50%)*	4 *Neth as a % of US (3÷1)*
Assets	$300	48	24	8.0% (asset factor)
Income	50	12	6	12.0% (income factor)
Payroll	60	12	6	10.0% (payroll factor)

Although each of the three factors exceeds 7.5 percent, the average of the three factors does not exceed ten percent. Therefore, the substantiality safe harbour is not satisfied.

(f) *Attribution from entities under common control*

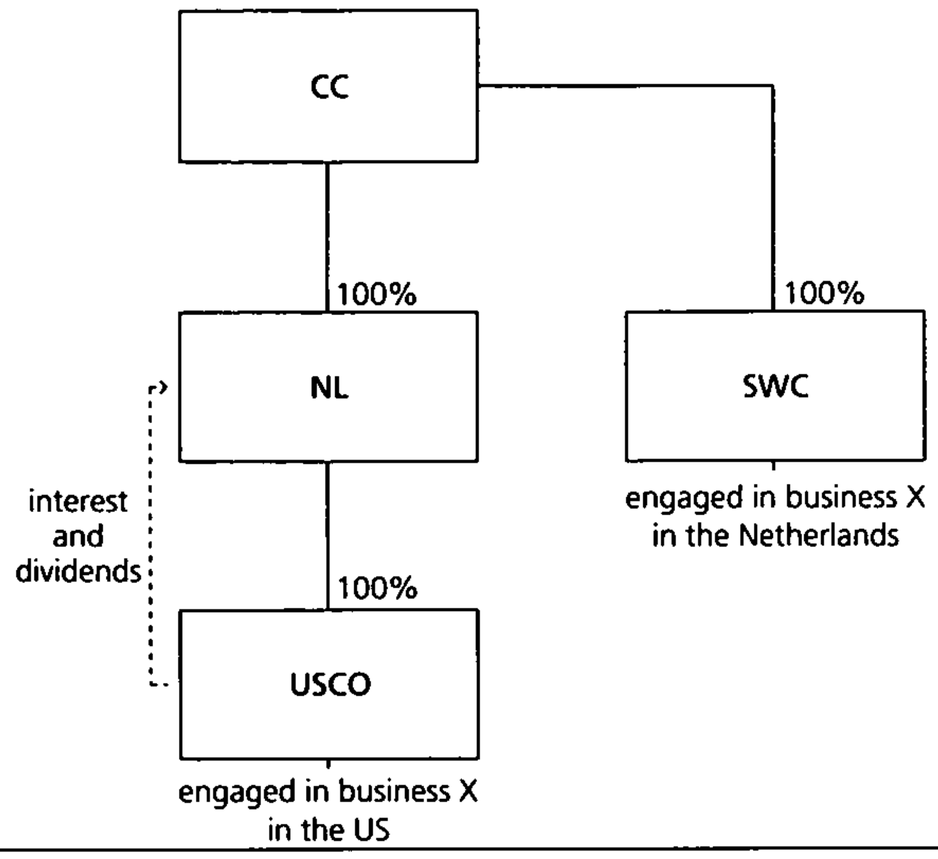
Finally, Netherlands business activities may be attributed to a Netherlands resident from an entity that, together with the Netherlands resident, is under the "common control" of a person (or a group of five or fewer persons), provided that (i) the controlling persons (or each member of the controlling group) is either a qualified person, a resident of an EC state or a resident of an identified state, and (ii) each member of the group owns directly at least ten percent of the voting power

61. Treaty Art. 26(2)(e)(v). The Treaty is not clear as to how many of the group members must be engaged in Netherlands business activities, but it is the author's understanding that only one member must be so engaged.
62. Treaty Art. 26(2)(e)(vi).
63. Treaty Art. 26(2)(e). Memorandum Art. XVI lists all of the "identified states" with respect to the United States and the Netherlands.

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and value of the entity that has the Netherlands business.[64] A person (or group) is treated as having "common control" of two persons if it holds a controlling beneficial interest in each person.[65]

Example 10



Example 10: CC, a Canadian corporation, owns 100 percent of the stock of NL, a Netherlands corporation, and 100 percent of the stock of SWC, a Swiss corporation. NL owns 100 percent of the stock of USCO, a US corporation. NL is not engaged in an active trade or business. SWC and USCO are actively engaged in the same line of business, and SWC is actively engaged in such business in the Netherlands. NL receives dividends and interest from USCO. NL is not a qualified person. However, SWC's active Netherlands business is attributed to NL for purposes of the active trade or business test because SWC and NL are under common control of CC, CC is a resident of an identified state (because Canada has an information exchange agreement in effect with the Netherlands). For purposes of the incidental and substantiality tests (including the substantiality safe harbour), NL is treated as owning 100 percent of SWC's Netherlands business assets (and income and payroll). Note that the country of residence of the commonly controlled entity (here, SWC) is not of relevance: this entity could be resident anywhere in the world so long as it and the Netherlands resident (here, NL) are under common control of the appropriate person or group. Note also that NL's proportionate share of Netherlands business attributed from SWC is 100 percent, even though NL does not directly own any stock of SWC. NL is treated as owning the proportionate share that is equal to the controlling person's (or group's) direct and indirect ownership of the controlled entity whose Netherlands business is being attributed.

5. Election to treat related EC business activity as Netherlands business activity

The Treaty provides a special annual election for purposes of the active trade or business test. If a Netherlands resident is eligible to make and makes the election, then, for purposes of the "incidental" and "substantiality" tests, activities conducted in other EC member states that are a component part of or directly related to the Netherlands business are treated as conducted in the Netherlands by the Netherlands resident.[66] This election (referred to here as the "EC business election") applies to activities conducted in the EC directly by the Netherlands resident in other EC countries, as well as activities that are conducted by other persons which are attributed to the Netherlands resident under the attribution of business activities principles discussed above at II.B.4.[67]

To be eligible to make the EC business election, a threshold three-factor test applies to ensure that the Netherlands business activities are substantial in relation to the other EC activities. The test is satisfied if, for the preceding taxable year, each of the following ratios exceeds 15 percent: (i) the ratio of the value of assets used or held for use in the active conduct of business in the Netherlands to the value of assets (or the proportionate share of the value) so used or held within EC member states (including the Netherlands), (ii) the ratio of gross income derived from the Netherlands business to the gross income (or the proportionate share of the income) derived from the business in EC member states (including the Netherlands); and (iii) the ratio of payroll expense for services performed in the Netherlands to payroll expense (or proportionate share thereof) for services performed in all EC member states (including the Netherlands).[68]

If this test is met, the Netherlands resident is eligible to make the EC business election. If the election is made, the "incidental" and "substantiality" tests are applied by treating all (or the proportionate share) of the EC business assets and activities that are conducted by or attributed to the Netherlands resident as though they were conducted by the resident in the Netherlands.

If the EC business election is made, the regular substantiality safe harbour, described above at II.B.2.(b), does not apply, and a different safe harbour test applies (the "election safe harbour"). The election safe harbour also focuses on the ratios of the assets, gross income and payroll expense of the Netherlands business to those of the related US income-producing activities. However, the election safe harbour increases the amount of Netherlands assets, income and payroll required to come within the safe harbour because, under the election, all of the actual and attributed EC assets, income and payroll are treated as Netherlands items. Specifically, if the EC business election is made, the substantiality safe harbour is met for a particular year if, for the preceding taxable year:

(1) the average of the asset factor, income factor and payroll factor exceeds 60 percent; and
(2) each of the three factors exceeds 50 percent (or, for any factor that does not meet the 50 percent test for the preceding year, the average for that factor for the three preceding years exceeds 50 percent).[69]

64. Treaty Art. 26(2)(e)(vii).
65. Treaty Art. 26(2)(g).
66. Treaty Art. 26(2)(h).
67. Memorandum Art. XVII. EC business activities can be attributed to a Netherlands resident from any person which, if it conducted business activity in the Netherlands, would have its proportionate share of such activity attributed to the Netherlands resident under the business attribution rules.
68. Although the text of the Treaty is somewhat vague on these points, it is the author's understanding that the 15% tests are applied to the results for the year preceding the taxable year in question, and that each of the ratios are calculated by including the Netherlands income, assets or payroll in the denominator of the ratio fraction.
69. Treaty Art. 26(2)(c) and (h).

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Example 11

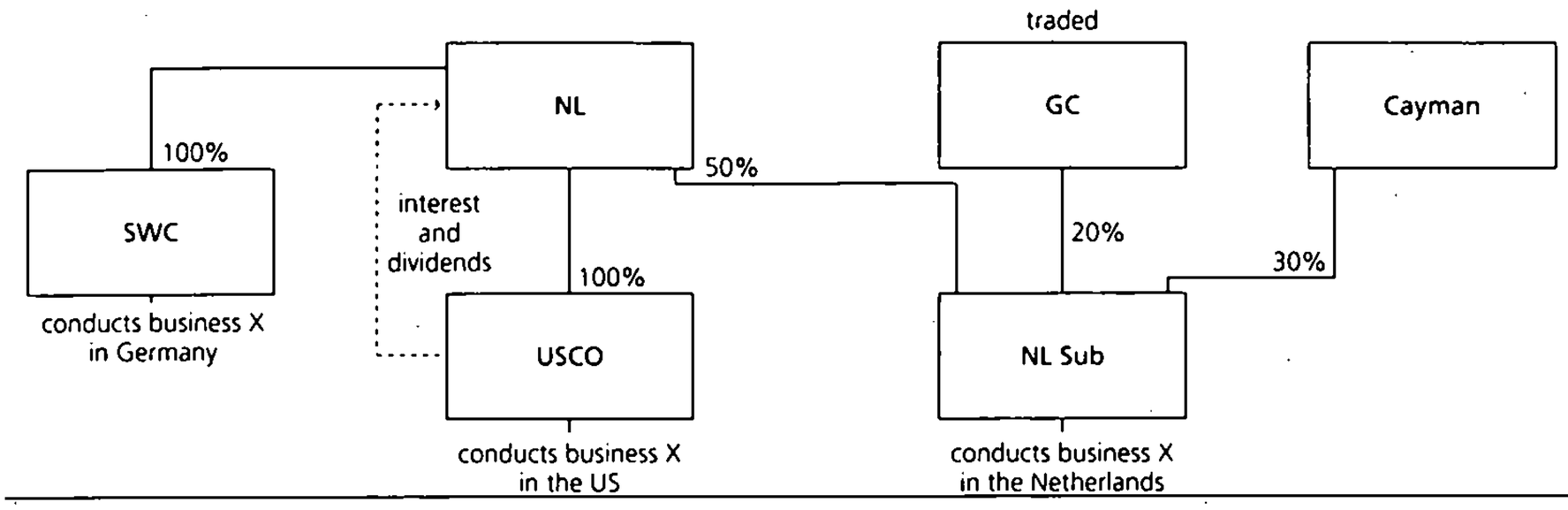


Chart I

	1	2	3	4	5	6	7	8
	USCO (US)	*NL Sub (Neth)*	*NL's share (50%) of NL Sub (Neth)*	*SWC (EC)*	*NL's share (100%) of SWC (EC)*	*Combined Neth and EC (3+5)*	*Neth as a % of Combined (3+6)*	*Combined as a % of USCO (6÷1)*
Assets	$300	48	24	131	131	155	18.3%	51.6%
Income	50	12	6	30	30	36	16.6%	72.0%
Payroll	60	12	6	30	30	36	16.6%	60.0%

Columns (1) and (2) of the chart show the asset value, income and payroll expense of USCO's US business activities and NL Sub's Netherlands activities, respectively. Column (3) shows NL's 50% proportionate share of NL Sub's assets, income and payroll. Column (4) shows the assets, income and payroll of SWC attributable to its EC business that is component part of or related to NL Sub's Netherlands business. Column (5) shows NL's 100% proportionate share of SWC items. Column (6) shows the aggregate of NL's proportionate share of income, assets and payroll of NL Sub (in the Netherlands) and SWC (in the EC). Column (7) applies the 15% test. The 15% test is satisfied because each of the ratios of NL's share of Netherlands activities to NL's share of EC activities exceeds 15%. Column (8) applies the election safe harbour (assuming that NL makes the EC business election). It shows the ratio of the combined Netherlands and EC assets, income and payroll to the assets, income and payroll of the US income-producing activity. The election safe harbour is met because each ratio exceeds 50% and because the average of the three ratios exceeds 60%.

Example 11: Assume the same facts as in Example 9, except that, in addition, NL owns 100 percent of the stock of SWC, a Swiss corporation that is actively engaged in Germany in the same line of business in which USCO and NL Sub are engaged. Assume that the Germany business activity is a component part of or directly related to the business conducted by NL Sub in the Netherlands. NL will be able to make the EC business election if the 15 percent ratio test is met. If the election is available and is made, 100 percent of SWC's Germany business activities are attributed to NL and are treated as though they were conducted by NL in the Netherlands. Attribution of SWC's activity to NL is permitted because, if SWC conducted its activities in the Netherlands, attribution would be permissible under the principles for attributing business activities from subsidiaries to parent entities described above at II.B.4.(e): NL owns a controlling beneficial interest in SWC. NL's proportionate share of SWC's activities is 100 percent because NL owns directly or indirectly 100 percent of SWC's stock.

Chart I illustrates that the election is available because the 15 percent test is satisfied, and that if the election is made, the modified substantiality safe harbour will be satisfied.

C. *Headquarter companies*

A person that is a resident of one of the Netherlands is entitled to all the benefits of the Treaty if that person functions as a headquarter company for a multinational corporate group. A Netherlands resident is considered a headquarter company for this purpose only if:[70]

(1) it provides a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing;

(2) the corporate group consists of corporations resident in, and engaged in an active business in, at least five countries, and the business activities carried on in each of the five countries (or five groupings of countries) generate at least ten percent of the gross income of the group;

(3) the business activities carried on in any one country other than the Netherlands generate less than 50 percent of the gross income of the group;

(4) no more than 25 percent of the Netherlands resident's gross income is derived from the United States;

(5) it has, and exercises, independent discretionary authority to carry out the headquarter functions referred to in (1) above;

(6) it is subject to the income taxation rules in the Netherlands that apply generally to Netherlands resident corporations (rather than some special, subsidized taxing regime); and

70. Treaty Art. 26(3).

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(7) the income it derives in the United States either is derived in connection with, or is incidental to, the group's active business referred to in (2) above.

If the gross income requirements of clauses (2), (3) or (4) above are not satisfied for the current year, they will be deemed to be fulfilled if the required ratios are met when averaging the gross income for the preceding four years.

A person is considered to be engaged in "supervision and administration" activities only if it engages in a number of the following types of activities: group financing (although this cannot be its principal function), pricing, marketing, internal auditing, internal communications and management. A headquarter company will be considered to provide a "substantial" portion of overall supervision and administration for the group if it performs these functions for the entire group or for a subgroup within the multinational (e.g. a geographical or product line subgroup), and the capital employed and control exercised in connection with these functions is substantial when compared with similar functions performed for the group (or the same subgroup) by other related companies.[71]

D. *Limited benefits for Netherlands companies*

A corporation resident in the Netherlands that is not a qualified person, and cannot satisfy the active business test is entitled to limited Treaty benefits if it (1) satisfies a stock ownership test (described below), and (2) satisfies the base reduction test described above at II.A.7.(a). Such a company is entitled only to the benefits under Articles 10 (Dividends), 11 (Branch Tax), 12 (Interest) and 13 (Royalties).[72]

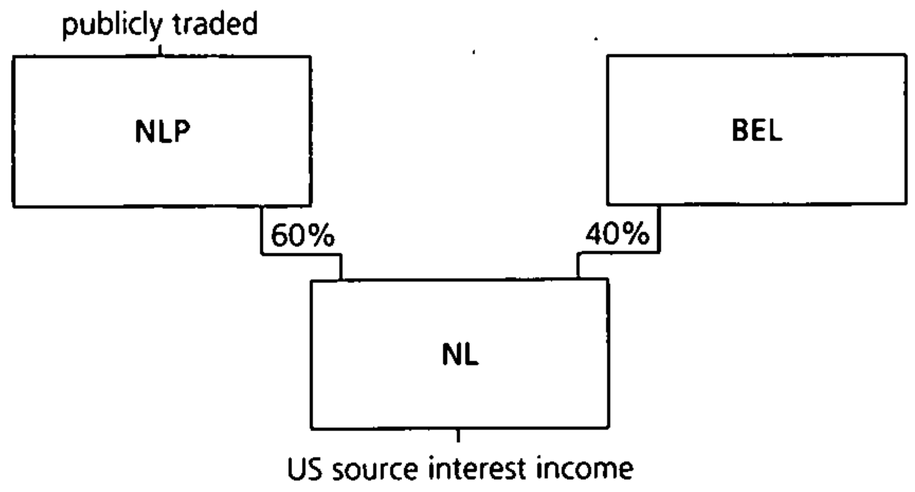
The stock ownership test is met if:

(1) more than 30 percent of the aggregate vote and value of its shares, and more than 30 percent of any disproportionate class of shares, is owned, directly or indirectly, by qualified persons that are resident in the Netherlands; and
(2) more than 70 percent of the aggregate vote and value of its shares is owned, directly or indirectly, by qualified persons and/or residents of EC member states.

Shares owned by a resident of an EC member state are taken into account for purposes of the second part of the test only if the particular dividend, income subject to the branch tax, interest or royalty payment for which Treaty benefits are claimed would be subject to a rate of tax under the tax treaty between the United States and that EC member state that is at least as favourable as the tax rate applicable to the Netherlands company under the Treaty.

Example 12: NL, a Netherlands corporation is owned 60 percent by NLP, a Netherlands corporation that meets the publicly-traded test, and 40 percent by BEL, a Belgium corporation that qualifies as a resident of an EC member state for Treaty purposes. NL receives interest from US sources that will be subject to 30 percent US withholding tax absent treaty relief. NL satisfies the first part of the stock ownership test because 65 percent (which is more than 30 percent) of NL's stock is owned by NLP, a Netherlands resident that is a qualified person. NL does not satisfy the 70 percent because BEL's interest cannot be combined with NLP's to satisfy the test for purposes of establishing Treaty benefits for interest payments. BEL's interest cannot be taken into account because, although Belgium is an EC member state, the income tax treaty between the United States and Belgium allows the United States to impose its withholding tax on interest payments at the rate of 15 percent. Because the US–Belgium treaty's provision on interest does not provide a tax rate for interest as favourable as the Treaty's zero rate, shares of NL owned by BEL are not taken into account for purposes of the more than 70 percent test.

Example 12



E. *Income from operation of ships or aircraft in international traffic*

The Treaty provides generally that profits derived from the operation of ships or aircraft in international traffic ("international transportation income") may be taxed only by the country of residence of the person that earns the profits.[73] If a person that has international transportation income fails to qualify as a qualified person, and cannot satisfy the active business test, the person nevertheless will be entitled to Treaty benefits with respect to that income if either of the following requirements is met:[74]

(1) more than 50 percent of the beneficial interest in the person (in the case of a company, more than 50 percent of the value of the company's stock) is owned, directly or indirectly, by either or a combination of qualified persons or individuals who are residents of any third state; or
(2) in the case of a company, the company's stock is primarily or regularly traded on an established securities market in a third state.

In addition, if satisfaction of either test depends upon ownership by individual residents of a third state, or stock trading in a third state, the third state must grant an exemption under similar terms for international transportation profits to citizens and corporations of the country from which the income is derived, either under its domestic law, or in a common agreement with that country (e.g. a diplomatic exchange of notes), or under a tax treaty between the third state and that country.

Example 13: NL, a Netherlands resident corporation, is engaged in the international operation of ships, and derives income from US sources attributable to these operations. NL is not a qualified person and does not satisfy the active trade or business test. NL's stock is not traded on any stock exchange. NL's stock is indirectly owned by five individuals each of which is resident in a different country, but each of which exempts US corporations from tax on

71. Memorandum Art. XVIII.
72. Treaty Art. 26(4)(a).
73. Treaty Art. 8 (Shipping and Air Transport).
74. Treaty Art. 26(6).

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international transportation income (either under the country's domestic law, or under a treaty or other agreement between the county and the United States). In this case, NL is eligible for Treaty benefits with respect to its international transportation income that would otherwise be subject to US tax.

This provision of the Treaty is based in part on the "reciprocal exemption" provisions of the US tax law with respect to international transportation income.[75] Under these provisions, income derived by a foreign corporation from the international operation of ships or aircraft is exempt from US income tax if the country of incorporation grants an equivalent exemption to US corporations and certain other requirements are met.[76] The exemption is available if the corporation's stock is owned more than 50 percent (determined by value) by individuals who are residents of the same foreign country or another foreign country that grants a reciprocal exemption, or if the corporation's stock is primarily and regularly traded on an established securities market in the corporation's country of incorporation, in another foreign country that grants a reciprocal exemption, or in the United States.[77]

F. *Benefits granted in the discretion of the competent authority*

If a person does not qualify for Treaty benefits under one of the numerous rules previously described, the person can request the competent authority of the country in which the income arises to determine that Treaty benefits are available. In making such a determination, the competent authority is required to consider "as its guideline" whether obtaining Treaty benefits is or was one of the principal purposes for the establishment, acquisition or maintenance of the person or for the conduct of its business. The competent authority of the country in which the income arises is required to consult with the competent authority of the other country before denying Treaty benefits under this provision.[78]

1. Factors to be considered

In the case of a Netherlands corporation that has income from US sources, the competent authority of the United States may consider the following factors (among others) in determining whether obtaining Treaty benefits was one of the principal purposes for the maintenance or operations of the corporation:[79]

(1) the date of incorporation of the corporation in relation to the date the Treaty entered into force;
(2) the continuity of the historical business and ownership of the corporation;
(3) the business reasons for the corporation residing in the Netherlands;
(4) the extent to which the corporation is claiming special tax benefits in the Netherlands;
(5) the extent to which the corporation's business activity in the United States is dependent on the capital, assets or personnel of the corporation in the Netherlands; and
(6) the extent to which the corporation would be entitled to US treaty benefits comparable to those afforded by the Treaty if it had been incorporated in the country of residence of the majority of its shareholders.

2. Changes in circumstances

In addition, the Memorandum states that one of the common situations in which a competent authority determination will be requested is the case where a company that formerly qualified for benefits undergoes change in circumstances that technically disqualifies the company.[80] Such changed circumstances may include a change in the state of residence of a major shareholder of a company, a sale of a part of the stock of a Netherlands company to a person resident in another EC member state or an expansion of a company's activities in other member states of the EC. The competent authority may determine that a change in circumstances need not result in a denial of benefits.

In considering whether to continue a company's entitlement to benefits after such a change, the competent authority is encouraged to consider the legal requirements for facilitation of the free flow of capital and persons within the EC, and the differing internal income tax systems, tax incentive regimes and tax treaty policies among the EC member states. In addition, a change in circumstance that is not attributable to tax avoidance motives will weigh in favour of continued entitlement to Treaty benefits.

3. Post-acquisition reorganization

The Memorandum describes another circumstance in which discretionary entitlement to benefits should be granted. This is the case where a group of companies is acquired and a reorganization is needed in order to entitle one or more of the acquired companies for Treaty benefits.

> *Example 14*: NLP, a Netherlands corporation, purchases all of the stock of LUX, a Luxembourg corporation from an unrelated third party. NL Sub is a wholly-owned subsidiary of LUX. Assume that NLP meets the publicly-traded test. Although all of NL Sub's stock is indirectly owned by NLP after the acquisition, NL Sub cannot qualify for Treaty benefits under the subsidiary test (see II.A.5 above) because, for purposes of this test, indirect ownership is taken into account only if the intermediary is a resident of either the United States or the Netherlands, and LUX is not a resident of either. Assume also that NL Sub derives income from US sources and is not entitled to Treaty benefits under any other provision of Article 26.
>
> The Memorandum provides that, in the context of Example 14, if NL Sub submits a reorganization plan to the US competent authority, and if the plan would cause NL Sub's to be entitled to Treaty benefits, then the US competent authority should treat NL Sub as entitled to Treaty benefits for a transition period of reasonable duration between the time of the acquisition and the completion of the reorganization.[81] The liquidation of LUX would be one example of a reorganization that would cause NL Sub to qualify for Treaty benefits, because NL Sub would then satisfy the subsidiary

75. Sec. 883 of the Code.
76. Similar rules apply to non-resident individuals. See Sec. 872(b) of the Code.
77. See Sec. 883(c) of the Code. The Treaty provision is more restrictive than the Code's reciprocal exemption. For example, the exemption is also available under the Code if the foreign corporation is a "controlled foreign corporation" or a subsidiary of a publicly-traded company.
78. Treaty Art. 26(7).
79. Memorandum Art. XIX.
80. Memorandum Art. XXI.
81. Memorandum Art. XXV.

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test. Other reorganizations could involve transfers of the NL Sub stock to another Netherlands or US corporation in the NLP group that in turn is owned directly by NLP.

4. Companies trading in stocks and securities

The Treaty provides that certain companies engaged in stock and securities trading activities shall automatically be entitled to Treaty benefits if a request is made under the competent authority provision. In the case of a company resident in the Netherlands, it would automatically qualify if the company:

(1) holds stocks and securities the income from which is not predominantly from sources within the United States;
(2) has widely dispersed ownership; and
(3) employs in the Netherlands a substantial staff actively engaged in trades of stocks and securities owned by the company.[82]

G. *Proof of eligibility for benefits*

The Memorandum provides standards for requiring taxpayers to prove their status as "qualified persons", or otherwise prove their eligibility for Treaty benefits.[83] A taxpayer must be able to provide, upon request, "sufficient proof" to establish the taxpayer's entitlement to Treaty benefits. However, the Memorandum acknowledges that a broad and ongoing requirement to provide proof of entitlement would impose a severe administrative burden on the taxpayer. Accordingly, the competent authorities agree to develop by mutual agreement reasonable procedures for the periodic reporting of the facts necessary to support entitlement to benefits.[84] The competent authorities agree to strive to minimize the frequency of reporting. For example, once an entitlement to benefits has been documented, the taxpayer should thereafter only be required to report any relevant changes in the facts.

H. *Entry into force*

The treaty will not be effective until the US Senate and its counterpart in the Netherlands formally ratify the Treaty. Assuming that the Treaty is ratified in 1993, then, subject to a transition rule, the Treaty will be effective for taxable years beginning, and payments made after, 1 January 1994.[85]

However, if a person is entitled to greater benefits under the existing US–Netherlands treaty than under the Treaty, the person may elect to have the existing treaty (in its entirety) apply in lieu of the Treaty for a one-year period.[86] Assuming that the Treaty is ratified in 1993, then, for persons electing this one-year transition rule, the Treaty would be effective for tax years beginning after and payments made after 1 January 1995.

III. CONCLUSION

The Treaty limitation of benefits provisions are an historic culmination of 12 years of debate and action on treaty shopping. It sets two important precedents. First, it indicates that the United States may be willing to negotiate comprehensive tax treaties with countries it considers to be tax havens, provided that potential abuses are restricted, such as through the "conduit company" concept. Second, the Treaty allows derivative benefits keyed to the EC. It will be interesting to see whether the other EC member states will now seek protocols to incorporate this concept into their US treaties, and whether the United States will incorporate it into its new model treaty and/or in new and renegotiated bilateral treaties.

The new Treaty will have a major impact on residents of third countries who have utilized the existing US–Netherlands treaty in structuring their current US investments or in establishing a holding company or finance company for a corporate group. These parties will have to assess whether they will be eligible for benefits under the Treaty, and if not, they will need to consider whether and how to restructure their operations to minimize the US withholding and other taxes that would be imposed under the terms of the Treaty. A multinational corporation now using a Dutch holding company that would not qualify for benefits under the Treaty may seek to replace it with a holding company organized in another country that would be eligible for benefits under a US tax treaty. For example, the use of a Luxembourg holding company may be a viable alternative.

Another alternative, perhaps less attractive for restructuring than for new business, is a joint venture with other EC residents as participants. The derivative benefits for companies owned in part by EC residents may provide an additional justification for using a Netherlands holding company or finance company in the context of joint ventures among and between non-European firms and European firms.

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82. Memorandum Art. XX.
83. Memorandum Art. X.
84. Certain Dutch investment organizations (a "beleggingsinstelling") that are required to furnish proof to the Dutch taxing authorities as to their ownership by Dutch resident shareholders, can use the same proof to establish their eligibility for Treaty benefits. See Memorandum Art. XI.
85. Treaty Art. 37(1).
86. Treaty Art. 37(2).

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TREATY SHOPPING UNDER THE NEW US–NETHERLANDS TREATY[1]

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I. INTRODUCTION

Almost by definition, treaty shopping is almost as old as tax treaties. The mere existence of an official mechanism to reduce taxes in international transactions is an invitation to its use by persons other than its intended beneficiaries. Governments tend to dislike the practice when it is their revenues which suffer, but to this observer the objection is one of dollars and cents, francs and centimes or marks and pfennigs, not one of principle. The tolerance level rises visibly when it is the other fellow's revenues which suffer – especially if this increases home-country revenues by cutting back on the need to give credit relief for foreign taxes paid by domestic taxpayers.

In some countries, the official reaction to treaty-shopping has gone beyond mere acceptance. Tax treaties have become national assets to be made available for a fee to third parties. This has been true of a number of smaller jurisdictions which inherited tax treaties from their days as colonies. In the second half of this century tax treaties have been an important source of revenue to the Netherlands Antilles and to the British Virgin Islands. However, most of their business by now has been eliminated by the cancellation of their most profitable treaties.

Earlier, Switzerland had earned itself a reputation as a purveyor of tax treaty benefits, but its role as such was reduced by the adoption, under pressure from its treaty partners, of the 1962 Swiss measures against abuse of tax conventions.[2] The Netherlands has had a longer run. Netherlands companies are available to all comers as vehicles for inward investment to the many countries with which the Netherlands maintains tax treaties – the usual application being a holding company or a company which makes inward loans or technology transfers. In such cases, Netherlands treaties serve to reduce source-country withholding taxes on dividends, royalties and interest.

About 11 years ago, US Treasury spokespersons began making public statements to the effect that the United States would not sign any further treaties not containing provisions designed to restrain treaty shopping. That led to the last article by this author on the subject of treaty shopping which appeared in 1982.[3] Since 1982, the use of such measures has become regular US practice. Anti-treaty-shopping provisions regularly are incorporated in US treaties[4] and the practice has spread to other countries. Even internal US law now contains such provisions which unilaterally "override" bilateral treaties not containing sufficient built-in safeguards.[5]

The Netherlands authorities made no secret of their lack of enthusiasm for a new treaty with the United States containing a "limitation on benefits" provision. An article co-authored by the person regarded as the principal US architect of the new Netherlands–US treaty states:

> [The] congressional willingness to deny treaty benefits, by legislative fiat, to persons who were 'abusing' treaties turned desultory and fitful talks with the Dutch into real negotiations.[6]

The new Netherlands–US tax treaty carries anti-treaty-shopping provisions to new heights. It contains some 23 pages of text under the heading "limitation on benefits"[7] intended to limit sharply the use of the Netherlands as a base country for investment into the United States.[8] The authors quoted above, despite their involvement in drafting the treaty, refer to those pages as full of "turgid, mind-numbing prose"[9] and, in fairness, any practicing lawyer soon learns that hard negotiations

Contents

I. Introduction
II. Operation of the Limitation on Benefits Provisions
III. Commentary
IV. The Strange Case of the Stacked Qualified Persons Companies
V. Conclusion

1. This paper seeks to organize the complicated treaty provisions in a relatively simple manner. In so doing, it omits mention of a number of details which can be important in a particular case. Reference to the treaty itself is essential.
2. Publication No. 19 of the International Bureau of Fiscal Documentation (IBFD: Amsterdam, 1963). Despite these rules, Switzerland continues to play a role in the international treaty-shopping scene. The 1962 rules do not cover every transaction. Even where the transaction is covered, the price exacted by the 1962 rules may be worth paying to secure the treaty benefits.
3. Kaplan, "The Shoppable Treaty: Should it Become Extinct", *Tax Management International Journal* (June 1982).
4. An early example was Art. 16 of the UK–US treaty (1980). A more recent example is Art. 28 of the Germany–US treaty (1990). This despite the fact that neither the United Kingdom nor Germany had been an attractive country for treaty shoppers.
5. See, e.g., IRC 1986, Sec. 884(c)(2) limiting the US branch profits tax on "qualified residents" of countries having tax treaties with the United States.
6. Morrison and Bennett, "The New US–Netherlands Treaty: Part I – Limitation on Benefits and Related Issues", *Tax Notes International* (8 February 1993).
7. Treaty Art. 26.
8. In terms, the treaty also operates to inhibit the use of the United States as a base country for investment into the Netherlands, but that is not its main thrust.
9. Morrison and Bennett, *supra* note 6.

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Chart I: The Ten Categories of Treaty Qualification for a Netherlands Company

Tests Categories	Permitted Ownership	Public Ownership	Conduit Company	Base Reduction	Active Business
1. Listed & Traded Company[1]		• Listing on a recognized U.S. or NL exchange • Regular trading on a recognized exchange [NOTE A]			
2. NL/US Indirectly Traded Company[2]	More than 50% directly or indirectly owned by 5 or fewer companies resident in the US & NL	As to shares of SH companies: • Listing on a recognized US or NL exchange • Regular trading on a recognized exchange [NOTE A]	The company must not be a conduit company [NOTE B]		
3. NL/EC/US Indirectly Traded Company[3]	• 30% directly or indirectly owned by 5 or fewer NL companies, *and* • 70% directly or indirectly owned by 5 or fewer EC companies or US companies [NOTE C]	As to shares of 30% owners: • Listing on US or NL exchange As to both groups: • Regular trading on recognized exchange [NOTE A]	The company must not be a conduit company [NOTE B]		
4. Indirectly Traded Conduit Company[4]	Company must satisfy the permitted ownership test either of the NL/US or of the NL/EC/US Indirectly Traded Company category	The shareholder companies must satisfy the relevant public ownership test	This exception assumes that the company *is* a conduit company [NOTE B]	Base reduction payments to low taxed, non- qualified, associated persons limited to: • 70% of total income to EC residents • 30% of total income to others [NOTE D]	
5. Qualified Person Company[5]	Company must be more than 50% directly or indirectly owned by qualified persons [NOTE E]			Base reduction payments to non-qualified persons, whether or not associated persons limited to: • 70% of total income to EC residents • 30% of total income to others [NOTE D]	
6. Qualified Person Charity[6]	The company is a not-for-profit company and a majority of its members, beneficiaries, etc. are qualified persons [NOTE E]				
7. Active Business Company[7]					• The company is engaged in a substantial active business, other than an investment business, in the NL and the US • Income is derived from that business or is incidental to it
8. Headquarters Company[8]					The company must provide a substantial portion of the overall supervision and administration of a multinational group doing business in at least 5 countries and must be taxed as an active business company in the NL
9. Limited Treaty Use Company[9] (covering only withholding taxes on dividends, interest, royalties and branch operations)	• The company must be more than 30% directly or indirectly owned by qualified persons resident in the NL, and • More than 70% directly or indirectly owned by qualified persons and persons resident in the EC whose treaty rate of tax is as low as that claimed under this treaty [NOTE E]			Base reduction payments to non-qualified persons, whether or not associated persons limited to: • 70% of total income to EC residents • 30% of total income to others [NOTE D]	
10. Shipping & Air Transportation Company[10]	The company must be more than 50% directly or indirectly owned by qualified persons and persons resident in a third country which grants a similar exemption	Alternatively, the company's stock is primarily and actively traded on an established securities market in a third country which grants a similar exemption			

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NOTES AND FOOTNOTES FOR CHART I

A. "Recognized" stock exchanges are exchanges registered with the SEC as national security exchanges, the Amsterdam Stock Exchange, the NASDAQ System except as to closely-held companies and other exchanges to be added to the list by the two countries.[11] They have announced that the stock exchanges of Frankfurt, London and Paris will be added to the list.[12]

B. A conduit company is one that makes payments of interest, royalties and other types of payments defined as "deductible" at least equal to 90% of its aggregate receipts from such items. An exception is provided for certain active business banks and insurance companies.[13]

C. As examples, this test could be satisfied by 70% ownership by a single NL company – the 30% NL ownership would be subsumed in the 70% EC ownership – or by 20% ownership by an NL company and 50% ownership by four companies from other EC countries. In all cases, it requires that a 70% block be owned by five of fewer shareholders.

D. Base reduction payments are deductible payments (interest, royalties and other payments to be defined) to non-qualified persons.[14]

E. Qualified persons are US citizens and all other persons entitled to the benefits of the treaty under one of the first six categories.[15] Entities entitled to treaty benefits under one of the final four categories (Active Business Company, Headquarters Company, Limited Treaty Use Company or Shipping and Air Transport Company) are not "qualified persons". This definition is less circular than it seems at first glance because four of the six categories are not defined in terms of ownership by qualified persons. Thus a Listed and Traded Company, for example, would be entitled to the benefits of the treaty without being defined in terms of itself and could be the qualified person mentioned in the Qualified Person Company category.
EC residents, to be "good" shareholders for purposes of the Limited Treaty Use Company category, must satisfy the hypothetical requirements for benefits under the new treaty that would be applicable if the other EC country were the Netherlands. In addition, they must satisfy the real requirements of their own treaty with the United States.[16] For example, a French company would be a "good" shareholder only if it could satisfy the anti-treaty-shopping provisions of both the Netherlands–US treaty and those of the France–US treaty.

1. Treaty Art. 26(1)(c)(i).
2. Treaty Art. 26(1)(c)(ii).
3. Treaty Art. 26(1)(c)(iii).
4. Treaty Art. 26(1)(c)(iv).
5. Treaty Art. 26(1)(d).
6. Treaty Art. 26(1)(e).
7. Treaty Art. 26(2).
8. Treaty Art. 26(3).
9. Treaty Art. 26(4).
10. Treaty Art. 26(6).
11. Treaty Art. 26(8)(d).
12. Understanding of the two governments, ¶ 22.
13. Treaty Art. 26(8)(m).
14. Treaty Art. 26(5).
15. Treaty Art. 26(8)(g).
16. Treaty Art. 26(8)(i).

make for untidy documents. In addition to the celebrated 23 pages, the treaty is accompanied by an "[u]nderstanding regarding the convention" issued by the two governments consisting of 30 numbered sections of which 15 concern the limitation on benefits article.

This article will contain its share of commentary and even some analysis. However, its principal focus is to restate the anti-treaty-shopping provisions of the new treaty in a manner that will allow mere mortals – this author being a long-standing member of that category – to understand their basic operation.

II. OPERATION OF THE LIMITATION ON BENEFITS PROVISIONS

Article 26 of the treaty begins by stating that individuals and governmental units, resident in one of the two contracting states, shall be entitled to the benefits of the treaty. As to companies, the treaty operates by defining ten categories which qualify for treaty benefits[10] – in one case for only partial treaty benefits. All others are ineligible unless they throw themselves on the mercy of the tax authorities and are granted discretionary relief.[11]

In defining the ten categories, five tests are employed. (see chart I above and Decision Tree below). Some tests apply to some categories, some to others; sometimes in the same form, sometimes with variations. No one test is applied to all ten categories. While the overall thrust is self-evident, the intended purpose of many of the rules is unclear. Variations of the same test appear without explanation. Some percentage tests are expressed as "more than ...%", others simply as "...%". In short, the limitation on benefits rules fairly cry out to be expressed in some systematic fashion.

The five tests are:

(1) *Permitted Ownership* – treaty shopping usually takes the form of ownership of a treaty entity by third-country taxpayers. To counter this, seven of the ten tests employ some measure of required ownership. This may be a requirement that the Netherlands company be owned by a small group of Netherlands and/or US corporate shareholders, that a specified percentage of the company be owned by Netherlands and other EC shareholders or that a specified percentage be owned by "qualified persons". "Qualified persons" are defined as a citizen of the United States and as any other person entitled to the benefits of the treaty "pursuant to the provisions of paragraph 1", meaning that members of some, but not all ten, categories of persons entitled to treaty benefits will be "qualified persons" whose subsidiaries also can qualify.[12]

(2) *Public Ownership* – five tests permit defined amounts of third-country ownership if the company or, alternatively, its parent company, is publicly held and widely traded.

(3) *Conduit Company* – two of the tests require that the company not be a "conduit company", i.e. a company which receives interest and royalty income and pays out 90 percent or more of that income as interest, royalties or certain other forms of tax-deductible payments. Note that a company does *not* lose its taint as a conduit company simply because the payees are qualified persons.

(4) *Base Reduction* – employing a variation on the conduit company approach, two of the tests require that the company not pay out too much of its otherwise taxable Netherlands income in the form of deductible payments of interest and royalties to persons who are not qualified persons.

(5) *Active Business* – two of the tests require that the company satisfy an elaborate set of rules designed to ensure that it is

10. At times the treaty presents difficulties in deciding whether an item is a new category or merely a sub-category. Thus, the "indirectly traded conduit company" is treated as a full category for purposes of the table below but as a sub-category in the decision tree which follows the table. In both cases, the form of presentation was dictated by clarity of presentation.

11. The two governments have pre-agreed upon one set of facts that will be entitled to discretionary relief and this comes close to being an eleventh category, the principle difference being that entitlement is not automatic – advance clearance must be obtained. For a Netherlands company to qualify it must:
(1) hold stocks and securities the income from which is not predominantly from US sources,
(2) have "widely disbursed" ownership,
(3) employ a "substantial staff" in the Netherlands engaged in the securities trading, and
(4) secure the approval of the US Internal Revenue Service.
Understanding between the two governments, ¶ XX.

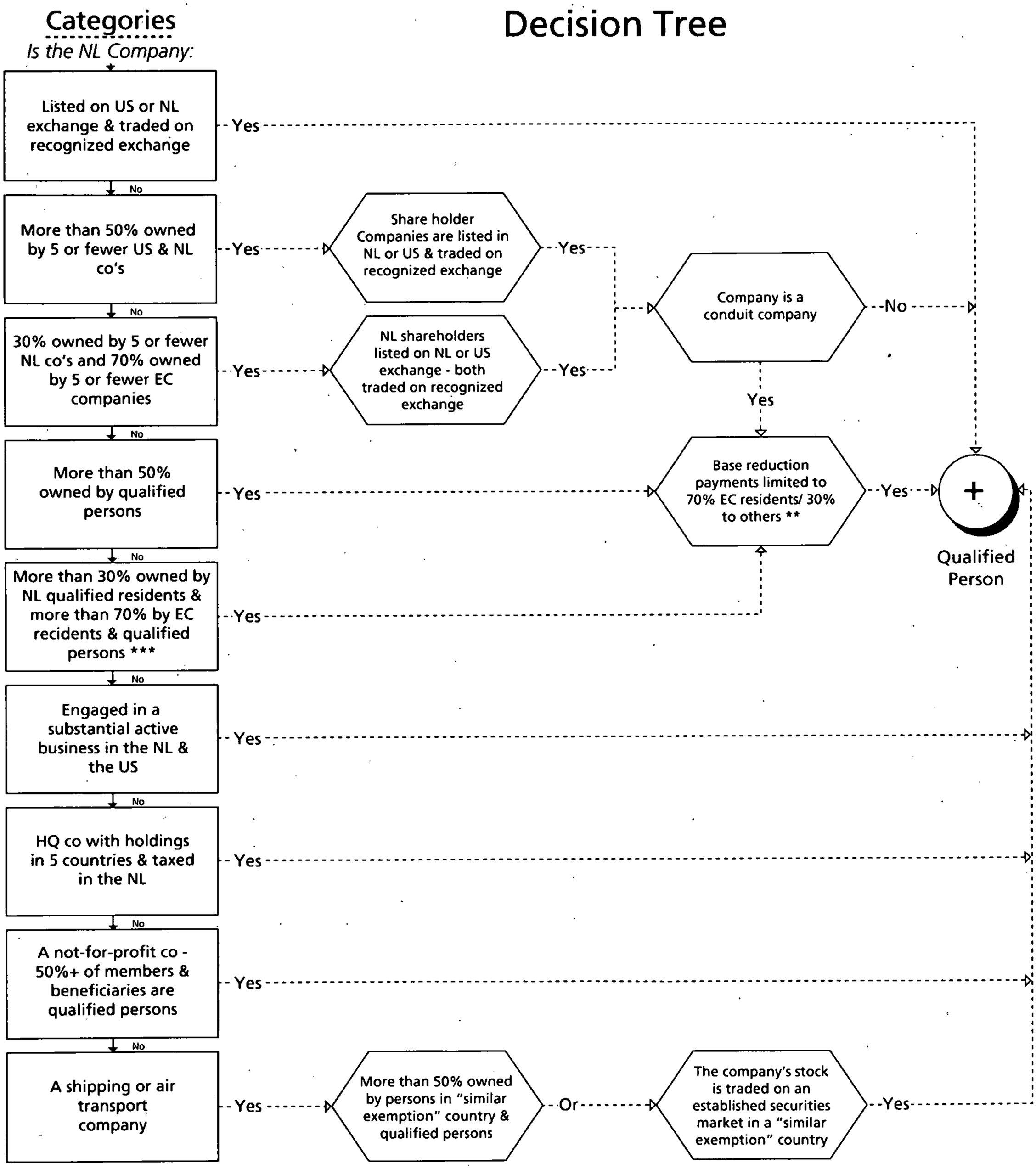
12. Treaty Art. 26(8)(g).

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a *bona fide* Netherlands business corporation or a *bona fide* Netherlands headquarters company.

For those readers who prefer a decision tree, the information in Chart I is presented in that form below.

Decision Tree



Notes

* At each dead-end, e.g. where the response is "no" but there is no arrow with that caption, descend to the next lower category. When all categories are exhausted, the Netherlands company is a non-qualified person.

** Two variations of the base reduction rule are involved. If the company is a conduit company, only payments to associated non-qualified persons in low-taxed jurisdictions are taken into account. In other cases, payments to all non-qualified persons are taken into account.

*** Entitlement to treaty benefits under this category carries only limited treaty entitlement with it – use of the treaty provisions reducing withholding taxes on dividends, interest, royalties and branch operations, but of not other treaty provisions.

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II. COMMENTARY

In some respects, the limitation on benefits provisions operate in a predictable fashion.

It is not difficult to understand why they give emphasis to base erosion[13] since that is a favoured technique of third-country investors into the United States by way of a Netherlands company.

The exemption for listed and publicly-traded companies is a logical one. The Netherlands is the home jurisdiction of some large multinational concerns such as Phillips and Royal Dutch Shell which are mainly owned by investors of other nationalities. Most observers would agree that these companies have a legitimate claim to be regarded as Dutch for treaty purposes. Indeed, if Netherlands' treaties were not available to them, they effectively would be stateless.

The active business exception reflects a concern with real life cases of long-established, active businesses in the country owned by nationals of another country.[14] At some point, a company becomes a local entity despite being owned by non-local shareholders.

Other features are not so self-evident. Indeed, some of them are quite mystifying. For example, why were some, but not others, of the companies qualifying for treaty benefits designated as "qualified persons" – as shareholders whose ownership qualifies the company for treaty benefits? This leads to the surprising result that a Netherlands headquarters company may itself qualify for treaty benefits, but its Netherlands subsidiary will not be a qualified person company because a headquarters company is not a qualified person.

Even more mysterious, is the use of the phrase "directly or indirectly owned". Of the ten categories of Netherlands companies entitled to treaty benefits, six employ the concept of direct or indirect ownership. For purposes of three categories, and of only those three, the treaty defines the phrase to mean:

> "that all companies in the chain of ownership that are used to satisfy the ownership requirements...must meet the residence requirements...[15]

Since this definition explicitly is made applicable only to the NL/US and NL/EC/US indirectly traded categories, and thus automatically becomes applicable to the indirectly traded conduit company category,[16] it must have a different meaning as applied to the other three categories that refer to "direct or indirect" ownership – the apparent meaning being that indirect ownership can be by way of a non-qualified person. For example, a Netherlands company more than 50 percent owned by Netherlands individuals could own 100 percent of a Bermuda company which in turn owned Netherlands company #2 – which itself would be entitled to treaty benefits under the qualified person company category. Why is a qualified person company permitted to have a non-qualified person in the chain of ownership while the three categories of indirectly traded companies are not? Why indeed!

Some of these mysterious features may stem from the long and difficult treaty negotiations. It is likely that others are attributable to the seeming lack of a consistent definition of "treaty shopping" on the US side – a lack that was apparent well before the publication of the new Netherlands–US treaty. As examples:

(1) As has been the case with prior versions of US anti-treaty-shopping clauses, the new treaty places US citizens automatically in the qualified person category. This means that a Netherlands company can count such citizens in the "good" category in deciding if the company is entitled to treaty benefits with respect to its income from US sources. However, US citizens investing in the United States through a Netherlands company may well be treaty shoppers. Why should they be favoured over, say, Saudi residents?

The probable explanation for the inclusion of US citizens in the "good" category is the double standard that has become regular fare in US international tax relations. For example, no attempt is made to prevent US investors from using Netherlands companies when investing in the EC and many do so. The reason for this difference is not hard to guess. When third parties use Netherlands companies to invest in the United States it is US revenues which suffer, but when US companies use Netherlands companies for investment in the EC US revenues are increased because creditable foreign taxes are reduced.[17]

2. The new treaty adopts, for the first time in US practice, the "derivative benefits" doctrine under which residents of states having comparable tax treaties with the United States are not considered to be treaty shoppers when they invest in the United States through a Netherlands company.[18] While it is logically correct to say that such persons should not be presumed to be treaty shoppers, because they had the same treaty benefits available to them at home, they often will be jurisdiction shoppers – investing through the Netherlands to escape home-country restrictions of one or another type.

Why should the United States encourage such behaviour? Once more, it is likely that the reason can be discovered by examining the question of whose ox is being gored.

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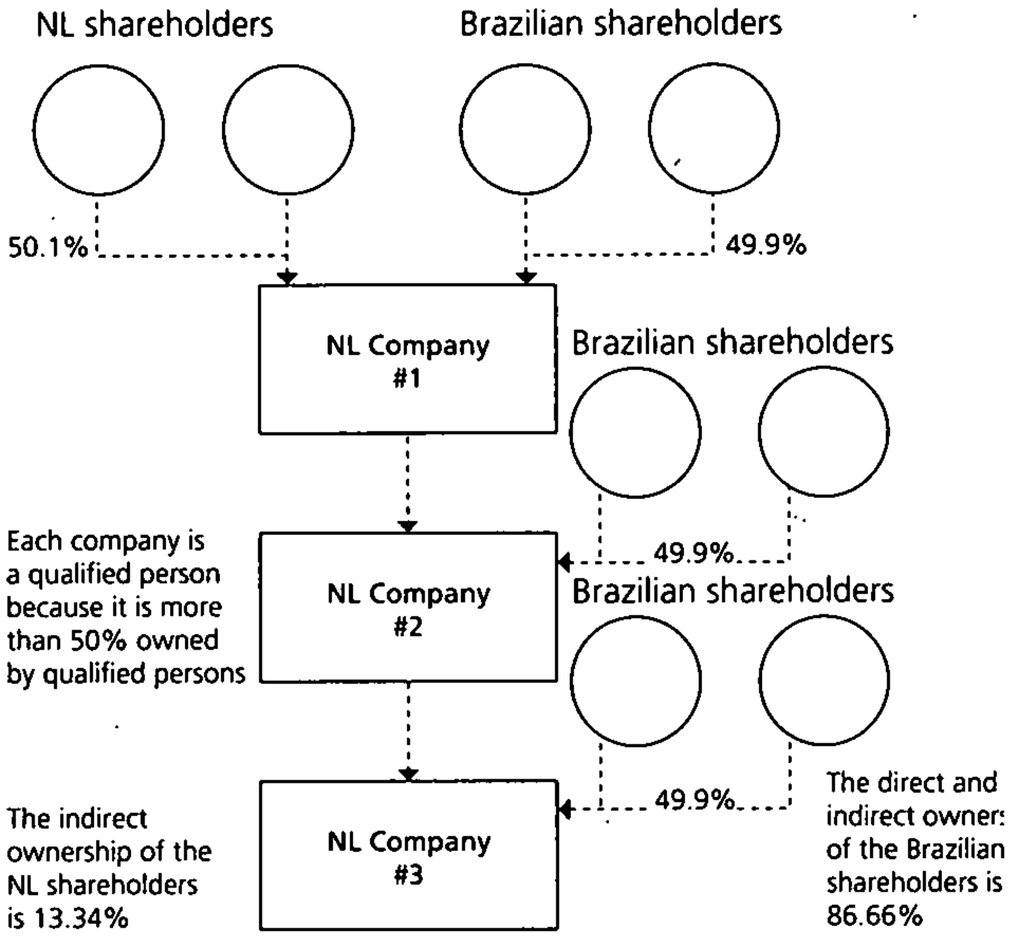
13. Base erosion is the practice of paying out treaty-favoured income received by the base company in a deductible form, such as interest or royalties, in order to minimize taxes of the base jurisdiction – the Netherlands in this case. The practice is greatly aided by the fact that the Netherlands does not, under its internal law, levy a withholding tax on interest or royalties paid by a Netherlands company.
14. Such as the German textile company which has been French-owned for about 150 years but has conducted a substantial, active and successful business in Germany during that period. That company should not be deprived of the right to claim protection under Germany's tax treaties.
15. Treaty Art. 26(8)(k).
16. This last incorporates the ownership tests of the first two.
17. An even more striking example of the US double standard is the evolution of the US foreign tax credit which, in its present form, is designed in many cases to give less than 100% credit for foreign taxes paid unless the US parent company artificially reduces the base on which its subsidiaries pay foreign taxes by a series of charges for "management" and other services supposedly rendered in the United States. At the same time, the United States is engaged in a campaign against foreign concerns doing business in the United States which, as a group, are accused of employing artificial tactics to reduce their US taxes.
18. This doctrine is incorporated in the limited treaty use category.

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IV. THE STRANGE CASE OF THE STACKED QUALIFIED PERSONS COMPANIES

Most surprisingly, for a treaty that shows such signs of paranoia, no reference is made in the treaty or in the understanding of the two governments published with it about the possibility of abuse through the use of multiple holding company structures. For example, a Netherlands company with 50.1 percent ownership by Netherlands individuals would be a qualified person under the qualified person company test. If that company owned 50.1 percent of a second Netherlands company, under a literal reading of the treaty it too would be a qualified person even though the Netherlands individuals would indirectly own only approximately 25 percent of its equity. If the second company owned 50.1 percent of a third Netherlands company, the Netherlands individuals would indirectly own only approximately 13.5 percent of its equity. Nonetheless, on a literal reading of the treaty it would be entitled to treaty benefits. This is illustrated by the following chart which assumes a structure created by Brazilian (i.e. non-qualified persons) investors.

Chart II: Stacked Qualified Persons Companies



There is no doubt that the US tax authorities have means to combat such structures if the intervening companies are mere shells. However, in the absence of a published anti-avoidance rule, it will be necessary first to find the abusive structures – not an easy task.

V. CONCLUSION

In the 1982 article mentioned at the outset, I concluded by quoting a French author and practitioner who stated:

> "La rédaction des clauses des conventions internationales n'est pas chose aisée...La science fiscale peut encore progresser dans le domaine international".[19]

True in 1975 when written, true in 1982 when quoted, and true today.

19. "Formulating provisions for international conventions is not an easy task...Fiscal science can still make progress in the international domain". Kergall, "Les Affaires Internationales", *La Fiscalité* (Hachette, 1975), at 79.

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INTERNATIONAL:

INDICATIONS OF FUTURE POLICY IN THE LATEST OECD TASK FORCE REPORT

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Contents

I. Introduction
II. Transfer Pricing and Tax Avoidance
III. Methodology
IV. Profit Split
V. Double Standards
VI. International Aspects
VII. Restrictions on the Report
A. Documentation and penalties
B. Advance pricing agreements
VIII. Conclusion

I. INTRODUCTION

Shortly after the United States issued its draft regulations for transfer pricing in January 1992 the OECD, in response to widely voiced concern that those regulations contravened the international standard of arm's length, set up a task force to evaluate and comment on those draft regulations. Membership of the Task Force included representatives of Canada, Finland, France, Germany, Japan, the Netherlands, Sweden, Switzerland and the United Kingdom. The United States acted as observer. Other OECD member countries were closely consulted and the Task Force obtained comments from the Business and Industry Committee of the OECD (BIAC), and the International Chamber of Commerce (ICC).

The Task Force Report was de-restricted by the Council of Ministers on 17 December 1992, but was not available until January 1993 and in some countries, including the United Kingdom, was not on sale until February or March 1993. The United States released its new regulations (under temporary classification) in January 1993 and before the Task Force report had received full circulation. This is not to say that the Task Force Report was too late to be of use, for the US Treasury had been well aware of the contents in advance and the Task Force formed the forum for the necessary coordinated international tax authority response to the US draft regulations.

In a nutshell, the Task Force Report contained no general or detailed comment or views on the US draft regulations that had not already been expressed and well publicized by professionals, businessmen and academics in the summer of 1992. Simply, the Report repeated the widely held view that the draft regulations, in aiming to provide certainty, had resorted to rigid and complex methodology which was capable of producing allocation of corporate profit from inter-company transactions which would bear little resemblance to an allocation on the international standard of arm's length pricing. The temporary regulations, issued in January 1993, have addressed a number, though not all, of the various particular concerns.

The content of the Task Force Report may therefore be argued to be of no more than academic interest at this stage. But this would be to ignore the fact that the OECD has committed its Working Party on Taxation of Multinational Enterprises to undertake as a matter of urgency a review of the major OECD 1979 Report on Transfer Pricing (see para. 1.29). This review commenced in December 1992 and will build upon the work of the Task Force. Read with this aspect in mind, the Task Force Report contains a number of indications of where this major review is starting from.

II. TRANSFER PRICING AND TAX AVOIDANCE

The disappointing aspect of the Task Force Report is that it sends strong signals that the issue of transfer pricing is still dominated in government circles by the outdated and incorrect view that it is mainly about counteracting tax avoidance by MNEs.

Given that the Preface to the 1979 OECD Report on Transfer Pricing indicated that transfer pricing should be a neutral concept relating to the system of pricing the transfer of goods, it is only to be expected that the Task Force Report takes care not to use the term transfer pricing in a sense synonymous with tax avoidance. However, the order in which issues are dealt with and the shades of emphasis throughout leave no doubt that the specter of tax avoidance looms disproportionately large. Thus, the Task Force Report provides continuing encouragement for the incorrect

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use of the term transfer pricing to mean, in a pejorative sense, a pricing decision by an MNE to deliberately shift income from one member of the group to another to reduce the tax liability in the first member country.

For example, para. 1.20 which sets out the three factors which influence the approach adopted by tax authorities places "the prevention of tax avoidance" at the top of the list. It is true that the point is made in the introduction that the other factors listed are of equal importance (prevention of international double taxation, certainty of application and administrative feasibility), but the inescapable fact is that anyone addressing what is a wider taxation issue without a preoccupation with tax avoidance would never place tax avoidance at the head of a list, for it can only be a secondary aspect.

Another example is found in para. 1.22, which discusses how existing international instruments might be put to greater or better use in maintaining consensus on the application of the international arm's length standard. Top of the list is "exchange of information", which in practice means in most circumstances exchanges of information without the prior knowledge of and cooperation of the taxpayer MNE. Bottom of the list (and accompanied by a comment of "time consuming" for which read "little enthusiasm from some members of the Task Force") are advance transfer pricing agreements which have the great advantage of encouraging taxpayer and tax authority to think about the problem in advance and work together in a spirit of cooperation. Exchanges of information are identified by tax authorities as a tool with which to combat tax avoidance as the Group of Four Report (see VIII below) clearly indicates; cooperation with taxpayers in this area is specifically discounted unless forced upon the tax authority by domestic law. Para. 1.22 may be read as equally discouraging of cooperation with taxpayers.

Even more importantly, the preoccupation with tax avoidance seems to have led the OECD to abandon basic principles of taxation (see V below).

There are a number of good thinkers at the OECD who understand that, whatever the historical reasons for its introduction in tax legislation, transfer pricing is now less about tax avoidance and more about allocation of income of an MNE between the countries in which the MNE conducts its operations. There is also an appreciation at the OECD that, as over 50 percent of world trade now takes place between intragroup entities of an MNE, the problem is an urgent and substantial one for tax authorities.

So, why has an issue which, in the reality of the global economy of the 1990s, represents a fight between national tax authorities for a fair share of tax take on internationally integrated MNE operations, emerged as predominantly a fight between tax authority and taxpayer, with a presumption that the latter has nothing in mind other than to construct international transactions to the detriment of one tax authority or another? There are two reasons.

First, the OECD needs to obtain the full agreement of the Council of Ministers of the Member Countries before its Reports may be published. There is no scope for a majority view to prevail. So, consensus is all. Those countries which regard tax avoidance as the paramount problem in transfer pricing are unlikely to signify agreement unless their views are reflected. Those who take the more modern and, it is submitted, correct approach that transfer pricing is neutral and that the real issue is apportionment on a national basis of income earned on an international basis among competing countries, must be content with a dilution of the tax avoidance content and a carefully worded text which gives some support to neutrality.

Second, it is not the OECD permanent staff which makes up the Task Force. Rather, they assist representatives from each Member Country, for the OECD in these matters is a creature of the tax authorities and represents the tax authorities' view. Given that all tax authorities suffer a scarcity of staff available to work on transfer pricing, not all countries may be able to release someone for the task force and, even if they do, pressures of domestic workload may restrict the part they are able to play. Much of the work on an OECD task force may be done by those representatives who have the greatest personal interest in the topic under review. Most often, such representatives are those who have long-standing experience in the area and almost inevitably this has, in transfer pricing, led to a concentration on the tax avoidance aspect which is where tax authorities have directed their limited staff resources. A representative may have seen transfer pricing only as a matter of (sometimes blatant) tax avoidance and not had experience of the far greater number of MNE pricing transactions in which tax avoidance is not in point. The danger of personal experience gained from dealing regularly with an abuse type of situation is that it is likely to colour an individual's reaction to any potential situation and that perspective is lost. If you see only wrong, it is difficult to constantly keep in mind that right is involved in the majority of cases which, because of your work, you will never see.

There is a third, perhaps mischievous explanation, and that is that the consequences of an integrated global economy are so complex and difficult to resolve that certain politicians and officials find it convenient to confine the discussions on transfer pricing to its tax avoidance aspects.

III. METHODOLOGY

Given that the Task Force Report is a response to the 1992 US draft transfer pricing regulations, it is only to be expected that it reiterates the methodology first set out in the 1979 OECD Report to be used by governments in applying the arm's length standard, i.e.:

(a) the comparable uncontrolled price method (CUP),
(b) the cost plus method,
(c) the resale price method,
(d) other reasonable methods which produce an acceptable figure (usually called the "fourth method").

What is amusing is the comment (para. 6 of the Executive Summary) that "these principles are strongly endorsed by the business community and tax practitioners". This is an excellent example of the proposition that you get the answer to the question you ask. Ask the business community whether they

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endorse the 1979 methodology when the alternative on offer is the rigid methodology proposed in the US draft regulations which is capable of producing a result which may bear no resemblance to commercial reality, and the response is bound to be resoundingly in favour of the OECD methodology; at least it has the merit that the results obtained by recourse to it will have some connection with commercial reality.

The really useful question to ask is the more potentially embarrassing one of whether the OECD methodology works well in practice. It is worth remembering that one of the reasons for the United States introducing new provisions and regulations was the feeling that the OECD methodology in the 1979 Report needed greater definition to work effectively. It is true that countries with a more businesslike and therefore flexible approach to taxation of corporate profits might answer that the US problem arises from its tax system which looks towards absolute certainty and therefore, lengthy and total legal definition, but these countries only cope with the OECD methodology because it is capable of being interpreted with such a degree of flexibility that it may be argued to be all things to all men.

The experience of tax practitioners known to and including the writer is that the CUP method is of little use, for there are few, if any, comparable uncontrolled transactions. Even a substantially similar but not exactly comparable CUP may require adjustments which might more accurately take the CUP into the realms of the fourth method mentioned above. As with the resale price and cost plus methods, a similar but not exactly comparable CUP is more of a point of departure from which to start evaluating a fair price rather than a complete method in itself. Transfer pricing inquiries are being resolved, and pricing strategies developed, using a facts and circumstances functional analysis. The basis of the resultant fair profit (or loss) split may properly be argued to be no more than an example of the "fourth" OECD method. As MNEs conduct operations on an increasing integration or centralization basis, no one of the three standard OECD methods is likely to be sufficient used alone. A thorough reading of the 1979 Report shows that the OECD recognized the importance of functional analysis on a facts and circumstances basis and in no way does this conflict with the arm's length principle. In effect the competing tax authorities are searching for a fair profit split where there is no comparable uncontrolled price available.

IV. PROFIT SPLIT

Although the term "profit split" has tended to be resisted by tax authorities when official discussions take place on methodology in transfer pricing, in semi-private meetings it is not unknown for officials to admit that the fair price they are seeking to establish for goods, services or intangibles is, in the usual absence of a comparable uncontrolled price, one which might be defined as a reasonable profit split.

Because the US draft regulations focused on a new methodology called the Comparable Profit Interval (CPI) the Task Force Report had to define profit split and distinguish it from profit comparison. This they did rather neatly in para. 3.12:

> the main advantage of a profit split over a profit comparison is that a profit split is based on the commercial activity of the entity under examination itself and its related parties and inevitably is related to their economic success or failure and is closely connected to the actual transactions of the group. It thus avoids one of the main criticisms made of comparable profits methods that they tend to penalise the commercially unsuccessful by seeking an adjustment to profits based on the results of their more successful commercial rivals.

Moreover, the point is made in para. 3.11 that

> "Profit comparisons are only valid if the comparable is a true one and they accord with commercial reality."

Although implicit in the discussion on CPI throughout chapter 3, the Report does not actually state in clear terms that, as CPI is designed to apply only in the absence of exact comparables, it can never be a valid comparison. Nor does it make the point that CPI would apply to virtually all transfer pricing transactions, for exact comparables very rarely, if ever, exist. Profit split is clearly no panacea for all transfer pricing transactions and para. 3.15 recognizes a number of dangers. However, the Task Force Report does accept that profit split has an important part to play, particularly in conjunction with a detailed functional analysis. Accordingly it is noted that profit split will be the subject of more exhaustive examination in the forthcoming review of the OECD 1979 Report.

V. DOUBLE STANDARDS

Clarity may well be the first casualty of consensus, but para. 18 of the Executive Summary of the Task Force Report is something far more serious. Muddled thinking, due, one can only conclude, to an unhealthy preoccupation with tax avoidance, has resulted in the OECD producing a formal report suggesting that it is quite acceptable to have an unfair, and wholly capricious, method of ascertaining profit or gain if tax avoidance is suspected.

The Report, having gone into considerable detail in chapter 3, "Difficulties Created by the Proposed [US] Regulations and Recommendations", as to why the CPI is an unreliable and unacceptable method of ascertaining profit or arm's length price, makes the statement in para. 18 that: "The proposed Regulations should be explicitly directed towards such cases [tax avoidance] and confine as far as possible the application of the CPI ... to these cases."

There is only one measurement of income acceptable as a basis for taxation and that is a fair and proper measurement. Furthermore, until income on such a fair and proper basis has been ascertained, it is impossible to consider whether tax avoidance may be in point.

It is accepted that there have been, are, and probably always will be, some cases of substantial tax avoidance through transfer pricing. There must be provisions which will both recompense the tax authority and discourage taxpayers from engaging in such abuses. However, principles of taxation dictate that anti-avoidance provisions must be of a type which follow on from the correct measurement of income which shows income or expenditure to have been under or over-

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reported. There are three main types of "penalty" provisions relating to transfer pricing:

(1) interest on tax paid late and financial penalties for underfiling of income;
(2) recategorization of the excess of non-arm's length outgoings to related parties as dividends or repatriation of capital;
(3) restriction of tax treaty relief from withholding taxes on excess interest or royalties paid to an associated party.

It is incredible that the OECD should seemingly give support to abandoning the established principles of taxation in favour of combatting what is after all, at that stage, no more than suspected tax abuse with a potentially incorrect and arbitrary measurement of income. No acceptable and therefore workable international tax system can be devised on the basis that suspected tax abuse be met with certain abuse inherent within the tax system.

VI. INTERNATIONAL ASPECTS

The Task Force Report correctly stresses that transfer pricing is an area which can only be dealt with satisfactorily if international consensus is maintained. Due consideration is given to what should be the international standard and why the US draft regulations, which may be argued to depart materially from the existing international standard of arm's length, are unlikely to be acceptable as a new international standard. However the Task Force's weakness is in the understanding of the extent of international consensus and its relationship with national sovereignty is demonstrated by the recommendations.

Section E of the Executive Summary makes 16 formal recommendations, the first of which is

> that the United States confirm[s] that it will not be bound by the proposed Regulations in the mutual agreement procedure or any arbitration process under an arbitration clause provided for in its tax conventions.

Here the OECD seems to be seriously suggesting that the United States applies the methodology in the draft regulations only to transfer pricing transactions which are not also the concern of another country with which the United States has a tax treaty. This would leave the regulations applying only to transactions between US corporations and tax havens; this is not a remotely practical possibility.

While the US transfer pricing regulations may technically be argued to be interpretative of the provisions in the US tax code, the Catch 22 is that the only way to rebut the regulations is to show that they are contrary to the very general provision in the tax code. In practice US regulations may have the force of secondary legislation. The transfer pricing regulations are a major item applying to all taxpayers alike; they could not be relegated to the status of a minor item applying only to a transaction with a related entity in a tax haven.

Furthermore, although rhetoric in the US Congress might indicate that transfer pricing is all about tax avoidance, this is something of a smoke screen. In the 1990s transfer pricing is materially about protecting the US share of tax revenue on international transactions which are growing apace with the development of the global economy. There is also an underlying realization that policing transfer pricing is one way to keep foreign inward trade within bounds.

Also, and not just in the United States, there is a natural limitation on a country's ability to "negotiate" a figure under the mutual agreement procedure (MAP) in a tax treaty. It is the reason why the OECD could not obtain agreement to a MAP provision under which both contracting states were required to reach agreement, and why the present MAP provision does no more than ask that the two states shall endeavour to reach agreement. Countries are not prepared to enter into tax treaties under which they cede jurisdiction on matters of their domestic law. Tax authorities take the view that they are not empowered to depart from the legally correct price determined by their domestic law. The US transfer pricing regulations are the US domestic law. Because the international arm's length standard is so loosely defined in tax treaties, the question of treaty override does not arise.

In a sense it is understandable that the OECD has gone for an emollient but impractical approach. International enforcement of transfer pricing is a notoriously delicate and difficult area, and it may be that the decision was taken to make an impractical recommendation rather than leave the issue out altogether or face the difficulties head-on. However, there are a number of unhappy indications that progress is not being made on resolution of disputes between tax authorities (e.g. the EC Arbitration Convention is not making progress and competent authority disputes are increasing) and it could be that the OECD will have to revisit this area next time round.

VII. RESTRICTIONS ON THE REPORT

The final chapter (4) of the Task Force Report sets out what matters the Task Force did not discuss. There is no doubt a good reason for these omissions – namely, that time did not permit. Indeed, it might well be a wonder, given the operating constraints of the OECD, that even a limited report could emerge in a matter of months rather than years.

The difficulty with the omissions is that they concern topics which are crucial to a balanced overall view of transfer pricing. Para. 4.1 indicates this by stating that the draft US regulations were only one step in the implementation of transfer pricing and that the United States had specifically asked for comments on a number of other areas, paramount among which were documentation and penalties, and advance pricing agreements. By not addressing these aspects and concentrating on a narrow selection of methodology, the report has failed to embody a sense of what transfer pricing really is about. The methodology is considered virtually out of all perspective.

A. *Documentation and penalties*

For example, documentation and penalties are dismissed in five sentences in para. 4.2, which merely notes that OECD countries recognize the need for countries to obtain information and admits to placing emphasis on the priority of the

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exchange of information articles in tax treaties as a means of obtaining information. Presumably, this cannot not mean other than that the OECD favours the exchange of information route in preference to the more draconian domestic provisions introduced by the United States in 1989 and 1990.

The positive aspects of an approach through domestic legislation are accordingly completely ignored. The disadvantage of exchanges of information between tax authorities are that they are historical, taking place sometimes years after the transaction under review and, most importantly, they take place without the knowledge and cooperation of the taxpayer. There may be no alternative where blatant tax avoidance is in point and the taxpayer is proving uncooperative. However, in the 1990s the majority (90 percent plus) of cross-border transactions on which transfer pricing issues might arise have nothing to do with tax avoidance. They arise out of normal commercial transactions in an increasingly integrated global economy and comprise a potentially substantial compliance difficulty for both taxpayer and tax authority; an MNE's operational transfer pricing policy may be based commercially upon the benefits of global integration and transcend national borders, whereas a tax system is by its nature confined to national interests. Therefore, a measured documentation (i.e. tax return) system in relation to intra-group cross-border transactions can provide a useful basis to encourage MNEs to address the issue contemporaneously with the transactions taking place, and for tax authority and MNE to communicate constructively outside the umbrella of tax abuse to resolve any queries at that stage. In the 1990s it is unlikely to be in the interests of an MNE to become embroiled in a lengthy transfer pricing dispute.

Documentation and penalties are a carrot and stick. If MNEs decline or ignore the opportunity to address the issue in a positive manner at tax return date, then penalties weigh heavily in favour of the argument that they might reconsider such an approach. Penalties are there to deal with the minority of taxpayers who either have a cavalier approach to transfer pricing or who wish to engage in deliberate tax avoidance.

Accordingly the OECD Report should have responded to the US documentation and penalty developments on the basis of seeking to define a less draconian, more practical and internationally acceptable system of documentation than the provisions introduced by the United States. Exchanges of information between tax authorities should be the fall back provision, not the main way of accessing information.

B. *Advance pricing agreements*

The Task Force Report has merely "noted with interest" the 1992 US IRS Report, which emphasized the importance that the IRS attaches to its new procedure for Advance Pricing Agreements (APAs), and has added that experience is showing them to be expensive in skilled specialist time. Three major matters of importance are ignored.

First, transfer pricing issues in a global economy cannot be resolved without skilled specialist time, and it matters not whether the dispute relates to past, present or future transactions. Administration of transfer pricing provisions requires the involvement of a highly trained inter-disciplinary team (lawyers, economists, accountants) able to understand and assess sometimes complex commercial and economic data. As experience is gained in what is a comparatively new area, time should be able to be saved. However, there is not the remotest possibility of transfer pricing issues being properly handled by clerical officers with limited training. There are no grounds whatsoever for rejecting APAs solely on the basis that they require expensive skilled specialist time. All transfer pricing disputes require such specialists, and the advantage of an APA is that less time needs to be spent in reaching an agreement for an APA than in resolving a serious dispute through the Courts. It is a misconceived argument to reject APAs simply on grounds of use of expensive skilled specialist time.

Second, the Task Force Report gives the erroneous impression that APAs are an entirely new development. The only thing that is new is that the US authorities have recently taken what for them is a quantum leap, and decided to remove the restriction that advance rulings would only be available on matters of legal interpretation and not on a view of facts and circumstances. Because transfer pricing involves taking a view of facts and circumstances, advance rulings on transfer pricing transactions had been ruled out. The reason why the United States changed position was that the present International Tax Counsel to the US Treasury, James Mogle, in his previous role as Chief Counsel to the MNE General Motors, presented the IRS with the fait accompli of an advance agreement between no less than 16 European countries to the General Motors intra-group pricing plan, and the IRS recognized that here was something it might usefully consider. APAs in a much more relaxed, and less expensive to administer form, have been available and used constructively for many years outside the United States.

Therefore, the OECD report should have commented on the wider, more informal use of APAs, and discussed whether the problems of the US style APAs arose from the particular formality and detail of the US tax system, which is in sharp contrast to the more flexible and businesslike approach found in many European tax systems. The distinction between a formal APA and a reasonable understanding between tax authority and taxpayer should also have been drawn.

The third, and probably most important, aspect of APAs is that they represent a vital potential step forward in dealing with transfer pricing issues which are increasing at a breathtaking rate in quantity and complexity. Namely, that the issues should be addressed at the time the relevant transaction is being dealt with and in a spirit of cooperation between tax authority and MNE.

Tax authorities are already complaining about the high resource cost of dealing with transfer pricing; there is one sure thing, and that is that those costs will continue to rise steeply if tax authorities persist, as the OECD Task Force Report indicates they will, in treating transfer pricing as a tax avoidance issue in which the taxpayer is never in the right and only has tax avoidance in mind.

The Report notes that the OECD Committee on Fiscal Affairs is reviewing APAs by member countries. If the same mem-

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bers of the Task Force constitute the team on the APA review, it is hoped that they will display a more constructive attitude towards APAs; otherwise it is unlikely that the review will fulfil its potential to play a useful role in the development of the administration of transfer pricing.

VIII. CONCLUSION

It can be said, of course, that the Task Force Report did fulfil its main objective which was to reinforce the various representations to the US Treasury by governments and international commercial and trading associations, namely that there were serious deficiencies in the 1992 draft transfer pricing regulations looked at from the perspective of an international standard for measurement of income for taxation purposes.

However, the Task Force Report also acted as a preparatory exercise for the other scheduled OECD Reports on transfer pricing. Here is it desperately disappointing. Unfortunately, what the Task Force Report demonstrates is that the OECD, however good its intent and however talented its permanent staff, is such a creature of the tax authorities and their consensus that it has virtually no way of upholding principles of taxation and maintaining professional standards when the members of its task force have a primary preoccupation with tax avoidance.

Before the Task Force Report was released, senior representatives of tax authorities had suggested to the writer that it would be appropriate to disregard the Group of Four Report by the tax authorities of the United States, United Kingdom, Germany and France which had, when released earlier in 1992, essentially suggested that the only way forward in transfer pricing was greater exchanges of information between tax authorities, and that it would be more appropriate to take the OECD Task Force Report as representative of current thinking. Now that the Task Force Report has emerged, it is clear that it has not moved on from the Group of Four Report at all. So here are two reports within 12 months indicating that tax authorities are having real difficulty in accepting the sea change that has taken place in transfer pricing.

In its 1979 and 1984 Reports on Transfer Pricing the OECD managed to convey a neutral and intellectually respectable approach to transfer pricing. The requirement for consensus meant those reports were somewhat generalized, but they have withstood the test of time and made an undoubted contribution in facilitating agreement on a broad international standard. It is to be hoped that the updating of the 1979 Report will revert to those earlier OECD standards, dealing with transfer pricing for what it is, i.e. the allocation and measurement of income of MNEs between competing national tax authorities. Time will tell. Meanwhile, this unhappy 1992 Task Force Report can only be judged as a hastily produced response to proposed US regulations which fell prey to an over-preoccupation with tax avoidance that it took over as though it was the only or only real issue.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

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International Aspects of American Tax Law for Dutch Businesses and Their Advisors, Velp, 27-28 April (English):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands, Tel.: 040-608811, Fax: 040-449895.

Tax-Efficient Corporate Organisation, Aldermaston, Berkshire (England), 28-30 April 1993 (English):
Marion Oakley, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, Tel.: 071-7798601, Fax: 071-779-8599.

MAY 1993

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F.P.V. Europe, Rue de Luxembourg 45, B-1040 Bruxelles, Belgium, Tel.: 2-502 2030, Fax: 2-502 3278.

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Development and Use of Intangible Property, Amsterdam, 13-14 May 1993 (English):
IBFD, International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Tax Planning Association 19th Annual Conference, Rome, 20-21 May 1993 (English):
Elizabeth Husband, ITPA Conference Liaison Office, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-62910, Fax: 44-732-63762.

The 6th East–West Tax Conference, Budapest, 27-28 May 1993 (English):
IBFD, International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JUNE 1993

Essentials of International Tax, Brussels, 1-2 June 1993 (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

Tax Planning Conference, Paris, 3-4 June 1993 (English):
Paula Blay, International Tax Review Conferences, Nestor House, Playhouse Yard, London EC4V 5EX, Tel.: 44-71-779 8603, Fax: 44-71-779 8603.

Advanced Techniques for Multinational Corporate Tax Strategy in Europe, Amsterdam, 14-15 June 1993 (English):
IBC Legal Studies and Services, IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

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TRANSFER PRICING REGULATIONS ISSUED IN THE UNITED STATES

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Throughout the last quarter of 1992, Treasury and IRS spokesmen in the Bush Administration promised that the IRS would issue revised transfer pricing regulations prior to the change in Administration. On 13 January 1993, their promises were made good as the IRS announced the issuance of temporary and proposed Section 482 regulations.[1] These regulations revise the rules under which cross-border transactions between controlled parties are examined to determine whether they have been carried out at arm's length. The regulations are effective as of 21 April 1993, apparently to provide some opportunity for the Clinton Administration to review their content.

The substantive regulations of the Treasury Decision were accompanied by two sets of proposed regulations. One set proposes to limit the impact of foreign law on the ability of the IRS to make an adjustment.[2] This is a regulatory limitation on the scope of *Proctor & Gamble v. Commr.*[3] In that case, the Court of Appeals for the Sixth Circuit affirmed a decision of the Tax Court and held that provisions of Spanish law prohibiting payment of a royalty prevented the IRS from creating Subpart F income for a Swiss controlled foreign corporation. The same set of proposed regulations also defines when a profit split method of pricing may be elected by a taxpayer.[4] The other set of proposed regulations addresses the reasonable cause exception to the accuracy related penalty in transfer pricing matters.[5] The penalty can be as much as 40 percent of the tax increase. The proposed regulations provide guidance on how the penalty will be imposed in the transfer pricing context, and more importantly, the application of an exception to the penalty that is premised on the existence of reasonable cause.

Contents

I. Background
II. Temporary Regulations
A. In general
B. Best method rule
C. Comparability
D. Arm's length range
E. Results and aggregation
F. Terms and structure
G. Multiple years' data
H. Collateral adjustments
I. Safe harbour
J. Non-routine intangible
III. Pricing Methods
A. Transfers of tangible property
B. Profit split method
C. Intangible property
IV. Restrictions Under Foreign Law
A. Background
B. Temporary and Proposed Regulations
V. Penalty Provisions
A. In general
B. Penalty provision
C. Foreign-to-foreign exception
D. Reasonable cause exception
VI. Conclusion

I. BACKGROUND

In January 1992, the IRS issued proposed regulations implementing the commensurate with income standard that was added to the arm's length transfer pricing provision of US tax law, Section 482.[6] The regulatory proposals followed a 1988 IRS White Paper addressing the subject.[7]

The regulations proposed major changes in the way Section 482 was to be applied and were controversial. The proposed regulations were premised on the standard that a transaction should be considered arm's length only if it reflects the terms that an uncontrolled taxpayer would enter after the exercise of sound business judgement. The proposed regulations departed from the primacy of the comparable uncontrolled price method and concentrated instead on a new pricing method, the comparable profit interval (CPI). In adopting this approach, the proposed regulations adopted three new methods for testing the arm's length nature of a transaction:

- the matching transaction method, which was an extremely limited application of the comparable uncontrolled price method,
- the comparable adjustable transaction method, which was similar to the comparable uncontrolled price method, but subject to override by the CPI, and
- the comparable profits method, involving an economic analysis of operating results so that a transaction would be viewed to be arm's length only if it resulted in profits within a determined band comprised of the CPI.

The CPI was determined by reference to profit level indicators which were applied to the taxpayer's financial data for a three-year period. If the actual results of operations fell within the range of the CPI, there would be no adjustment. If, however,

1. T.D. 8470; Notices of Proposed Rule Making IL 21-91 and IL 401-88.
2. Proposed §1.482-1T(f)(2) of the regulations.
3. 961 F. 2d 1225 (6th Cir. 1992), *affd.* 95 T.C. 323 (1990).
4. Proposed §1.482-6T of the regulations.
5. Proposed §1.6662-5(e) and (j) of the regulations.
6. Notices of Proposed Rule Making INTL-0372-88 and INTL-0401-88.
7. Notice 88-123, 1988-2 C.B. 458.

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the taxpayer's results were outside the CPI, an adjustment was to be made to bring the taxpayer's results to the most appropriate point within the CPI. Although no factors were provided for determining the most appropriate point, IRS spokesmen hinted that a slight miss in the transfer pricing methodology adopted by a taxpayer would allow the adjustment to fall within a favourable part of the range. The increase in taxable income would be minimized. In comparison, a significant miss would cause the adjustment to fall within a less favourable part of the range. The increase in taxable income would be severe. Once the appropriate profit was determined, the intercompany transaction would be revised for tax computation purposes so that the targeted profit amount could be generated.

The proposed regulations were controversial. Philosophically, the primacy of the CPI under the comparable profits method was viewed by many to be inconsistent with the arm's length method. When a taxpayer purchases a widget, the profit margins of an unrelated vendor are generally not of any concern to the purchaser if the market supports the price. Rather, the price charged for the widget is of paramount concern. The proposed regulations ignored that point. In addition, the proposed regulations forced taxpayers to use the CPI without providing a reasonable method for its application if an adjustment were required. This caused a significant amount of uncertainty which could not be alleviated by IRS spokesmen.

Nonetheless, the proposed regulations contained provisions that were well received. By proposing the CPI, the IRS accepted the concept that no single arm's length price exists for most goods and services. Rather a range of acceptable prices exists, all of which could be arm's length, more or less. Also, the IRS indicated a willingness to view transactions over a period of time. Thus, taxpayers could justify aberrations in transfer prices in one year by looking at performance over a number of years. The temporary regulations are intended to adopt these more acceptable provisions and to move away from the more onerous aspects of the proposed regulations, which are now withdrawn.

II. TEMPORARY REGULATIONS

A. *In general*

The regulations adopt an overall principle that is more in line with the historic view of an arm's length transaction. According to the temporary regulations, Section 482 is intended to ensure that the returns of taxpayers will clearly reflect income when a transaction is entered into with a controlled person. That transaction is sometimes referred to as a "controlled transaction". Taxpayers engaged in a controlled transaction are placed on a parity with uncontrolled parties by determining the relative economic activity undertaken in the controlled transaction.[8]

The temporary regulations acknowledge that while Section 482 grants authority only to the IRS to make adjustments, nothing in the statute or the regulations prevents a taxpayer from reporting a transaction in its tax return to reflect arm's length amounts even if those amounts differ from the contractual terms adopted.[9] In principle, a taxpayer may report a transaction in a particular arm's length way or may report a particular arm's length amount even though the commercial terms of the transaction are significantly different. This acknowledgment is, of course, limited by certain statutory and practical considerations. To illustrate, Section 1059A prevents a taxpayer from contending that the arm's length purchase price of an imported item can exceed the reported customs valuation, as adjusted. Also, a taxpayer's opportunity to ignore the commercial terms of a particular transaction may be limited by the amount of objective, contemporaneous documentation that must exist to support the arm's length transaction.

In determining true taxable income arising from a transaction between related parties, the standard to be applied is that of an uncontrolled taxpayer engaged in a comparable transaction under comparable circumstances.[10] In determining comparability, different pricing methods may be applied to related transactions where the transactions are most reasonably tested on a separate basis.[11] To illustrate, when services are provided in connection with the transfer of property, the IRS may test the arm's length nature of the pricing for the services separately from the pricing for the property. This represents a major philosophical change from the proposed regulations which tended to blend intangible property income with other income.

B. *Best method rule*

In lieu of applying listed methods in specific order, the temporary regulations provide that the best method in the circumstances should be applied.[12] This is the method that provides the most accurate determination of an arm's length result in the circumstances. The temporary regulations refer to this as "the best method rule". On the surface, this is a more flexible approach. However, in practice, this method was often followed in the course of IRS examinations. If an examiner did not agree with the data provided by a taxpayer relying on the comparable uncontrolled price method, he or she often contended that neither the resale price method nor the cost plus method was applicable and applied the fourth method. The fourth method could have comprised a profit split based on a functional analysis. Now to apply the fourth method, the examiner need not contend that the comparable uncontrolled price method was not appropriate. Rather, the examiner may contend that a particular method is more accurate, and in the circumstances, is the best available method.

In determining the method that provides the best measure of an arm's length result, factors to be considered include:

- the completeness and accuracy of the available data;
- the degree of comparability between controlled and uncontrolled transactions; and

8. §1.482-1T(a)(1) of the regulations.
9. §1.482-1T(a)(3) of the regulations.
10. §1.482-1T(b)(1) of the regulations.
11. §1.482-1T(b)(2)(ii) of the regulations.
12. §1.482-1T(b)(2)(iii)(A) of the regulations.

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– the extent of the adjustments that are required when applying the method.[13]

Under the best method, any available pricing method may be applied without first disproving any other method. If a taxpayer can demonstrate that a method other than the one used by the IRS produces more accurate results, that other method must be used. If the best method rule does not clearly indicate the preferred of two methods, the matter may be resolved by reference to a third method. If the application of a third method produces results that are consistent with one of the two competing methods, the third method will control the choice of the best method.[14] A similar analysis applies when two or more applications of the same method produce different results. This is illustrated in the following example:

> Foreign corporation FP sells widgets to its wholly-owned US subsidiary, DS. During the course of an IRS examination that tests the arm's length nature of the intercompany transfer price, the comparable uncontrolled price method is applied to three different uncontrolled transactions. Different results are obtained under each method. To determine whether each such method may be used to establish the arm's length range (see I.D. below), the comparable profits method is applied by the IRS. The latter method generates results that are similar to two of the three uncontrolled transactions, but deviates from the third method. As a result, data from only two of the uncontrolled transactions are considered to be comparable.[15]

C. *Comparability*

While various provisions in the temporary regulations address comparability, as a general rule, comparability with uncontrolled transactions is to be determined by reference to:

– functions performed,
– risks assumed,
– contractual terms adopted,
– economic conditions that apply, and
– property or services involved in the transaction.[16]

The relative importance of these factors depends on the method applied.[17] Some emphasize product comparability, others emphasize functional comparability, and still others emphasize broad similarity in terms of products and functions while comparing financial returns. The intent of the regulations is to focus on the factors that make sense in the circumstances.

For two transactions to be comparable, absolute identity is not required.[18] The transactions are comparable if they are sufficiently similar so that the uncontrolled transaction provides a reasonable and reliable benchmark for estimating an arm's length result. When there are differences between uncontrolled and controlled transactions, a reasonable number of adjustments may be made to account for the differences. As in the existing regulations, the adjustments are allowed if they have a definite and reasonably ascertainable effect on the result. If adjustments cannot be made because of a lack of data or because the adjustments are substantial and therefore speculative, the uncontrolled transaction will not be considered to be comparable. This may be illustrated by the following example:

> Foreign subsidiary FS is a manufacturer of widgets. It sells those widgets to its parent corporation, domestic corporation DP, in large volumes. It also sells widgets to unrelated parties, but those sales are in smaller volumes. The price to unrelated parties is $ 100 per widget, with discounts of two percent for orders of 20 units and five percent discounts for orders of 100 units. DP purchases in orders of 60 units. In these circumstances, the comparable uncontrolled price method indicates that the arm's length price for sales to DP is $ 100, and a discount of 3.5 percent should be allowed for orders of 60 units (5 percent – 2 percent = 3 percent; 100 units – 20 units = 80 units; 3 percent ÷ 80 = 0.0375 percent per unit). However, if DP's orders were for 1,000 units, the appropriate discount could not be determined on the basis of adjustments to data involving third party sales.[19]

In reviewing the functions performed, the temporary regulations adopt the concept of the functional analysis.[20] A functional analysis compares the activities performed by the parties to two transactions. For two transactions to be comparable, the parties generally must perform the same functions with respect to each transaction. Functions that are analysed in determining comparability include:

– research and development,
– product design and engineering,
– manufacturing or process engineering,
– product fabrication, extraction, and assembly, purchasing and materials management,
– marketing and distribution, including inventory management, warranty administration and advertising,
– transportation and warehousing, and
– administration, including management, legal, accounting, finance, credit, collection, training and personnel management.

In theory, the application of the functional analysis to evaluate the choice of comparables is reasonable. The arm's length price for a state-of-the-art product developed after years of research and refinement should not be controlled by the price charged in an uncontrolled transaction for a similar product based on old technology. However, recent experience in the computer industry seems to indicate that state-of-the-art products may quickly become a commodity in which price differentials between old and new products are compressed. Moreover, the analysis required in the temporary regulations may not be implemented easily by taxpayers facing real world conditions. Smaller entities may have only limited access to data, and the cost of generating anything other than a superficial report may be prohibitive. Larger entities may find that the sources of information are closed because of

13. §1.482-1T(b)(2)(iii)(A) of the regulations.
14. §1.482-1T(b)(2)(iii)(B) of the regulations.
15. §1.482-1T(b)(2)(iii)(C) of the regulations.
16. §1.482-1T(c)(1)(i) of the regulations.
17. §1.482-1T(c)(1)(ii) of the regulations.
18. §1.482-1T(c)(2)(i) of the regulations.
19. §1.482-1T(c)(2)(iii) *Example* of the regulations.
20. §1.482-1T(c)(3)(i) of the regulations.

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intense competition within a particular industry or because concerns over anti-trust law violations. Indeed, it may turn out that the only party in a position to develop the required data is the IRS. It can develop its own set of statistics through industry programmes or can subpoena third parties to obtain information which serves as a basis for evaluating the tax return of another taxpayer.

In analysing the risks involved in two transactions, the goal is to determine whether risks borne by the various parties are similar.[21] For this purpose, risks include:

- market risks such as fluctuations in cost, demand, pricing and inventory levels,
- risks associated with the success or failure of research and development activities,
- financial risks, including fluctuations in foreign currency rates of exchange and interest rates,
- credit and collection risks,
- product liability risks, and
- general business risks related to the ownership of property, plant and equipment.

Since controlled taxpayers can manipulate risks in a controlled transaction, the risks assumed in the tested transaction must be analysed first for substance.[22] The intent is to determine which risks are real and which are only "window dressing". Thus, adequately documented risks are to be reviewed to confirm three factors. First, the review must confirm that the risks assumed by each of the parties to a controlled transaction are commensurate with the potential economic benefit that will be derived from that transaction. Second, the review must confirm that the controlled party assuming a risk has the economic capacity to absorb losses arising from the assumption of the risk. Finally, the review must confirm that the controlled party assuming the risk in its business has managerial control over the activities that influence the amount of income or loss that may be realized.

If the allocation of the risk is documented before the outcome is known, the IRS will accept the risk factor if the parties conduct is consistent with the allocation.[23] Such consistency in risk allocation must continue from year to year. Thus, parties that are allocated losses because of risks assumed during loss years are expected to be allocated profits when the transaction becomes profitable.[24] This approach is understandable because of the opportunities that exist to allocate risk to a US taxpayer in loss years – thereby shifting losses to a US taxpayer – but to move the risk to a foreign affiliate in profitable years – thereby shifting profits offshore. Nonetheless, it is an open question whether this approach is logically correct in all circumstances. Disregarding luck, only smart and timely investments should be rewarded by the market. Where a party making the earlier investment runs out of money and requires a significant cash inflow from new investors to complete a project, it cannot be said that the earlier investment is both smart and timely. In these circumstances, it is not uncommon for new investors to receive a premium because the earlier investment is worthless without the later cash infusion. The regulations ignore this aspect of business and continue to reflect an assumption that profit can be foreseen from the mere act of spending money.

The temporary regulations recognize that other factors may impact the determination of comparability. Among the other factors that must be analysed are economic conditions[25] and terms of contract.[26] Such economic conditions include:

- the existence of realistic alternatives to the actual transactions that were available to the parties,
- the size and level of the market,
- the existence of any location-specific costs, and
- the level of competition.

Contract terms that must be considered include:

- the form of payment,
- the terms of payment and financing,
- the volume involved in the transaction,
- the existence of warranty obligations,
- the rights of a party to updates,
- the duration of the rights of each party,
- the right to renewal under the contract, and
- the existence and terms of any collateral relationships and transactions.

The temporary regulations recognize that special circumstances may exist in determining comparability and these circumstances must be accounted for.[27] To illustrate, the controlled parties may have adopted a reasonable market penetration strategy for a limited period of time that does not exist in the circumstances of the third-party comparable.[28] In further illustration, there may be differences arising from the fact that the uncontrolled transaction arises in a different geographic area of the world.[29] Finally, in the controlled transaction, the parties may enjoy the benefits of location savings from operating in a low-cost jurisdiction which is not available to the parties in the uncontrolled transaction.[30] Here, however, the regulations adopt a questionable position by allocating a portion of the location savings to the customer. That allocation is premised on the assumption that a significant customer of a manufacturer will automatically demand a portion of the benefits derived from low-cost operations.[31] Taxpayers may find it prudent to test this assumption by determining whether this market condition exists in its industry.

D. *Arm's length range*

Recognizing that no single arm's length price exists, the temporary regulations provide that no adjustment will be made under Section 482 if the results of the transaction between controlled parties fall within a range of results derived from two or more applications of the same pricing method to different uncontrolled comparables.[32] This range of acceptable results is referred to in the regulations as the "arm's length

21. §1.482-1T(c)(3)(ii)(A) of the regulations.
22. §1.482-1T(c)(3)(B) of the regulations.
23. §1.482-1T(c)(3)(C) of the regulations.
24. §1.482-1T(c)(3)(D) of the regulations.
25. §1.482-1T(c)(3)(iv) of the regulations.
26. §1.482-1T(c)(3)(iii) of the regulations.
27. §1.482-1T(c)(4) of the regulations.
28. §1.482-1T(c)(4)(i) of the regulations.
29. §1.482-1T(c)(4)(ii) of the regulations.
30. §1.482-1T(c)(4)(ii)(D) of the regulations.
31. §1.482-1T(c)(4)(ii)(D) *Example* of the regulations.
32. §1.482-1T(d)(2)(i)(A) and (B) of the regulations.

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range". To form part of the range, each application of the pricing method to a specific comparable must satisfy the criteria for its application. With the exception of the comparable profit method, there is no limitation on the extent of the arm's length range. Nonetheless, a wide range may suggest that insufficient adjustments have been made for differences between the controlled and the uncontrolled transactions.

Where the controlled transaction falls outside the arm's length range, the IRS may make an adjustment to any point in the range.[33] However, the IRS need not develop an arm's length range to propose an adjustment and the IRS may propose an allocation based on a single comparable uncontrolled price.[34] If that occurs, the taxpayer may subsequently demonstrate that its results are within a range established by additional comparable transactions. If an arm's length range is demonstrated and the controlled transaction falls within that range, but is not identical to the IRS's single comparable, no adjustment will be made. If an adjustment is required, it most likely will be made to the midpoint of the range.

The application of the arm's length range concept is illustrated by the following example:

> DP is a US corporation. It manufactures widgets which are sold to DP's foreign subsidiary, FS. FS acts as exclusive distributor of DP's widgets in a particular foreign country. It reviewing the arm's length nature of the transfer prices between DP and FS, the IRS applies the resale price method using the results of three uncontrolled distributors as comparables. After making appropriate adjustments, the gross profit margins of the three comparable distributors are eight, ten and 12 percent, which the IRS determines is not an unusually wide range in the industry. The gross profit margin of FS is 9.5 percent. Because FS's gross profit margin falls within the arm's length range, no adjustment is made even though one distributor reported a lower gross profit margin.[35] If, however, FS's gross profit margin were 15 percent, it would fall outside the arm's length range and an adjustment would be required, ordinarily to the mid-point of the arm's length range which is a ten percent gross profit margin.[36]

E. *Results and aggregation*

The proposed regulations adopt a rule under which it is not necessary for the IRS to determine whether the method or procedure employed in a controlled transaction corresponds to the method or procedure that might have been used in an uncontrolled transaction.[37] Only the results are important. This is illustrated in the following example:

> DP is a US corporation that is a manufacturer of widgets. FS is its exclusive distributor in Europe. As part of DP's annual budgeting process, it establishes the price and production schedule for each model widget that is to be distributed by FS in Europe during the fiscal year. FS's gross profit margin is scheduled to be 18 percent, which is the same gross profit margin that an unrelated distributor in Europe earns from the distribution of a competing widget. Because the gross profit margins are the same, the IRS will not examine whether the administrative services performed by DP on behalf of FS must be factored into the transfer price for inventory.[38] Presumably, the cost of performing such services may have to be borne by FS as part of a separate determination.

In addition, the IRS is authorized to consider the combined effect of two or more separate transactions which are so interrelated that consideration of multiple transactions is necessary to determine the arm's length consideration for the controlled transactions.[39] Unrelated transactions are not taken into account.[40] The related transactions may occur before, during or after the taxable year under examination and may produce unexpected results. This rule is illustrated by the following examples:

> *Example 1*: DP is a domestic corporation. It enters into a licence with its foreign subsidiary, FS1, to use a proprietary manufacturing process for the manufacture and sale of widgets throughout a specified territory. FS1 licenses an affiliate, FS2, to distribute the widgets in the territory. In determining whether the licence fee received by DP is of an arm's length amount, the amounts received by FS1 from FS2 and the respective profits of FS1 and FS2 are relevant factors to be taken into account.[41]

> *Example 2*: DP is a domestic corporation that manufactures widgets. It has three subsidiaries that are formed and operating in a particular foreign country. FS1 is the exclusive distributor of widgets in that country, FS2 is the exclusive marketer of related services, and FS3 administers the warranty programme. In testing the arm's length transfer price of widgets by FS1, the IRS is authorized to consider the combined effect of the licence fee that FS2 pays for marketing intangibles and the service fees earned by FS2 and FS3 for the performance of related services.[42]

> *Example 3*: Assume the same facts as in *Example 2*, except that DP has two sets of competitors in the foreign country. The first set is comprised of uncontrolled companies, each of which independently services a segment of the widget market. The second set of competitors is comprised a group of related companies. The prices charged by each of the independent companies differ from the prices charged by its counterpart in the related group. The IRS may conclude that only the members of the group of related companies are comparable to each of DP, FS1, FS2 and FS3. In such case, the arm's length range may be computed solely by reference to the transactions of the competitor group rather than the transactions of the independent companies.

33. §1.482-1T(d)(2)(i)(C) of the regulations.
34. §1.482-1T(d)(2)(i)(D) of the regulations.
35. §1.482-1T(d)(2)(i)(E) *Example 1* of the regulations.
36. §1.482-1T(d)(2)(i)(E) *Example 2* of the regulations.
37. §1.482-1T(d)(2)(ii) of the regulations.
38. §1.482-1T(d)(2)(ii) *Example* of the regulations.
39. §1.482-1T(d)(3)(i)(A) of the regulations.
40. §1.482-1T(d)(3)(i)(B) *Example 4* of the regulations.
41. §1.482-1T(d)(3)(i)(B) *Example 1* of the regulations.
42. §1.482-1T(d)(3)(i)(B) *Example 2* of the regulations.

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F. *Terms and structure*

The terms of a contractual arrangement between controlled parties will be respected by the IRS as long as the parties' conduct is consistent with the agreed upon terms and the contractual arrangement has economic substance.[43] If the conduct of the parties is inconsistent with a written agreement, the written document may be ignored. Similarly, if no written agreement exists between controlled parties, but a course of conduct is consistent with an agreement in substance, the IRS may conclude that an agreement exists in substance. Thus, for example, if a wholly-owned manufacturer consistently sells its entire output to a related party in the United States, the manufacturer does not have a market-related risk because a total-output arrangement exists in substance between the related party and the manufacturer. The pricing structure between the two companies must account for that factor as if a written agreement existed.

Except where a controlled transaction lacks economic substance, the IRS will evaluate controlled transactions based on the structure actually adopted by the parties.[44] It will not treat the transaction as if it were structured differently. Nonetheless, the IRS may consider alternatives that were available in determining whether the terms of the uncontrolled transaction would be acceptable to an uncontrolled taxpayer faced with alternatives similar to those faced by the controlled taxpayer faced. The IRS anticipates that the analysis of alternative transactions will result in a greater range of adjustments. Nonetheless, it appears to be an opportunity for a corporate group having different internal profit centres to contend that one profit centre negotiated with a second and caused the transaction to be at arm's length. In evaluating the existence of possible alternatives, one important factor is management's evaluation of each profit centre's performance. No alternative transaction is acceptable generally if it will result in a reduced bonus for local managers.

The anticipated analysis is thought to be central to the use of the arm's length standard and the traditional notion of comparability. The objective of the comparable uncontrolled price method is to identify an alternative price at which the taxpayer could have conducted the controlled transaction. By analysing alternative structures, the IRS believes that it is testing comparability. In essence, this provision allows the IRS to undertake a form of management analysis to determine whether the structure actually adopted by the controlled taxpayers makes economic sense. Where the IRS analysis succeeds in demonstrating the existence of alternatives that produce better results for the US taxpayer, and the results of the analysis are unanticipated and cannot be rebutted factually, a company may find that it has an internal management problem that supersedes its tax problem.

G. *Multiple years' data*

Although the IRS will ordinarily evaluate the results of a controlled transaction based on data from uncontrolled taxpayers attributable to the same period, the temporary regulations authorize the use of data obtained from different years.[45] This will occur where information on comparables is unavailable, inadequate or unreliable or where the life cycle of a product mandates the use of data from other years.[46] In addition, information from other years may be appropriate when analysing risks and market share strategy. If data from other years is used, it should be compared with the data of the controlled parties for a similar period to determine whether the same economic conditions affected the results of the controlled and the comparable transaction in equivalent ways. This may be illustrated by the following examples:

> *Example 1*: FP is a foreign corporation that designs and manufactures widgets. FP's functional currency is the FCU, the currency in circulation in its country of residence. DS is a domestic subsidiary of FP. DS is the exclusive US distributor of widgets manufactured by FP. The intercompany sales to DS are denominated in terms of FCUs. Accordingly, DS bears the currency risk with regard to its inventory of widgets. In the year under examination, the FCU appreciated against the US dollar and as a result, the profit margin of DS was eight percent. In the same year, a comparable competing distributor of widgets in the United States reported a profit margin of ten percent. However, the competitor bore no currency risk as its inventory was priced in terms of US dollars. In determining whether the gross margin of DS reflects an arm's length charge for its inventory, the gross profit margins of DS and the competitor for years before and after the year in issue may be examined.[47]
>
> *Example 2*: FS is a foreign corporation that manufactures widgets. The widgets are distributed in the United States by DS, the domestic subsidiary of FS. During each year in the five-year period under examination by the IRS, DS reports a loss. It justifies the loss in each year by reference to the results of five separate companies. Each reports a loss for a different year under examination, and in the aggregate, losses are reported among the five companies for all five years. Each of the five companies is profitable for four years and each reports an overall profit for the five-year period. The transactions are not clearly comparable over the five-year period since the economic conditions that resulted in DS's losses for each of the five years did not have a comparable effect over a comparable period of time on the five separate companies.[48]

H. *Collateral adjustments*

In making an adjustment under Section 482, the IRS is directed by the temporary regulations to take into account the effect of an arrangement between controlled parties for reimbursements or other compensating adjustments.[49] These are known as "compensating adjustments". For the compensating adjustment to be made, certain tests must be met. The arrangement must be in writing. It must call for reimburse-

43. §1.482-1T(d)(3)(ii) of the regulations.
44. §1.482-1T(d)(3)(iii) of the regulations.
45. §1.482-1T(d)(3)(v)(A) of the regulations.
46. §1.482-1T(d)(3)(v)(B) of the regulations.
47. §1.482-1T(d)(3)(v)(D) *Example 2* of the regulations.
48. §1.482-1T(d)(3)(v)(D) *Example 3* of the regulations.
49. §1.482-1T(e)(2) of the regulations.

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ment or compensating adjustments between the controlled parties so that an arm's length adjustment is reached. Finally, the adjustments must be made before the timely filing of a US tax return.[50]

If the foregoing tests are met, the adjustment is deemed to accrue to the recipient on the date of actual payment, or if earlier, the last day of the taxable year. The adjusted results constitute taxable income of the taxpayer for all income tax purposes. The accrued compensating adjustment may be satisfied in any appropriate manner, including a cash payment or an adjustment to the books and records of the company. The adjustment may take the form of (i) offsets to other accounts receivable or payable, (ii) recharacterizations of dividends paid, or (iii) recharacterizations of capital contributions.[51] Any adjustment that is not satisfied by the due date of the tax return must bear interest thereafter.

The foregoing treatment is subject to a limitation. The compensating adjustment procedure is intended to allow taxpayers to establish a pricing mechanism in advance for budgetary purposes and to adjust the budgeted amount to an arm's length amount if required to comply with Section 482.[52] It was not intended to apply to abusive situations. As a result, the IRS need not allow the collateral adjustment if the taxpayer engages in a pattern of transactions designed to abuse the collateral adjustment procedure.[53] The temporary regulations provide no illustrations of an abusive situation. Presumably, the regulations will be amplified by published revenue rulings and technical advice memorandums.

The temporary regulations also contemplate that a primary adjustment by the IRS will be accompanied by a correlative adjustment to the results of the counter party to the transaction.[54] Thus, if income of one controlled party is increased, the income of the counter party must be decreased by a corresponding amount. The correlative adjustment must be reflected in the permanent documentation of the counter party that is maintained for US tax purposes even if the adjustment does not affect the tax liability of that other party for an open year.[55]

The correlative adjustment is not made until the primary adjustment is final.[56] Thus, one of the following must occur before the correlative adjustment is made:

- tax is assessed following the execution of a waiver of restrictions on assessment and collection of a deficiency in tax on Form 870,
- an offer of a waiver on Form 870-AD is accepted,
- a deficiency in tax is paid,
- a stipulated decision is entered in the Tax Court, or
- a final determination of tax liability is reached by an offer in compromise, closing agreement or a final resolution of judicial proceedings.

Finally, the temporary regulations acknowledge that a taxpayer may be entitled to set off the amount of a favourable non-arm's length transaction, such as an overcharge for services rendered by the taxpayer, against the amount of an unfavourable non-arm's length transaction, such as an excessive payment by the taxpayer for goods or services.[57] Thus, the proposed adjustment for the latter transaction can be reduced by the non-arm's length portion of the former transaction. In that way, an economic netting effect is achieved. However, for reporting purposes, the two transactions may have to be reported on a gross presentation basis if the source of an item of income – and the resulting US tax liability of the counter party – would otherwise be distorted. To illustrate, if a US taxpayer forgoes the payment of interest in return for an increase in the fee charged by a foreign corporation for services performed outside the United States, the interest payment will be increased, possibly resulting in the imposition of 30 percent US withholding tax, and the service fee will be reduced.

The temporary regulations impose certain limitations on the opportunity to benefit from the set-off provisions. First, in comparison to regulations that were in effect for many years, a set-off is allowed only for transactions that occur in the same year as the proposed IRS adjustment. Under the earlier regulations, a set-off was allowed for transactions in other years if a written agreement was in existence tying the two transactions together. In addition, to establish that a set-off is appropriate, the taxpayer must notify the IRS of the basis for the set-off within 30 days of the date of the letter providing formal notification of the proposed adjustments.

I. *Safe harbour*

A safe harbour is provided for taxpayers that have relatively small levels of controlled transactions.[58] To be eligible, either the US party or the foreign counter party to a cross-border controlled transaction must have less than $ 10 million in gross receipts for the year in issue.[59] In making the computations, all US affiliates must be aggregated with the US controlled taxpayer and all foreign affiliates that engage in cross-border transactions with the US affiliate must be aggregated.[60] This may pose a problem for foreign-based groups that own US businesses through different corporate ownership and reporting chains. US branches of foreign corporations generally are not eligible for the safe harbour. However, a US branch of a foreign corporation that is resident in a tax treaty jurisdiction might be eligible if an appropriate non-discrimination clause applies.

If an eligible taxpayer elects to be covered by the safe harbour, no adjustments will be made under Section 482. Provided that certain compliance rules are met, the taxpayer may compute its taxable income in accordance with measures of profitability published by the IRS.[61] Once made, the election may be revoked only with the consent of the IRS.[62]

50. §1.482-1T(e)(2)(i) of the regulations.
51. §1.482-1T(e)(2)(ii) of the regulations.
52. §1.482-1T(e)(2)(iv) *Example* of the regulations.
53. §1.482-1T(e)(2)(iii) of the regulations.
54. §1.482-1T(e)(3)(i) of the regulations.
55. §1.482-1T(e)(3)(ii) of the regulations.
56. §1.482-1T(e)(3)(iii) of the regulations.
57. §1.482-1T(e)(5)(i) of the regulations.
58. §1.482-1T(f)(1) of the regulations.
59. §1.482-1T(f)(1)(ii) of the regulations.
60. §1.482-1T(f)(1)(iii) of the regulations.
61. §1.482-1T(f)(1)(i)(B) of the regulations.
62. §1.482-1T(f)(1)(iv)(B) of the regulations.

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The safe harbour does not apply for any year in which the eligibility tests are not met.[63] However, subject to an anti-abuse rule, the safe harbour will apply automatically in subsequent years when the eligibility requirements again have been met.

J. *Non-routine intangible*

Where an item of intangible property is central to the conduct of a business activity so that the business could not be conducted in its absence, the intangible property is considered to a non-routine intangible. Examples are composition-of-matter patents for a pharmaceutical company and a manufacturing intangible without which a particular product could not be produced. Neither intangible property that is a normal result of conducting a business nor intangible property for which there may be acceptable substitutes in the marketplace at a comparable price is a non-routine intangible.

The concept of the non-routine intangible implements the super-royalty aspect of the commensurate with income standard. Because its use or application is so valuable, the temporary regulations adopt the view that the owner would not make it available to unrelated parties. Accordingly, no examples of substantially similar transactions are considered to exist and the use of comparables is prohibited. The comparable profits method must be applied in determining the arm's length nature of the intercompany transfer pricing (see the discussion in III.A).[64] As a result, taxpayers must determine whether any non-routine intangibles are used by one of the parties to a transaction, and if so, whether the non-routine intangible was either (i) self-developed or acquired from an unrelated party or (ii) transferred from a related party. If it exists and if it were transferred from a related party, the use of the comparable uncontrolled transaction method is precluded; the comparable profit method must be used.

III. PRICING METHODS

A. *Transfers of tangible property*

The regulations provide five methods for determining whether the transfer of tangible property has been at arm's length.[65] These are:

1. The comparable uncontrolled price method

Transactions are comparable if the property transferred and the underlying circumstances of the two transactions are substantially the same.[66] In general, only minor differences are allowed and those differences must be capable of elimination through a limited number of adjustments. Material differences between transactions preclude the use of this method.

2. The resale price method

This method is similar to the existing regulations. For purposes of the best method rule, it is viewed to be an accurate measure if the controlled taxpayer performs a distribution function and does not add substantial value to the goods by physically altering them before resale or by the use of an intangible.[67] For this purpose, neither packaging, repackaging, labelling nor minor assembly generally will constitute physical alteration.

> Controlled and uncontrolled transactions should involve distribution of products within the same broad product categories. The appropriate gross profit is computed by multiplying the applicable resale price by the appropriate gross profit margin expressed as a percentage of sales. That margin is determined by reference to comparable uncontrolled transactions.[68] Where possible, the gross profit margins should be that of the distributor involved in the controlled sale because similar characteristics are more likely to be found among different resales of property made by the same distributor. However, that likely will occur in significant volume only in rare instances. In the absence of comparable uncontrolled transactions by the same distributor, uncontrolled transactions of other distributors may be used.

3. The cost plus method

This method is similar to the existing regulations. For purposes of the best method rule, it is viewed to be an accurate measure if the controlled taxpayer performs a manufacturing or assembly operation in which goods are sold to related parties.[69] Controlled and uncontrolled transactions should involve products within the same broad product categories. However, similarity as to the producer's investment of capital and assumption of risks is more important than close physical similarity of the property involved in the controlled and uncontrolled sales.[70]

In determining an appropriate mark-up percentage, accounting reclassification may be required when analysing financial data of other companies in order to achieve consistent treatment of the elements that enter into the computation of the production price.[71] This is particularly relevant when determining whether full costs or only direct costs are used. Also, adjustments may be required to account for differences in:

- the complexity of the manufacturing process,
- the performance of manufacturing, production and process engineering activities,
- the performance of procurement, purchasing and inventory control activities,
- the conduct of testing functions,
- the responsibility for selling, general and administration activities, and
- the existence of currency risks.[72]

The foregoing adjustments are illustrated in the following example:

63. §1.482-1T(f)(1)(iv)(C) of the regulations.
64. §1.482-5T(a) of the regulations.
65. §1.482-3T(a) of the regulations.
66. §1.482-3T(b)(2)(i) of the regulations.
67. §1.482-3T(c)(1) of the regulations.
68. §1.482-3T(c)(2)(iii) of the regulations.
69. §1.482-3T(d)(1) of the regulations.
70. §1.482-3T(d)(3)(i) of the regulations.
71. §1.482-3T(d)(2)(iii) of the regulations.
72. §1.482-3T(d)(3)(ii) of the regulations.

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DP is a domestic corporation. It manufactures widgets that are sold for distribution to a foreign subsidiary, FS. DP earns a gross profit mark-up of eight percent with regard to its manufacturing activities. Three unrelated manufacturers of widgets generate a gross profit mark-up of between six and eight percent. However, DP accounts for its supervisory, general and administrative costs as operating expenses which are not allocated to sales. In comparison, the three unrelated parties reflect supervisory, general and administrative expenses in cost of goods sold. When those expenses are subtracted from the cost of goods sold of the unrelated parties, their gross profit mark-up is increased to between ten and 12 percent. Assuming no other adjustments are applicable, the price at which DP sells widgets to FS is not within the arm's length range.[73]

Where a controlled taxpayer is comparable to a purchasing agent that does not take title to property, the commission earned expressed as a percentage of the purchase price of the goods may constitute the appropriate gross profit mark-up.[74]

4. The comparable profits method

This method relies on the general principle that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time.[75] It is similar to the comparable profits method of the proposed regulations. However, this method is not a mandatory check on any of the other methods. For purposes of the best method rule, this method is an accurate measure of an arm's length result where the tested party does not use a non-routine intangible that is either (i) acquired from an uncontrolled taxpayer, in which case the party must assume significant risk and possess the right to significant economic benefits from the use of the non-routine intangible, or (ii) is self-developed. Thus, a group that consists of truly stand-alone companies will not be forced into using this method. Other groups having offshore manufacturing operations may face a different result. The comparable profit method may be a mandatory guide for arm's length pricing.

In applying this method, the party to be tested should be the party that performs the simplest operations.[76] Comparables may be most easily found for the industry segment that comprises that operation. A result is considered to be arm's length under this method if it falls within the range of constructive operating profits based on a single profit level indicator derived from comparable parties over a three-year period that ends with the taxable year in issue.[77] Profit level indicators are financial ratios that measure the relationships among profits, costs incurred and resources employed.[78] A variety of profit level indicators may be used in any given case, including the rate of return on capital employed and financial ratios such as the ratio of operating profit to sales and the ratio of gross profit to operating expenses.

The arm's length range will include all the results obtained if certain specified adjustments have been made to the data to refine their comparability to that of the controlled party.[79] For example, material items in a profit and loss statement may have to be reviewed to confirm consistency between the comparable and the tested parties. Where appropriate, accounting reclassifications may be required to relate the level of operating profit to the level of investment before computing the profit level indicators. Similarly, adjustments may be required to account for differences in functions performed and risks assumed.[80] Such adjustments are to be made only if they have and definite and reasonably ascertainable effect on operating profit. If these adjustments are not made, the arm's length range is determined by reference to the interquartile range (i.e. results between the 25th percentile and the 75th percentile) or another statistically valid method using at least four comparable parties.[81]

5. Other methods

To use another method, none of the foregoing methods can reasonably be applied[82] and the taxpayer must disclose the method on its US income tax return.[83] The taxpayer must also prepare contemporaneous documentation supporting the method adopted.[84] That documentation must explain why the method was selected and must be available for submission to the IRS within 30 days of a written request.

B. *Profit split method*

Temporary regulations issued on the same day provide for a sixth method based on profit split.[85] The profit split allocation must reflect the relative value of each controlled taxpayer's contribution to the combined profit and loss. This is to be determined in a manner that reflects the functions performed, risks assumed and resources employed by each participant in the relevant business activity. The allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing the functions of the various members of the group that participate in the joint activity. The proposed profit split regulations caution that the profit allocated to any particular member of a controlled group is not limited to the total net profit of the group.[86] Thus, under the profit split method, it is theoretically possible for one controlled company to derive a profit while another member derives a loss.

Three profit split methods are described:

- a residual allocation method,[87] which is the basic arm's length return method ("BALRM") of the 1988 White Paper;
- a capital employed allocation method,[88] under which the parties' combined income is divided on the basis of cap-

73. §1.482-3T(d)(4) *Example 1* of the regulations.
74. §1.482-3T(d)(3)(iii) of the regulations.
75. §1.482-5T(a) of the regulations.
76. §1.482-5T(b)(1) of the regulations.
77. §1.482-5T(d)(1) of the regulations.
78. §1.482-5T(e) of the regulations.
79. §1.482-5T(d)(2)(i) of the regulations.
80. §1.482-5T(c)(2) of the regulations.
81. §1.482-5T(d)(2)(ii) of the regulations.
82. §1.482-3T(e)(1) of the regulations.
83. §1.482-3T(e)(2)(i) of the regulations.
84. §1.482-3T(e)(2)(ii) of the regulations.
85. Proposed §1.482-6T of the regulations.
86. Proposed §1.482-6T(a)(2) of the regulations.
87. Proposed §1.482-6T(c)(2) of the regulations.
88. Proposed §1.482-6T(c)(3) of the regulations.

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ital employed (this assumes equivalent returns on capital); and
- a comparable profit split method,[89] which is similar to the profit split method under the earlier set of proposed regulations.

A fourth method comprised of any other reasonable method may be used where capital is either difficult to measure or is not a significant determinant of operating profit.[90] The fourth method may be premised on cost ratios or other factors. However, the IRS must be satisfied that the other ratios provide an economically valid basis for an allocation.

The objective of the profit split approach is to estimate an arm's length return by comparing the relative economic contributions that two or more controlled parties make to the success of a venture. The profits from that venture are divided on the basis of the value of those contributions. These methods may be used only if both parties own items of non-routine, self-developed intangible property that contribute significantly to earning the combined income.[91] Also, significant transactions between the controlled taxpayers must take place and the parties must comply with certain administrative requirements.[92] Once elected, the profit split method cannot be revoked except with the approval of the IRS.

Under the residual allocation method, a two-step computation is made.[93] First, the operating income of each party is computed so that each generates a market return for its contributions other than valuable non-routine intangibles.[94] A functional analysis is required to identify the contributions of each party, including functions performed, resources employed and risks assumed. In this manner, profit is first allocated to the routine contributions. The residual profit that remains is divided among the controlled taxpayers based upon the relative value of the non-routine intangible property each contributes to the relevant business activity.[95] Where the relative value of actual expenditures remains more or less constant over time, the value of actual expenditures may be used to estimate the value of the contributions. Where, however, the expenditures are difficult to identify or where the facts otherwise cast doubt on the relationship between value and expenditure, other methods may be used to approximate the relative values of the contributions of each taxpayer.

The application of the residual method is illustrated in the following example:

> DP, a US corporation, developed, manufactured and marketed a line of household detergents in the United States, including a detergent that causes substantially less water pollution than competing products. The new detergent captures a substantial share of the US detergent market. FS is a European subsidiary of DP and is a well established, stand-alone company. FS alters the formula of the detergent to adapt it to European washing machines and to make the fragrance more appealing to European customers. In 1995, FS manufactures and sells the detergent in Europe.
>
> Because both DP and FS contribute valuable, non-routine intangibles to the European soap business, application of the profit split method is an appropriate method of determining the profit of each entity from the development, modification and manufacture of the low pollution detergent suitable for the European market. For 1995, DP has no direct expenses associated with the licence of the detergent formula to FS and incurs no expenses related to the marketing effort in Europe. FS's sales are $ 500 million and its expenses other than licence fees to DP are $ 300 million. Its net income exclusive of royalty expense is $ 200 million.
>
> The operating assets employed by FS are $ 200 million and data from comparable companies supports a finding that an average market return on assets is ten percent. Accordingly, the net return on $ 200 million is $ 20 million. The residual profit is $ 180 million, which is the amount that is attributable to the non-routine intangibles related to the detergent.
>
> The split of the $ 180 million profit is computed by reference to the capitalized value of expenditures as of 1995 on detergent-related research, development and marketing expressed as a percentage of the 1995 sales. Only sales related to the products covered by those expenditures are taken into account.
>
> In the case of DP, the analysis is computed on the basis of worldwide sales and in the case of FS, the analysis is computed on the basis of European sales. An analysis of the facts indicates that the R&D of DP amounts to $ 0.20 of every dollar of global sales and that the R&D performed by FS amounts to $ 0.40 of every dollar of European sales. Thus, regarding the sales in Europe, $ 0.60 of research, development and marketing expense is incurred with regard to each dollar of sales, and of that amount, DP is responsible for $ 0.20 and FS is responsible for $ 0.40. Since these amounts comprise the relative contributions of each entity, the profit split is determined on a $^1/_3 - {}^2/_3$ basis. DP is entitled to a royalty of $ 60 million ($^1/_3$ x $ 180 million) and FS retains $ 120 million ($^2/_3$ x $ 180 million). In the facts, this amounts to a royalty of 12 percent of sales.[96]

Under the capital employed allocation method, the combined profit or loss is allocated to the related parties on the basis of the relationship between the average capital employed by each related party in the relevant business activity during the taxable year and the aggregate capital employed in that activity.[97] For this method to apply, each related party must assume an approximately equal level of risk with respect to its investment in the joint activity. This is determined by reference to both the amounts at risk and the relative probability of success or failure.

89. Proposed §1.482-6T(c)(4) of the regulations.
90. Proposed §1.482-6T(c)(5) of the regulations.
91. §1.482-6T(b)(1) and (2) of the regulations.
92. Proposed §1.482-6T(b)(3) and (4) of the regulations.
93. Proposed §1.482-6T(c)(2) of the regulations.
94. Proposed §1.482-6T(c)(2)(i) of the regulations.
95. Proposed §1.482-6T(c)(2)(ii) of the regulations.
96. Proposed §1.482-6T(c)(2)(iii) *Example*.
97. Proposed §1.482-6T(c)(3)(i) of the regulations.

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In measuring the value of intangibles employed, either fair market value or the capitalized cost of development may be used.[98] Once chosen, the valuation method must be used consistently from year to year for all intangibles in the activity. Only the developer[99] of an intangible acquired from a controlled taxpayer or a participant in a cost-sharing agreement[100] may take an intangible into account. Where an intangible is used in more than one activity, it must be apportioned when making these computations.

The capital employed method is illustrated by the following example:

> DP is a US corporation and the sole shareholder of FS, a foreign corporation. DP and FS manufacture and market widgets in the United States and Europe, respectively. Both have substantial R&D operations and both are engaged in endeavours that are subject to approximately equal risk. Their combined reported operating profit determined in accordance with generally accepted accounting principles is $ 720 million, of which DP's share is $ 400 million and FS's share is $ 320.
>
> When expenditures for marketing, sales promotion and R&D are capitalized and amortized over their respective useful lives, DP's intangibles amount to $ 440 million and FS's intangibles amount to $ 160 million. When the value of tangible assets is added, DP's total capital is $ 1,440 million (the sum of tangible and intangible assets used in its business), or 60 percent of combined capital, and FS's total capital is $ 960 million, or 40 percent of combined capital.
>
> Under the capital employed method, the $ 720 million of combined operating profit is allocated for US tax purposes between the two companies on a 60-40 basis derived from the relative amounts of combined capital employed. As a result, DP's share of combined profits is increased to $ 432 million (60 percent x $ 720 million) and FS's share is reduced to $ 288 million (40 percent x $ 720 million). The aggregate profit remains $ 720 million.[101]

C. *Intangible property*

In comparison to the proposed regulations, the temporary regulations provide separate treatment for intangible property. Intangible property includes:

- patents, inventions, formulae, processes, designs, patterns, or know-how,
- copyrights and literary, musical or artistic compositions,
- trade marks, trade names or brand names,
- franchises, licences or contracts,
- methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data, and
- other similar items.[102]

The rules for intangibles, therefore, do not cover transfers of tangible property.

Three methods are provided with respect to the transfer of intangible property.[103] These are:

1. The comparable uncontrolled transactions method

This is essentially the matching transaction method and the comparable adjustable transaction method of the proposed regulations. Taxpayers are no longer required to test the results under this method by applying the CPI. However, intangible property having a high profit potential may not be comparable with the industry norms for intangibles having much lower profit potential.

In order to be comparable, the property transferred in the two transactions must be from the same class of intangible property, must relate to the same class of products or services, and must have substantially the same profit potential.[104] In addition, the underlying circumstances of the two transactions must be sufficiently similar so that difference can be reflected by only a reasonable number of adjustments that have a definite and reasonably ascertainable effect on the amount charged.[105] Factors that must be considered when determining the comparability of the circumstances include:

- the terms of the transfer relating to exploitation rights, exclusivity, restrictions on use and limitations on covered territory,
- the stage of development of the intangible,
- the rights to updates or improvements,
- the uniqueness of the property rights and the period during which it is likely to remain both unique and protected,
- the duration of the licence and the existence of termination or renegotiation rights,
- the existence and the extent of any product liability risks for the transferee,
- the existence of collateral transactions or ongoing business relationships, and
- the functions and ancillary services that are performed by the transferor and transferee.[106]

2. The comparable profits method

This method was described above at III.A.

3. Another method

This method is similar to the other method described above at III.A.

In general, the IRS expects to see a royalty for the use of intangible property unless a different form of consideration is demonstrably more appropriate.[107] If the intangible property is transferred for a period in excess of one year, the rate is generally subject to annual adjustment to ensure that it is commensurate with the income attributable to the intangi-

98. Proposed §1.482-6T(c)(3)(ii) of the regulations.
99. See §1.482-4T(e)(4) of the regulations.
100. See §1.482-2T(d)(4) of the regulations.
101. Proposed §1.482-6T(c)(3)(iii) *Example*.
102. §1.482-4T(b) of the regulations.
103. §1.482-4T(a) of the regulations.
104. §1.482-4T(c)(2)(ii)(A) of the regulations.
105. §1.482-4T(c)(2)(ii)(B) of the regulations.
106. §1.482-4T(c)(2)(ii)(B) of the regulations.
107. §1.482-4T(e)(1) of the regulations.

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ble.[108] Exceptions to the periodic adjustment rule are provided in two circumstances. The first exception applies when a licence with similar terms is entered with a third party.[109] Under this exception, no periodic adjustment will be made if:

- the taxpayers enter into a written licence agreement with a comparable term to an actual licence agreement between uncontrolled taxpayers;
- the consideration charged was an arm's length amount under the comparable uncontrolled transaction method for the first year in which substantial royalties were required to be paid under the agreement;
- the comparable licence agreement generally did not permit changes to the royalty; and
- the aggregate profits earned by the controlled transferee from the exploitation of the intangible fall within a range of profits that were anticipated when the licence agreement was executed.

The second exception applies to an arm's length transaction determined from the application of another method.[110] No periodic adjustment will be made if the transaction is deemed to be at arm's length under any method other than the comparable uncontrolled transaction method in the first year in which substantial periodic consideration is required to be paid. For this exception to apply, the transfer of the intangible property must be pursuant to a written agreement that is in effect in the year in issue and upon audit, the appropriate documentation is furnished to the IRS within 30 days of a written request. Also, the total profits that were actually earned by the controlled transferee (or its total cost savings) in all open years must not be less than 80 percent or more than 120 percent of the prospective profits that were foreseeable when the controlled agreement was entered. Thus, the intangible property must have produced the level of profits or savings that were anticipated initially.

The temporary regulations reiterate that arm's length consideration for an intangible is not limited to the prevailing rates in an industry or to the rates paid in any uncontrolled transaction that do not meet the requirements of the comparable uncontrolled transaction method.[111] Thus, the arm's length consideration in a controlled transaction, particularly for non-routine intangibles that are not ordinarily transferred between uncontrolled taxpayers, may not be limited by the amount of consideration identified in uncontrolled transactions.

IV. RESTRICTIONS UNDER FOREIGN LAW

On the same day that the temporary regulations were issued, the IRS issued proposed regulations addressing the effect which a provision of foreign law has on the power of the IRS to make an adjustment involving the income of a foreign entity. The regulations attempt to reduce the impact of *Proctor & Gamble v. Commr.*, *supra*.

A. *Background*

Since 1972, a limitation has been placed on the power of the IRS to make a transfer pricing adjustment under Section 482. A taxpayer cannot be allocated income for purpose of computing tax if it would have been illegal to earn the income, and the record contains no evidence that the taxpayer disregarded the law in carrying on its activities.[112] However, the IRS contends that this limitation applies only to activities that are illegal under US law. This position is premised on the fact that *Commr. v. First Security Bank* involved a proposed transfer pricing adjustment which would have comprised an illegal act under the law of a particular state. The limited application of the case that was adopted by the IRS was successfully challenged in *Proctor & Gamble*, a case in which a multinational group of companies was faced with a legal prohibition under Spanish law.

In *Proctor and Gamble Co.*, the US-based multinational owned a Swiss entity that in turn owned a Spanish subsidiary. The Spanish subsidiary was licensed to use certain intangible property belonging to the Swiss entity. However, Spanish law as applied by the Ministry of Industry prohibited the payment of a royalty because the recipient was the shareholder of the payor. Relying on the advice of competent local counsel, no appeal was taken from the Ministry's decision.

Disregarding the prohibition, the IRS allocated royalty income to the Swiss entity. Because that entity was a controlled foreign corporation of which the US-based multinational was a US shareholder, the allocation resulted in an inclusion of income for the US shareholder under Section 951, often referred to as Subpart F.[113] The allocation was challenged and the Court upheld the taxpayer.

The Court discerned no distinction between the circumstances in *Commr. v. First Security Bank of Utah* and the facts before it. In each instance, the companies chose to follow relevant law for which violation could have resulted in the imposition of serious criminal penalties. In each instance, there was no evidence that other taxpayers were regularly carrying out activities that were purportedly illegal under the relevant law. Once the Court refused to force a taxpayer to violate an applicable statute, the holding in *Commr. v. First Security Bank of Utah* controlled the resolution of the issue.

The IRS argued that the international structure could have been rearranged to permit the payment of royalties and that the taxpayer intentionally disregarded this option. However, the Court found this reasoning to be unpersuasive. Whether ownership potentially could have been modified to allow for the payment of royalties was irrelevant. Taxpayers are not obliged to conduct affairs so as to maximize taxes as long as a transaction in issue has substance.

The IRS argued that the decision placed foreign law in a superior position to domestic US law because the IRS was prevented from making an allocation under Section 482 to cause a taxpayer to properly reflect income. However, the

108. §1.482-4T(e)(2)(i) of the regulations.
109. §1.482-4T(e)(2)(ii)(A) of the regulations.
110. §1.482-4T(e)(2)(ii)(B) of the regulations.
111. §1.482-4T(e)(4) of the regulations.
112. *Commr. v. First Security Bank of Utah*, 405 U.S. 394 (1972).
113. In broad terms, Subpart F provides that certain types of income derived by controlled foreign corporations are to be included in the income of certain US shareholders almost as if the profits of the foreign corporation from the specified income were distributed as a dividend.

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Court concluded that Section 482 applies only where the controlling interest has utilized its power to shift income. There was no reason for the provision to apply where that exercise of power was absent as a result of a valid law.

The IRS announced at the end of 1992 that it would not appeal the matter to the US Supreme Court. Rather, it advised that the technical issue would continue to be raised for other taxpayers and would be litigated by the IRS until an appeals court in a different circuit reaches a conflicting decision. At that point, the IRS may request Supreme Court review.

B. *Temporary and proposed regulations*

The temporary and proposed regulations augment the announced IRS litigation policy. Their effect is to change the exclusion into an item of deferral. This merely delays the timing of income recognition.[114] This also defers the tax benefit of deductions that are allocable and apportionable to the item of deferred income. The proposed regulations also impose a set of administrative compliance requirements. Failure to comply with those requirements may prevent a taxpayer from having the opportunity of raising the prohibition of foreign law at a subsequent time.[115]

Under the temporary and proposed regulations, a taxpayer must demonstrate that the receipt of an arm's length payment was prevented by a foreign legal restriction.[116] If that showing can be made, the taxpayer may elect the deferred income method of accounting with respect to the item in issue. An applicable legal restriction is a restriction that:

- is publicly promulgated and generally applicable in a foreign country;
- has been unsuccessfully challenged by the taxpayer or a related party so that all practicable legal remedies afforded under foreign law for obtaining a waiver have been exhausted;
- expressly prevents the payment of an arm's length amount; and – was not circumvented through other transactions between the controlled taxpayers.[117]

If the restriction meets all the foregoing tests and the taxpayer has elected the deferred income method of accounting, any Section 482 adjustment will be deferred until the restriction is removed.[118]

To elect the deferred income method of accounting, a written statement must be attached to a timely US income tax return (including an amended return). The election must identify the affected transactions, the parties involved and the applicable foreign legal restriction. Deductions and credits chargeable against a deferred amount are subject to deferral under Section 461. The return must be filed not later than the date the IRS first contacts any member of the controlled group concerning an examination of the return for the taxable year in which the foreign restriction applies.

If a taxpayer demonstrates that the transaction as structured is arm's length by reference to comparable uncontrolled transactions, the deferred income rules will not be applicable. The item will not be adjusted.[119] This exception is intended to apply to circumstances where foreign governments limit the amount of royalties that may be paid in transactions between uncontrolled parties, and will likely have widest impact in the developing world. These circumstances should be compared to the facts of *Proctor & Gamble* where the Spanish legal restriction applied only to royalties that were paid to foreign shareholders.

The temporary and proposed regulations are illustrated in two examples.

> *Example 1*: DP is a domestic corporation that is the parent company of foreign corporation FS. DP licenses an intangible to FS, but the law in foreign country Y, the jurisdiction of residence for FS, prohibits the payment of royalties to related companies that are not resident in Y. DP attaches to a timely filed US income tax return a written statement that identifies the transaction, the parties and the foreign legal restriction. The arm's length royalty rate is determined to be ten percent of sales, which FS does not pay. However, FS pays dividends that are equal to ten percent of sales.
>
> The deferred income method of accounting is not applicable because the payment of dividends has the effect of circumventing foreign law.[120] The example does not address whether DP is entitled to an indirect foreign tax credit[121] for the full amount of foreign tax paid to country Y at such time as dividends from FS are received. If the dividend is treated as a "royalty" under US concepts, and that "royalty" is a significant expense that is not deductible under country Y law, is the country Y tax an income tax under U.S. foreign tax credit concepts? Presumably, the "royalty" does not bring indirect foreign tax credits with it.
>
> *Example 2*: The facts are unchanged from Example 1, except that the law under foreign country Y permits the payment of a royalty, but limits the amount to five percent of sales. FS pays a five percent royalty to DP and DP demonstrates the existence of comparable uncontrolled transactions in which a controlled licensor accepted a rate of five percent, even though the arm's length amount for the royalty would otherwise have equalled ten percent. The example concludes that no adjustment is to be made.[122]

V. PENALTY PROVISIONS

A. *In general*

Section 6662(a) imposes a penalty in connection with any underpayment of tax that arises, *inter alia*, from a substantial

114. Proposed §1.482-1T(f)(2)(iii) of the regulations.
115. Proposed §1.482-1T(f)(2)(i)(B) of the regulations.
116. Proposed §1.482-1T(f)(2)(i)(A) of the regulations.
117. Proposed §1.482-1T(f)(2)(ii) of the regulations.
118. Proposed §1.482-1T(f)(2)(iii) of the regulations.
119. Proposed §1.482-1T(f)(2)(iv) of the regulations.
120. Proposed §1.482-1T(f)(2)(v), *Example 1* of the regulations.
121. Under IRC Sec. 902, a US corporation may claim a credit for the foreign income taxes paid by its foreign subsidiaries. The credit is claimed at the time dividends are received from the foreign company. Certain minimum levels of ownership must be maintained in the subsidiaries (at least 10% of the voting shares of a first tier subsidiary and at least 5% indirect ownership interest in the voting shares of lower tier subsidiaries). No credit is allowed for foreign taxes paid by subsidiaries lower than third tier subsidiaries.
122. Proposed §1.482-1T(f)(2)(v), *Example 3* of the regulations.

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valuation misstatement. The valuation penalty provisions were extended to cover understatements of tax arising from transfer pricing adjustments because of the perceived difficulty faced by the IRS in obtaining information relating to the methodology employed in establishing a transfer price between controlled parties. In the view of the IRS, many taxpayers do not rely upon any specific comparable transaction or other contemporaneous information in planning for or in defending intercompany transactions. These taxpayers defend transfer pricing positions by finding whatever transaction or method gives rise to a result that most closely approximates the controlled transaction reported on their tax returns. As a result, the IRS believes that there is unnecessary delay in the conduct of examinations and undue controversy between the taxpayer and the IRS as each seeks to develop pricing formulas on a post-transaction basis.

B. *Penalty provision*

Section 6662 imposes a penalty when there is an understatement of tax arising from a substantial valuation misstatement. A substantial valuation misstatement includes an allocation under Section 482 if:

- the transfer price claimed on the return in connection with property, services or the use of property received from a controlled party, presumably outside the United States, is inflated so that the taxpayer's payment amounts to 200 percent or more of the amount determined under Section 482 to be the arm's length price – in other words, the deduction or transfer price for goods is reduced by half as a result of the IRS adjustment; or
- the transfer price claimed on a return in connection with property, services or the use of property provided to a controlled party, presumably outside the United States, is understated so that the amount received by the taxpayer is 50 percent or less of the amount determined under Section 482 to be the arm's length price – in other words, sales receipts or other income is doubled as a result of the IRS adjustment; or
- the net transfer price adjustments proposed by the IRS for the year exceed $ 10 million.[123]

The penalty applies if any one of the foregoing provisions is found to be applicable. Thus, a penalty may be imposed with regard to an adjustment of less than $ 10,000,000 if it reflects an overstated payment or an understated receipt.[124]

The penalty equals 20 percent of the adjustment in tax. However, if a gross valuation misstatement exists, the penalty is 40 percent of the underpayment of tax. A gross valuation misstatement arises if:

- the payment to a controlled party which is reported on the US tax return exceeds an arm's length price by more than 400 percent – the deduction is reduced by more than 75 percent; or
- the receipt from a controlled party which is reported on the US tax return is understated so that it does not exceed 25 percent of an arm's length return – sales receipts or other income is increased by more than 300 percent; or
- the net adjustment in tax under Section 482 exceeds $ 20 million.[125]

In determining whether the $ 10 million and $ 20 million thresholds have been met, the IRS compares the amount reported on the original return with the amount determined to be arm's length. Increases in taxable income may be reduced by decreases, including set-offs[126] that reduce adjustments when controlled taxpayers enter into non-arm's length transactions some of which favour the US company (see the discussion of correlative adjustments above at II.H.).[127] If the taxpayer adjusts its results by filing an amended return, the IRS will make its comparison by reference to that amended return, rather than the original return. For this rule to apply, the amended return must be filed before the taxpayer is first contacted by the IRS and advised that an examination is to begin for the year.[128]

If a loss or a credit in one year ("the year of origin") is carried to another year ("carryover year") and reduces the tax in that other year, the penalty may be imposed for the carryover year if the loss or credit reflects a gross valuation misstatement in the year of origin.[129] Only one penalty may arise from the excessive carryover. As a result, the excessive carryover is not again taken into account for the purpose of imposing a second penalty in the carryover year.

C. *Foreign-to-foreign exception*

For purposes of determining whether the $ 10 million and $ 20 million thresholds have been met, adjustments to transactions solely between foreign corporations are not taken into account.[130] This rule does not apply, however, if the adjustment increases the effectively connected income or the US-source income of one of the foreign corporations. In the former set of circumstances, US tax imposed under Section 882 is involved and in the latter set of circumstances, US tax under Section 881 is involved. Of course, if the thresholds have been met without taking the foreign transactions into account, the penalty will be imposed on the increase in tax that results from the foreign transactions.

D. *Reasonable cause exception*

In determining whether the $ 10 million and $ 20 million thresholds have been met, any increases in taxable income that are attributable to a transfer pricing adjustment will be excluded if the taxpayer shows that there was reasonable cause for the result reported and it has at all times acted in good faith.[131]

There are two elements to the reasonable cause and good faith exclusion, both of which must be satisfied in order to

123. IRC Sec. 6662(e).
124. Proposed §1.6662-5(j)(4)(iv), *Example 1* of the regulations.
125. IRC Sec. 6662(h).
126. Proposed §1.482-1T(e)(5) of the regulations.
127. Proposed §1.6662-5(j)(2)(i) of the regulations.
128. Proposed §1.6662-5(j)(1) of the regulations.
129. Proposed §1.6662-5(j)(3)(1) of the regulations.
130. Proposed §1.6662-5(j)(2)(iii) of the regulations.
131. Proposed §1.6662-5(j)(2)(ii) of the regulations.

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prevent imposition of a penalty.[132] The first element is that the taxpayer must have made a reasonable effort to accurately determine its proper tax liability.[133] The second element is that the taxpayer must have reasonably believed that its transfer pricing methodology produced an arm's length result.[134]

The determination required under the first element addresses the existence of a pricing methodology. It must be made not later than the time the return is filed for the tax year and must be supported by documentation that is contemporaneous with that determination. The documentation must include an analysis indicating that the result was arm's length within the meaning of the temporary regulations. If the documentation cannot be provided within 30 days of an IRS request, it is presumed that the taxpayer did not make a reasonable effort to accurately determine its proper tax liability, notwithstanding the actual existence of that documentation. This element addresses the existence of a pricing methodology. In essence, if the document cannot be presented on short notice, it likely did not exist when the return was filed.

With regard to the second element, the reasonableness of the taxpayer's belief is to be made in light of the experience and knowledge of the taxpayer. This element addresses the quality of the methodology adopted. The taxpayer must show that at the time the tax return was filed, it reasonably believed that the result would more likely than not be sustained on its merits.[135] This element addresses the quality of the methodology adopted. If at the time the prices were established, the taxpayer had a reasonable belief that its methodology would produce an arm's length result and the taxpayer had a reasonable belief that the underlying critical assumptions would not change during the taxable year – and in fact those assumptions had not changed by the time the tax return was filed, the taxpayer's belief in the arm's length nature of the transfer pricing method will be considered reasonable. However, the belief is not reasonable if, before the tax return is filed, the taxpayer learns of a change to a critical assumption but fails to review the reasonableness of its initial result.

In determining the reasonableness of a taxpayer's belief that its transfer pricing methodology is arm's length, factors to be considered include (i) whether the taxpayer used one or more methods prescribed in the substantive regulations,[136] and (ii) whether the taxpayer relied on the advice of a competent professional such as an attorney, accountant or economist.[137] The advice may be in the form of a study and the professional may be in the employ of the taxpayer – the adviser need not be an outside consultant. However, reliance on a professional is considered to be reasonable only if:

- full disclosure of all relevant information has been made by the taxpayer,
- the methodology and critical assumptions underlying the advice are reasonable, and
- the quantity and quality of data used in the study reflects the data available in the taxpayer's industry.

Critical assumptions are comprised of the objective business and economic criteria that are fundamental to the operation of the taxpayer's transfer pricing methodology. They include any fact about the taxpayer, a third party or an industry that would significantly affect the substantive conclusions of the study if the assumption changed.

A taxpayer may be considered to have acted with reasonable cause and good faith even if it chooses to defend its transfer pricing results by way of a methodology that is different than that used in preparing its return.[138] The key issue is not the particular method used to defend a position in an examination, but the reasonableness of the original tax return position.

VI. CONCLUSION

The temporary regulations attempt to bridge the differences that arose between the tax bar and the IRS in connection with the proposed regulations issued in 1992. The temporary regulations reflect an approach that broad guidelines based on reasonableness are preferable to detailed rules setting forth the mandatory use of specific methodology in specific circumstances. The tone throughout the temporary regulations is conciliatory.

Nonetheless, it is too early to determine whether the tone reflects style or substance. To the extent that taxpayers either are required to perform a functional analysis of comparable transactions or cannot avail themselves of a pricing method based on comparable transactions, the changes in the regulations may be of style, only. US-based multinational groups with manufacturing operations in the third world that are not clearly of a stand-alone nature may find this to be the case. For those groups, the existence of non-routine intangibles transferred to the foreign subsidiary may preclude use of any method other than the comparable profit method. On the other hand, to the extent that the CPI is no longer the principal method and another adjustable method is available, the temporary regulations are a major step forward.

Even if the regulations turn out to be favourable for multinational groups, the mood in Congress is much more aggressive with regard to international business. A consensus appears to be forming for the computation of a minimum profit that is taxable in the United States on all international business transactions, whether inbound (i.e. US distributors acting on behalf of foreign parents) or out-bound (i.e. foreign manufacturers acting on behalf of US parent companies). If this type of proposal is enacted, the benefit that may be derived from the use of a method other than the comparable profits method may be ephemeral.

132. Proposed §1.6662-5(j)(5)(i) of the regulations.
133. Proposed §1.6662-5(j)(5)(ii) of the regulations.
134. Proposed §1.6662-5(j)(5)(iii) of the regulations.
135. Proposed §1.6662-5(j)(5)(iii)(A) of the regulations.
136. Proposed §1.6662-5(j)(5)(iii) of the regulations.
137. Proposed §1.6662-5(j)(5)(iii)(B) of the regulations.
138. Proposed §1.6662-5(j)(5)(iii)(C) of the regulations.

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JAPAN:

TAXATION OF DIVIDENDS AND INTEREST

Alum Bati

This article looks at the taxation of dividends and interest paid to, or received from, non-Japanese companies. It concentrates on the new thin capitalization rules as well as withholding taxes and the method of giving tax credits for foreign taxes.

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Contents

I. Principles of Japanese Taxation
A. Source of income
B. Creditable taxes
C. Computation of tax credits

II. Double Tax Treaties
A. Dividends
B. Tax sparing
C. Administration
D. Interest

III. Thin Capitalization
A. Basic rule
B. Calculation of interest disallowance
C. Definitions
D. Industry practice exemption
E. Effective date

IV. Tax Havens
A. Dividend out of taxed profit
B. Foreign dividends/interest received by a tax haven
C. Taxes paid in the tax haven country

I. PRINCIPLES OF JAPANESE TAXATION

An overview of general Japanese tax principles (subject, of course, to exceptions and qualification) relating to the giving of tax credits is a helpful starting point.

Foreign withholding taxes, national or local, are creditable. The amount of credit is subject to an overall limitation.[1] Japan applies the overall method in computing Japanese tax on foreign dividends and interest (and other non-Japanese-source income). This allows cumulation of foreign dividends and interest and, therefore, the averaging of foreign taxes paid.

In the case of dividends received from abroad, Japan only gives indirect or underlying tax credits where at least 25 percent of the shares in that company are owned by the recipient and have been owned for at least six months before the dividend becomes payable.[2] The 25 percent rule may be modified by a tax treaty. Indirect credits are also available for dividends from second-tier subsidiaries in certain circumstances.

Foreign taxes may be expensed rather than taken as a credit.[3]

There are special rules applying to tax havens (which treat income of certain non-resident companies as taxable in Japan) but, basically, where a dividend is paid out of income already taxed in Japan, the dividend may be excluded from taxable income.[4]

Indirect or underlying tax credits are not normally available in respect of preference dividends (but see below).[5]

A. *Source of income*

All interest and dividends earned by a resident of Japan are, in theory, taxable in Japan. However, non-permanent residents of Japan (basically, non-Japanese citizens whose residence in Japan has not exceeded five years) are not taxable on non-Japanese- source income if it is not received in or remitted to Japan. Non-residents are taxable only on Japanese-source income.

Japanese-source dividends include dividends from Japanese companies.[6]

Japanese-source interest includes interest on Japanese local or national government bonds, Japanese corporate bonds or debentures, interest on monetary deposits with a branch in Japan, distribution of profits of joint operation trusts or bond and debenture investment trusts, and interest on loans to a person carrying on business in Japan and relating to that business.[7]

However, interest is not regarded as domestic-source income where it is on loans to a non-resident individual or foreign corporation for the purchase of ships or aircraft for use in that person's business, or on loans made to anyone for business carried on outside Japan, or on loans made to a non-resident other than for use in his business.[8]

Normally, only domestic-source income is subject to Japanese withholding taxes, even if foreign-source income is paid in Japan by a Japanese resident (other than one who is a paying agent). The corollary of this is that withholding is required

1. Art. 69 Corporation Tax Law, Law No. 34, 1965 ("CTL") and Arts. 141 and 142 of Corporation Tax Law Enforcement Order (Cabinet Order No. 97 of 1965) ("CTLEO").
2. CTL Art. 69(4), CTLEO Art. 146.
3. CTL Art. 41.
4. Special Taxation Measures Law No. 26, 1957 ("STML"), Art. 66-7.
5. CTLEO Art. 147(2)(iii).
6. Income Tax Law (ITL) Law No. 33, 1965, Art. 161(v); CTL Art. 138(v).
7. ITL Art. 161(iv), (vi); CTL Art. 138(iv), (vi).
8. ITL Basic Circular, 161-20.

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from domestic-source income even if it is paid abroad, although it does not have to be accounted for until the end of the month following the month in which tax is withheld (see double tax treaties below for possible modifications to these rules).[9]

Where foreign-source dividends or interest are paid through an agent in Japan, the agent will withhold Japanese income tax at the appropriate Japanese rate.[10]

Example

Hiroshi is entitled to dividends from J Inc., a US corporation, of US$ 10,000 (before US or Japanese withholding taxes). The net amount received by the paying agent in Japan will be $ 8,500 (i.e. after 15 percent US withholding tax). The paying agent will convert into yen and deduct, from the net amount of $ 8,500, a further 20 percent Japanese withholding tax. Net received by Hiroshi will be the equivalent of $ 6,800.

In this example, Hiroshi will be able to take credit for the foreign and Japanese withholding taxes in calculating his final liability to Japanese taxes.[11]

In the case of foreign dividends, withholding tax deducted by Japanese paying agents will be calculated on the net dividend amount received by them. However, in the case of foreign interest paid through an agent, the agent will deduct Japanese withholding tax from the gross amount but give credit for the foreign tax withheld.

Example

Foreign Co. pays dividends of 100 (before foreign withholding tax of 15) and interest of 20 (before foreign withholding of 2). Both payments are received in Japan by an agent. In the case of the dividend, the agent will deduct 20 percent withholding tax from the net amount of 85. In the case of interest, he will deduct withholding tax of 20 percent (i.e. 4) but will give credit for the foreign tax so the net tax withheld will be 2.

B. *Creditable taxes*

Having determined that the source of the dividends or interest is foreign (and tax treaties may have a bearing on this), one has to consider whether the foreign taxes are creditable.

Double tax treaties will specify (sometimes in general terms) which taxes are covered by the treaty. Credit is generally available for national or local taxes corresponding to Japan's corporation tax and charged upon income of a corporation or which is, like Japan's inhabitants' tax, a proportion of another tax which is itself charged on income. Excess profits taxes, and taxes on specified income or on some specific amount, such as withholding taxes on dividends and interest, are also creditable.[12] Penalty taxes are not creditable.

Foreign direct taxes, e.g. withholding taxes, are normally creditable.

Subject to double tax treaties (see II below), foreign indirect or underlying taxes are only creditable in respect of dividends where the recipient is a company which owns at least 25 percent of the issued share capital of the paying company or owns at least 25 percent of the issued voting shares of the paying company. The shares must be owned (or indirectly owned in the case of second tier subsidiaries) for at least six months before the dividend becomes payable for indirect tax credits to apply.[13]

C. *Computation of tax credits*

In principle, foreign dividends and interest are pooled with other income and foreign taxes credited against the total Japanese tax liability. In practice, however, there are a number of restrictions on the availability of tax credits even though foreign taxes may be creditable.

1. Foreign tax credit limitation

The amount of foreign taxes credited against national corporation tax cannot exceed the amount arrived at by applying the following formula:[14]

$$A = \frac{B}{C}$$

where

- A is the amount of Japanese national corporation tax;
- B is total taxable income from foreign sources (but excluding twothirds of income from foreign sources not taxed in the country of source.[15] Foreign-source losses must be deducted from foreign-source income, and foreign-source income must be grossed up for creditable foreign taxes if credit is wished to be taken.[16] The amount in B is usually limited to 90 percent of worldwide income although a higher percentage may be allowed if more than 90 percent of total employees are employed outside Japan or if foreign taxes exceed 50 percent of total income;
- C is total worldwide taxable income before loss relief brought forward from previous years.[17]

Generally, foreign tax exceeding 50 percent of foreign taxable income must be expensed rather than be taken as a credit.[18]

There are special and complex tax credit limitation rules which apply to interest withholding taxes, including "tax spared" credits.[19] The rules differ slightly depending on

9. ITL Arts. 181, 212(1),(2); CTL Art. 139.
10. In the case of interest, the withholding tax will be 20% from the gross, i.e. interest received plus foreign taxes but credit will be given for foreign taxes up to 20%. For dividends, the withholding will be 20% from the net dividend, although in some cases it may be to the advantage of higher rate taxpayers to elect for *bunri kazei*, or a final withholding tax of 35%.
11. On a dividend, net of US withholding tax, of less than ¥ 250,000, or ¥ 500,000 where J Inc. pays only one dividend during the year, Hiroshi could have elected for the *bunri kazei* special withholding tax treatment. Hiroshi will not be entitled to the special tax credit available in respect of domestic dividends; see ITL Art. 92.
If the dividend is less than ¥ 100,000, or ¥ 50,000 where more than one dividend is paid by the company in the year, 20% will be the final withholding tax.
These limits give rise to an interesting, and advantageous, practical anomaly, i.e. many foreign companies pay quarterly dividends and Japanese receiving agents apply the limits on a per dividend basis. Thus, for example, if a company pays quarterly dividends the *bunri kazei* (35% election) could be applied to total dividends from that company of up to ¥ 1 million; see STML Art. 8-4.
12. CTL Art. 69(1); CTLEO Art. 141(1),(2).
13. CTLEO Art. 146.
14. CTLEO Art. 142(1).
15. Special Taxation Measures Law Enforcement Order, Cab. Ord. 43, 1957 ("STMLEO"), Art. 39-18(7). Income deemed to have suffered tax under tax sparing provisions of tax treaties is not considered "untaxed" for this purpose.
16. CTLEO Art. 148(2).
17. CTLEO Art. 142(2).
18. CTLEO Art. 142-3.
19. CTLEO Art. 142-3(2).

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whether or not the main business of the company concerned is a financial one (which includes a securities business).[20]

For non-financial businesses, the limit is calculated as follows:

(a) if the following ratio is less than 1:5 there is no special limitation (but the overall 50 percent limitation still applies):
Ratio = gross interest income:(gross interest income + gross profit)

"Gross profit" is sales less cost of sales.

The above calculation is an average over three years.

(b) If the ratio in (a) is more than 1:5, the limitation is as follows:
(i) if the average ratio of adjusted taxable income to the sum of gross profit and non-operating revenue in the year concerned and the two preceding years is more than 1:5, the full amount of withholding taxes are creditable (and the normal 50 percent limitation does *not* apply);
(ii) if the average ratio of adjusted taxable income to the sum of gross profit and non-operating revenue in the year concerned and the two preceding years is equal to or less than 1:5 but more than 1:10, no more than 15 percent of interest received may be credited;
(iii) if the average ratio of adjusted taxable income to the sum of gross profit and non-operating revenue in the year concerned and the two preceding years is equal to or less than 1:10, no more than ten percent of interest received may be credited.

The basic principle in Japan is that only net of foreign tax income need be brought into tax. Any disallowed tax credits may, therefore, be excluded from taxable income.

For financial institutions the exceptional treatment in (a) above does not apply. The ratio in (b) above is similar but the denominator is total revenue and the numerator is taxable income, i.e. taxable income:total revenue (including net capital gains).

2. Calculation of foreign tax credit

In addition to the tax credit limitation calculated as above, one has, of course, also to calculate the amount of foreign tax credit itself. There is normally no problem in the case of withholding taxes but indirect taxes relating to dividends may be more difficult.

Basically, the indirect tax credit is calculated as the lower amount given by applying the following formulas:

$$\text{Foreign taxes of paying company in the accounting period} \times \frac{\text{Dividend before withholding}}{\text{Income of paying company after foreign taxes}}$$

or

Dividends received (including withholding) – (2 x withholding on dividends).[21]

Example

J Co. receives a dividend of 75 from its UK subsidiary. The subsidiary has pre-tax profits of 200 and pays UK corporation tax of 66. The creditable tax for Japanese tax purposes (before applying the limitation in 1. above) will be:

$$66 \times \frac{75}{134} = 37$$

(Applying the alternative formula would give 75 as there is no UK withholding in such cases.)[22]

3. Relationship of foreign tax to accounting periods

The foreign tax which is taken into account is the tax relating to the income out of which the dividend is paid. If the dividend exceeds the distributable income of a particular accounting period (but see 8. below), the dividend is deemed to be paid out of earlier accounting periods on a last-in, first-out basis.

Example

A UK subsidiary started operations in 1989 and has the following distributable profit record (tax paid in brackets):
1989 150 (tax 45)
1990 150 (tax 45)
1991 150 (tax 45)
1992 60 (tax 15)
In 1992, the subsidiary declares and pays a dividend of 200 purportedly out of 1990 profits. As profits in 1990 were only 150, 50 of the dividend must in fact have been paid out of some other year. It is arguable that, for indirect credit purposes, none of the dividend is paid out of 1992 and the balance of 50 is paid out of 1989.[23] If so, the creditable tax calculation will be:

1990 $45 \times \frac{150}{150} = 45$

1989 $45 \times \frac{50}{150} = 15$

Maximum indirect foreign tax credit 60

Total gross dividend subject to Japanese tax is 260.[24]

4. Source of dividend undefined

Where no reference is made to the year out of which the dividend is paid, it is deemed to be paid out of the income of the current accounting period (subject to the rule concerning sufficiency of profits, etc.).

5. Three-year carry-forward of excess foreign tax credits

Foreign taxes in excess of the limitation above, and, to the extent they cannot be offset against local taxes (see 14. below) may be carried forward to an accounting period commencing not more than three years after the start of the period in which the tax credit arose. The carried forward credits are available on a first-in, first-out basis, subject, of course, to not exceeding the limit for the relevant accounting period.[25] Carried forward credits may be applied against national corporation and local inhabitants' taxes. These provisions apply for accounting periods beginning after 31 March 1989 (the

20. There are transitional provisions for loans concluded in accounting periods starting before 1 April 1989; see Corporation Tax Cabinet Order Transitional Measures, Art. 20.
21. CTLEO Art. 147(1).
22. A dividend by a UK company whose Japanese shareholder owns 10-25% of the shares does not get the benefit of either an underlying tax credit or a refund. See Japan/UK tax treaty.
23. CTLEO Art. 147(2)(i) refers to the dividend exceeding the income for the accounting period which has constituted the basis for the computation of the dividend. In such a case, it is assumed that the dividend is paid out of the profits of earlier periods, beginning with the most recent. As UK company law allows a company to designate which year profits have been paid out of, it seems that a year yielding higher foreign tax credits could be chosen.
24. See CTLEO Art. 147(2)(v).
25. CTL Art. 69(2); CTLEO Art. 144.

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carry-forward period used to be five years and transitional provisions apply to accounting periods commencing before that date).[26] Tax credits which have been expensed cannot be carried forward.[27]

6. Three-year carry-forward of excess limitation

Where the creditable foreign taxes are less than the limitation calculated in 1. above, the excess limitation may be carried forward for three years. This provision, combined with 5. above, essentially means that excess foreign tax credits can be carried forward or back for three years.

7. Preference dividends

Underlying tax credits are not available in respect of preferred dividends, meaning dividends on shares paid at a specified rate in preference to other shares (see double tax treaties below).[28] However, indirect tax credits are available in respect of dividends declared on participating preference shares to the extent that the basis on which dividends are calculated on the preference shares is the same as that for ordinary shares.[29] Withholding taxes are, in any event, creditable.

8. Income for an accounting period

The income for an accounting period (see 3. above) is the greater of the after-tax profit for the period or the profit for tax purposes in the foreign state (but adjusted for corporation or similar taxes included in expenses and income not subject to tax). Thus, for example, in the United Kingdom, petroleum revenue tax (treated as an expense for corporation tax purposes) will be added to taxable profits[30] before the comparison is made. Similarly, capital gains not subject to tax in, say, the Netherlands or Singapore, will be added back to taxable profits.[31]

9. Taxes imposed late

Creditable taxes in respect of a dividend paid for a particular accounting period include foreign taxes imposed (i.e. paid or assessed) before the end of the accounting period in which the Japanese company receives the dividend. Foreign taxes imposed after the end of that accounting period will not, therefore, be creditable in respect of a dividend received in an earlier period.[32]

10. Gross up

The dividend is grossed up for creditable foreign taxes.[33]

11. Refund of foreign taxes

Where already credited foreign taxes are reduced or refunded during a later accounting period *of the shareholder*, the refunded amount will reduce creditable taxes, if any, in that period. Any excess of refund is then set against brought-forward foreign tax credits and the balance, if any, is used to reduce creditable taxes for the next two accounting periods. If there is still an insufficiency of creditable taxes in those two periods, any balance left at the end of the second period is treated as taxable income in that period.[34]

12. Exchange rates

Foreign taxes are usually translated at the telegraphic transfer mid-rate rate of exchange applying on the date the dividend is payable or some other acceptable consistently applied rate. Acceptable methods include monthly average, the month or week end rate of the preceding month or week, etc.[35]

13. Treating foreign tax credits as expenses

In relatively rare instances, it may be to a taxpayer's advantage to treat foreign taxes as business expenses (effectively, treating only the net dividend as taxable income). However, if the taxpayer makes this election, it must be applied to all foreign direct (i.e. withholding) taxes.[36] In the case of indirect taxes, the taxpayer may opt in respect of each dividend whether or not to gross up for the indirect tax.[37] However, any taxes which are expensed cannot be carried forward.

14. Foreign taxes creditable against local taxes

Foreign taxes in excess of the limitation in 1. above may be offset against Japanese prefectural and municipal inhabitants' taxes, in that order. The former ranges between five and six percent and the latter ranges between 12.3 and 14.7 percent of the corporation tax amount.[38] A limitation applies to the amount of foreign taxes which can be offset against local taxes as it does for corporation tax. This is derived by applying the local tax rate to the limitation for national corporation tax purposes.

For individuals, foreign withholding taxes not exceeding 20 percent (for municipal tax) or ten percent (prefectural inhabitants' tax) of the maximum amount creditable under the ITL may be credited against these local taxes.

Enterprise tax is levied only on net foreign dividends and interest and, therefore, no foreign tax credits are available against it.

15. Allocation of expenses

General expenses, including interest, will normally be rateably apportioned between domestic and non-domestic-source income. However, where foreign income is mainly in the form of dividends, interest or royalties, some other fairer method of allocation may be applied.[39]

26. Corporation Tax Transitional Measures, Art. 18.
27. CTLEO Art. 144(2).
28. CTLEO Art. 147(2)(iii).
29. *Id.*
30. As well as being added to creditable taxes. See Protocol to UK–Japan double tax treaty.
31. CTLEO Art. 147(2)(iv).
32. CTLEO Art. 148(1).
33. CTL Art. 28; CTLEO Art. 148(2).
34. CTL Art. 69(5); CTLEO Art. 150.
35. CTL Basic Circular, 13-2-2-1; 16-3-42(4).
36. CTL Art. 41; CTL Basic Circular, 16-3-1.
37. CTLEO Art. 149.
38. Local Tax Law Enforcement Order, Arts. 9-7, 48-13.
39. CTL Basic Circular, 16-3-14, 16-3-17.

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16. Branches

A branch of a foreign company is taxable only on domestic-source income and is not entitled to foreign tax credits. Interest and dividends from abroad which are attributable to the business of the branch are regarded as Japanese-source income (subject to double tax treaties). Such income can, however, be excluded from the tax return if it can be shown that it has borne foreign tax.[40]

17. Stock dividends

Stock dividends constitute taxable income in Japan. This is so even where shares are issued rateably to all shareholders and no cash changes hands. Such dividends may not be subject to withholding taxes overseas (e.g. in respect of bonus or scrip issues of shares representing capitalization of reserves in the United States) but will be subject to Japanese taxation. However, withholding tax is only levied on the nominal value of the shares so it may be in a Japanese shareholder's interest to opt for stock dividends if available.

In the United Kingdom, a UK resident is not entitled to repayment of any tax credit associated with a stock dividend (which will be the case where the shareholder has elected to take stock instead of a cash dividend), and so a Japanese shareholder is unlikely to be entitled to a part repayment of the tax credit from the UK government.[41]

18. Unremittable foreign income

Dividends and interest earned overseas which cannot be remitted because of foreign law (e.g. foreign exchange controls) may be omitted from income until the restrictions are lifted.[42]

II. DOUBLE TAX TREATIES

Japan has tax treaties with approximately 40 countries. Most of these reduce the normal Japanese rate of withholding tax on dividends and interest. In the case of dividends, there may be an additional reduction in the rate of withholding tax where the foreign shareholder has a substantial holding. In the case of interest received in Japan, some tax treaties provide for tax-sparing credits (i.e. credit for foreign taxes deemed paid but not actually paid). Some features of the double tax treaty provisions relating to dividends and interest are reviewed below.

A. *Dividends*

The standard rate of Japanese withholding tax on dividends (20 percent) paid to shareholders in treaty countries is generally reduced to 15 percent (or ten percent in the case of substantial shareholdings). In one instance, Zambia, dividends paid to a Zambian shareholder are exempt from Japanese withholding tax.

Most current treaties with Japan were negotiated before the abolition of Japan's split-rate tax system (when distributed profits were taxed at a lower rate than retained income) so relatively high rates of withholding taxes were imposed on distributions overseas. As these high rates are no longer required, new treaties are likely to have lower rates of withholding tax (most likely five percent). Examples of this are the amended Netherlands treaty, the revised Norway treaty and the new Luxembourg treaty.

There are some interesting differences between the treaties and divergences from the OECD model.[43] First, most treaties seem to provide for the reduction of withholding tax to ten percent, usually where a corporate shareholder "owns" (directly or indirectly) at least 25 percent of the voting shares of the dividend paying company (share ownership percentages in fact vary from ten percent, United States, to 50 percent, e.g. Austria. The OECD model treaty refers to "the beneficial owner" of the dividend but this phrase is not generally used. Nor do Japan's treaties normally adopt the OECD model's limitation to direct holdings only.

Secondly, whilst the OECD model commentary expressly states that a time requirement for share ownership should not ordinarily be applied, Japan frequently requires shares to be owned for six months (e.g. Switzerland, France, Ireland) or 12 months (e.g. Germany, United Kingdom) prior to the dividend payment before the reduced rate for large holdings can be applied. In the case of the United States even more than 12 months could be required. It should be noted that Japan expressly reserved its position on this section of the OECD model.

Thirdly, the period of ownership mentioned above is sometimes calculated from the date the dividend becomes payable (e.g. Switzerland) but, more usually, from the date of payment (e.g. United States). In the case of Finland, however, the period of ownership is calculated from the end of the accounting period for which the distribution takes place.

1. Dividends defined

Dividends are usually defined (for withholding tax purposes) basically in accordance with the OECD model as meaning "income from shares, ... mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the laws of the State of which the company making the distribution is a resident".[44] There are, of course, variations from treaty to treaty to take account of foreign law. For instance, in the German treaty, income derived by "a sleeping partner" (Stiller Gesellschafter) from "his participation as such" is included. The treaty with Canada has an interesting addition: for Canada only, "dividends" include income from bonds or debentures which is treated as a distribution of profits.[45] Such recharacterized dividends will

40. CTLEO Art. 176(5), (6).
41. It is, however, not entirely beyond doubt, having regard to the UK–Japan double tax treaty Art. 11(3)(a)(ii), (b).
42. CTL Basic Circular, 16-3-7.
43. Organization for Economic Co-operation and Development Model Double Taxation Convention, 1977. The 1992 Model was not available to the author at the time of writing.
44. "Jouissance" shares and "jouissance" rights are also included in the Brazilian, French and Swiss treaties.
45. See para. 5 of the Protocol of May 1986 to the 1986 Convention between Japan and Canada.

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suffer Canadian dividend withholding tax but presumably receive credit in Japan under the interest article of the treaty.

Direct withholding taxes are almost invariably creditable in Japan against Japanese tax on the income but limited to the amount of Japanese tax appropriate to that income (see above for method of calculation).

Indirect taxes (e.g. taxes on the income out of which the dividend is paid) are also creditable under the majority of Japan's tax treaties where the recipient owns a specified percentage of the payer's shares. The requisite shareholding is usually 25 percent (either of voting shares or total shares) but is ten percent in a few cases (e.g. Brazil).

However, until recently, indirect tax credits were only possible in respect of taxes paid by first-tier subsidiaries. It now includes indirect taxes paid by second-tier subsidiaries also.

The general definition of *what* is creditable and *when* raises some important issues and interesting anomalies. First, most treaties, to give credit for foreign taxes, use the following form of words:

"Subject to the laws of Japan regarding the allowance as a credit against Japanese tax ..." but the UK/Japan treaty (and a few others, e.g. Hungary and Switzerland) uses the words "Subject to the *present* provisions of the laws of Japan ... and to any *subsequent modification* of those provisions ..." (italics added). The form of words was presumably preferred by the UK negotiators for the purposes of credit in the United Kingdom and was simply copied by the Japanese. However, "modification" might not include substantial revision, substitution or repeal so it appears, in theory, that the taxpayer in Japan will have to be aware of the law as it stood at the date of the treaty and its subsequent history.

Secondly, it is at least arguable that, as tax conventions override domestic legislation, to the extent that they give the taxpayer more favourable treatment, if a law favourable to a Japanese taxpayer receiving, say, UK dividends were repealed, the taxpayer could still rely on the repealed provisions.[46]

Thirdly, it is arguable that the words "subject to the laws of Japan regarding the allowance of credit" only apply to the method of calculation, e.g. the taxes against which foreign taxes are offsettable, as this is not specified in the treaties.[47] Otherwise, if the words are taken to include the very principle of giving credit for foreign taxes,[48] the treaty provisions could be made otiose by domestic legislation. For instance, the Japan/Australia treaty[49] allows underlying tax credit in Japan for shareholdings of ten percent or more but domestic law only allows it for 25 percent or greater holdings[50] and clearly the treaty provision must prevail.[51] It may also be possible to contend that, as most treaties specify a percentage of voting shares "or of the total shares issued by the company" (clearly envisaging something other than ordinary shares) whereupon "the credit shall take into account" underlying tax credits, is an imperative statement and cannot be overridden by domestic legislation.

To illustrate this point, one could refer to domestic law relating to indirect tax credits in respect of preference share dividends, i.e. dividends paid on specified shares in preference to others.[52] Preference share dividends are not, in terms of domestic law, regarded as dividends for indirect credit purposes and yet Japan's tax treaties define "dividends" (for withholding tax purposes) widely enough to include preference dividends.[53] Unfortunately, the treaties do not impute that definition into the indirect tax credit article but it is reasonable to suppose that the definition would be the same. If it were intended to exclude preference dividends under Japan's treaties, this could easily have been dealt with in the "dividends" definition – otherwise indirect credits for preference dividends are not allowable except perhaps in the case of dividends from Brazil. Finally, perhaps a Japanese taxpayer could argue on the basis of reciprocity in cases where the treaty partner grants underlying credits in respect of preference dividends.

2. Dividends connected with a permanent establishment

Japan's tax treaties invariably exclude the application of the reduced rate of withholding tax where the beneficial owner of the dividends has a permanent establishment (PE) in Japan and the dividend is effectively connected with a business carried on through that PE. In other words, where the shares form part of the assets of the PE, the full rate (20 percent) of Japanese withholding tax will apply.

B. *Tax sparing*

Many of Japan's treaties (principally with developing countries) provide for tax sparing credits, i.e. credits for tax not actually paid, usually in accordance with some investment incentive. The credits may be for withholding tax or in respect of taxes foregone on the income of the dividend-paying company. Examples of the former are the treaties with Brazil,[54] China, Korea and Thailand whilst examples of the latter include the treaties with China, India, Malaysia and Singapore.

C. *Administration*

Tax which must be withheld by the Japanese resident making payment of domestic-source dividends or interest to non-res-

46. See the Constitution of Japan, Art. 98(2), which states that "The treaties concluded by Japan ... shall be faithfully observed".
47. There is perhaps some support for this view in the Commentary to the OECD model. This states that "detailed rules on the computation and operation of the credit" are not given because of their complexity. One could also argue that, as treaties "shall be faithfully observed", this is a rather circular statement.
48. Something the treaties usually forbid with the words "which, however, shall not affect the principle hereof".
49. Art. 17(2).
50. CTL Art. 69(4).
51. The Ministry of Finance accepts this, its view being that express provisions in treaties override domestic legislation but that general provisions do not.
It is interesting that the Japan/Brazil treaty makes no reference to the treaty being "subject to the laws of Japan".
52. CTL Art. 69(4); CTLEO Art. 147(2)(iii).
53. And one would normally expect the payer country's law to apply in determining whether a payment constitutes a dividend for withholding tax purposes. Indeed, even in Japanese domestic law, a preference dividend would be regarded, in ordinary circumstances, as a dividend.
54. Brazil's branch profits withholding taxes are treated as being dividend withholding taxes.

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idents must be paid to the tax office by, in the case of a payment made in Japan, the tenth day of the month following the month of payment or, where payment is made abroad, by the end of the month following the month of payment.[55]

Generally, in order for reduced treaty rates of withholding tax to apply, the recipient must complete and send the appropriate form to the payer, who should in turn file it with the tax office. Some treaties (e.g. France) specify that for the reduced rate to apply the application must be made before the payment but, generally, where by oversight an application has not been submitted in good time and too great an amount has been deducted, the payer of dividends or interest may make an application on behalf of the recipient for a refund of the overpaid tax.

D. *Interest*

The "Interest" article of Japan's double tax treaties normally provides for the reduction of withholding tax from the standard domestic rate.[56] Withholding tax on Japanese-source interest paid to non-residents is usually reduced to ten percent. Often interest paid to (or guaranteed by) the Bank of Japan or the Export-Import Bank of Japan is exempt from withholding tax. Similarly, Japan often exempts from withholding tax payments of a like nature (see treaties with, for example, France, Germany, United States). Sometimes the exemption is extended to local authority debt (e.g. treaty with France, Malaysia), government bonds (e.g. treaty with Germany),[57] the interest element of hire purchase payments to the equipment lessor (e.g. France) and any loans to Japanese enterprises (e.g. Pakistan).

The reduced rate of withholding tax is sometimes[58] not applied where the debt-bearing instrument is dealt with on a stock exchange, the beneficial owner of the interest is not taxed on the income (e.g. a pension fund) and he sells the instrument within three months of the date it was purchased.

1. Interest defined

"Interest" is generally defined as meaning income from government securities, bonds or debentures (whether or not secured and whether or not carrying a right to participate in profits) and debt claims of every kind. The definition usually also includes items treated by domestic tax law as interest and sometimes includes the profit on the redemption of debentures or debts (e.g. Italy, Singapore – but Japan's domestic law does not normally regard the profit on redemption as being interest).

2. Source of interest

Interest paid by a resident of Japan is generally subject to Japanese withholding taxes as treaties usually specify that the source of such income is Japan. However, the source of interest paid by a Japanese resident may not be Japan where the payer has a PE in some other state, and the interest is borne by that PE: such interest is normally regarded as having a source in the country where the PE is located.

3. Interest connected with a PE

Reduced rates of withholding tax under Japan's treaties do not usually apply where the recipient of the interest has a PE in Japan and the interest is effectively connected with that PE.

4. Tax sparing

As with dividends, a number of Japan's treaties provide for giving credit to Japanese companies earning interest in respect of tax either not suffered or suffered at lower rates than credited. These tax sparing provisions usually apply in respect of loans for specific purposes (e.g. China, Korea, Malaysia, Philippines, Singapore).

5. Connected parties

Japan's double tax treaties usually provide that any reduced withholding tax rates do not apply to that portion of interest paid in excess of what unrelated parties would have agreed to pay. Japan does not recharacterize such "excess interest" as a dividend but simply applies the normal rate of withholding tax to it.

6. Administration

See under Dividends above.

III. THIN CAPITALIZATION

Rules have recently been introduced which disallow as an expense interest payments by companies (and branches of foreign companies in Japan) in certain circumstances where debt is considered excessive, i.e. the company is considered to be under-capitalized.[59] This section refers to thinly capitalized Japanese companies but the rules apply equally to branches of foreign companies operating in Japan.[60]

A. *Basic rule*

The basic rule is that

- the company has borrowings from a foreign controlling shareholder; and
- the interest-bearing portion of the average of those borrowings exceeds three times the net assets attributable to the shares owned by the foreign lender and average of total interest-bearing debt of the company exceeds three times net assets.

Disallowed interest is not reclassified as dividend.

55. ITL Art. 212.
56. The usual rate of withholding tax on interest in Japan is 20%, which consists of 15% national tax and 5% local inhabitants tax. The latter does not apply in the case of interest paid to non-residents.
57. But, interestingly, not the United Kingdom, even though the United Kingdom unilaterally grants such relief in the case of certain securities.
58. See UK treaty, Art. 12(7).
59. STML Art. 66-5, STML Cabinet Order 1992, No. 39-13 ("STML CO").
60. STML Art. 66-5(7).

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Example 1

Nippon KK has borrowings and annual interest payments as follows:

From independent banks	¥ 100m	interest: ¥ 10m p.a.
From its 51% US shareholder	300m	40m
From its 49% Japanese shareholder	250m	25m
	¥ 650m	¥ 75m

Nippon KK's total net equity is ¥ 210m.

In this case there will be no disallowance of interest expense under the thin capitalization provisions (although transfer pricing adjustments may be applied). Whilst total interest-bearing debt exceeds net equity by more than 3:1, borrowings from the US shareholder are less than three times net equity attributable to its holding.

Example 2

The facts are as in Example 1 except that total net equity is ¥ 167 million. In this situation, both the total debt-to-equity ratio and the ratio of US shareholder debt to attributable equity (167 x 51% = 85) exceeds 3:1. There will be a disallowance of interest.

B. *Calculation of interest disallowance*

The method of calculating disallowed interest[61] is best explained by referring to Examples 1 and 2 above.

Example 3

Disallowed interest in Example 2 will be calculated as the smaller of the following:

(1) $40m \times \frac{300 - (85 \times 3)}{300} = 6m$

i.e. the formula $A \times \frac{B - (C \times 3)}{B}$

where
A is the amount of interest payable to the foreign controlling shareholder (F),
B is the average of interest-bearing debt owed to F,
C is net equity attributable to F.

(2) $40m \times \frac{650 - 167 \times 3)}{300} = 20m$

i.e. the formula $A \times \frac{D - (E \times 3)}{B}$

where
D is the average of total interest-bearing debt,
E is the net equity.

C. *Definitions*

1. Foreign controlling shareholder

Direct holdings and indirect holdings through domestic companies are taken into account in determining control.[62]

Example 4

F Co ——(90%)——> Japan Co ——(60%)——> Japan Co 2

F Co is a foreign controlling shareholder of Japan Co 2 as it owns more than 50% (0.9 x 0.6 = 54%).

Control may also be in the form of a special relationship:[63]

- the same person owns, directly or indirectly, 50 percent or more of the shares of the Japanese company and the foreign lender; or
- the foreign company's directors/employees (current or former) constitute 50 percent or more of the board, or representative directors, of the Japanese company. In this situation, two further conditions have to be satisfied: the foreign corporation must provide a substantial proportion of the Japanese company's working capital and most of the latter's business operations must relate to transactions with the former.[64]

The special relationship test is similar to that for transfer pricing purposes.[65]

The rule for indirect foreign holdings applies so as to aggregate the average debt, interest earned, etc. in respect of each of the foreign related shareholders.

Example 5

F1 ——(100%)——> F2 ——(100%)——> Japan Co 1 (JC1) ——(51%)——> Japan Co 2 (JC2)

Each of F1 and F2 has lent ¥ 100 million to JC2. JC1 has lent ¥ 50 million to JC2. JC2's net equity is ¥ 80 million. It has no other interest-bearing debt. The rate of interest in each case is five percent per annum. The thin capitalization rules will apply to interest payments to F1 and F2 (but not JC1) because interest-bearing debt owed to F1/F2 exceeds 80m x 0.51 x 3 and total interest-bearing debt exceeds 80m x 3. Disallowed interest will be the smaller of:

(1) $(5m + 5m) \times \frac{200m - (80m \times 0.51 \times 3)}{200m} = 3.88m$

(2) $(5m + 5m) \times \frac{250 - (80 \times 3)}{200} = 0.5m$

2. Net assets

Essentially total assets less total liabilities, except that, where this is less than the total of share capital/capital surplus accounts (i.e. where there is a deficit on retained earnings), in which case the capital and capital surplus accounts are taken as equal to net assets.[66]

3. Interest-bearing debt

Only interest-bearing debt is included in the calculation. Note that it is the average balance during the year which is important, i.e. repaying debt just before the year end will not usually help escaping the rules.[67] Debt effectively connected with the Japanese branch of a foreign company is not taken into account so long as the branch's interest income is taxable in Japan.[68] Back-to-back loans are covered by a special provision for the inclusion of debt routed through third parties.[69]

61. STML CO Arts. 13, 14.
62. STML CO Art. 10; STML Art. 66-5(3).
63. STML Art. 66-5(3).
64. STML CO Art. 18.
65. STML CO Art. 19.
66. STML CO Arts. 5, 6.
67. STML CO Art. 3.
68. STML CO Art. 2.
69. STML CO Art. 4.

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However, the National Tax Administration has said that normal parent company guarantees to a commercial bank will not be caught by this.

4. Interest

"Interest" includes discounts on debenture bonds but only to the extent that it is recorded as an expense in the accounts.[70]

D. *Industry practice exception*

The thin capitalization rules apply basically where the debt-to-equity ratio exceeds 3:1. However, more generous gearing is acceptable where this is industry practice in Japan for a comparable company. Documentary evidence should be maintained to support the proposed treatment.[71]

E. *Effective date*

The new thin capitalization rules apply to accounting periods commencing after 31 March 1992.

IV. TAX HAVENS

Where Japanese shareholders own more than 50 percent of the shares in a tax haven subsidiary, the profits of that subsidiary are, in general, taxable on the Japanese shareholders in proportion to their holdings (so long as the relevant holding is five percent or more).[72] Tax haven countries for these purposes are basically countries which do not impose a corporate income tax or where the *effective* rate of tax is 25 percent or less. These tax haven rules create three special difficulties:

- What happens when a tax haven company pays a dividend out of profits already taxed in Japan?
- What foreign tax credits are available when determining whether a company is a tax haven company or not?
- If a tax haven company's profits are subject to an apportionment, to what extent can be credited the foreign taxes incurred by it on its dividend/interest income?

Each of these three problems is considered below.

A. *Dividend out of taxed profit*

Basically, a dividend paid out of cumulated profits will not be subject to further taxation to the extent that it does not exceed undistributed profit taxed in Japan during the previous five years. However, any tax credits given in respect of tax haven profits taxed in those years will be added back and foreign credits previously given will be recovered.

Example

Haven Co. is a 100 percent subsidiary of Japan Co. Its profits are taxable in Japan and it has the following record of profits ($m):

Year	*1*	*2*	*3*	*4*	*5*	*6*
Profit	10	10	10	20	15	5
Local Tax	-1	-1	-1	-2	-1.5	-0.5
Distributable	9	9	9	18	13.5	4.5
Dividend paid	–	–	–	–	–	63
Less: profit (gross) already taxed						-65
Add: foreign tax credit previously given						6.5
Japan tax on dividend, say, 50%	-5	-5	-5	-10	-7.5	-2.5
Foreign tax	1	1	1	2	1.5	0.5
Total Japan tax	-4	-4	-4	-8	-6	-2

If, the dividend had been paid in Year 7, no adjustment would have been made for that part paid out of Year 1 profits (and, consequently, there would have been no claw-back of the corresponding tax credit).[73]

B. *Foreign dividends/interest received by a tax haven*

A tax haven company which receives foreign dividends or interest will, for the purposes of determining the effective tax rate suffered by that company, be deemed to have paid any tax associated with that company (e.g. withholding taxes, but not indirect corporate taxes relating to dividends received). Any tax-spared credit which a Japanese company would be entitled to will also be treated as taxes borne by the subsidiary.[74]

C. *Taxes paid in the tax haven territory*

Such taxes are available for tax credit. This is the case even where the Japanese company to which profits are apportioned holds less than 25 percent of the shares in the tax haven company.

70. STML CO Arts. 11, 15.
71. STML Art. 66-5(2), (5).
72. STML 66-6 to 66-9.
73. STML Art. 66-8.
74. STML CO Art. 39-14(2).

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DENMARK:

TAX STATUS OF EXPATRIATES

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I. INTRODUCTION

Foreign employees transferred to Denmark for a period of six to 36 months who would normally be fully liable to tax in Denmark may benefit from a new special tax regime, provided a number of conditions are met. The new 30 percent rule was adopted by the Danish Parliament on 19 June 1992 and implemented by Act 489 of 24 June 1992, which introduced a new provision into Section 48 E of the Act dealing with tax at source.

Contents

I. Introduction
II. Purpose
III. Conditions for Opting into the Regime
A. Temporary connection
B. Full liability to tax in Denmark
C. Salary income
D. Essential influence or ownership of the business
IV. Taxation
A. General
B. Deductions
C. Previous taxation under the scheme
D. Termination of 30 percent taxation and reassessment
V. Effective Dates

II. PURPOSE

Prior to the statutory amendments most highly qualified foreign employees had required that their remuneration be based on a net principle when negotiating with Danish employers, which meant that they required payment of a stipulated amount after tax, leaving it up to the individual employer to determine the appropriate gross amount. Thus, foreign employees were neither interested in the actual gross amount nor in substantive Danish rules of taxation.

This type of pay determination leads to discrepancies within the pay structure of a business, as the remuneration payable to the foreign employee will exceed the remuneration paid to Danish executives. The remuneration of the foreign employee will typically exceed the salary paid to the chief executive officer. As a result of these discrepancies and the financial burden on the individual business, the recruitment of foreign employees has become virtually impossible for Danish firms.

The 30 percent tax option will enable the employer to determine a lower gross income for the employees involved. Consequently, it will be less costly for an individual business to appoint foreign employees, and the discrepancies in the pay structure will be eliminated. With these amendments it will be financially easier for the Danish business community to recruit key expatriate personnel, thereby enhancing Denmark's competitive edge in the international arena.

III. CONDITIONS FOR OPTING INTO THE REGIME

A. *Temporary connection*

Under the new provisions the 30 percent income tax rate is subject to the conclusion of a fixed-term employment agreement of not less than six and not more than 36 months' duration with a private individual, company, association, foundation, etc. which is fully liable to pay taxes in Denmark or which has a branch or any other permanent establishment in Denmark. Subject to similar conditions the employment agreement may be concluded with an organization which is exempt from Danish taxation, including a central or local government, government institution, etc.

B. *Full tax liability in Denmark*

Normally such a foreign employee would be subject to full tax liability in Denmark upon commencement of the employment. Nationality is of no relevance, but the special tax rule is not intended to apply to persons who already have a permanent connection to Denmark. Nor is the rule designed to benefit such persons by

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enabling them to leave Denmark with a view to subsequently returning for the purpose of becoming subject to the easier rule. Persons who have previously been subject to full liability to taxes in Denmark may not have terminated such liability with a view to benefiting from the easier rule.

C. *Salary income*

The rule only applies where the salary income equals a monthly basic amount of DKK 42,600 (1992 figures). The basic amount is subject to annual review.

The statutory basic amount entails that only persons whose annual gross income amounts to approximately DKK 511,000 (in 1992) are entitled to opt for the new tax regime. Only highly educated specialists and other key personnel will be in a position to opt for this rule, which will only become effective at a level of income where the number of employees having the required qualifications is relatively small. The determination of this amount takes account of the fact that the rule should not impose unfair competition on Danish employees.

Scientists and researchers may choose this scheme, however, even though their remuneration is lower, provided their service agreements stipulate that they are to undertake their research in Denmark, and that the individual research project to which the taxpayer is to be connected has been approved by a research council.

D. *Essential influence or ownership of the business*

The taxpayer may not have been involved directly or indirectly in the "management or control" of the business or had any ownership of the business for the five years prior to his employment.

The wording of the Act envisages that if the taxpayer is or has been involved in the management of the business the rule cannot be applied. In view of the legislative history of the Act, which deals only with ownership and voting rights, the Act cannot be construed in this way. Also a taxpayer who is appointed an executive of the business and is thus "involved in the management", but who has no ownership rights in the business, may opt for the regime, regardless of the wording.

When determining whether the taxpayer has had control or ownership of the business of the employer, it must be ascertained whether the person owns or has owned 25 percent or more of the share capital, or has had control of 50 percent or more of the voting rights in the paying company, etc. Shares belonging to the taxpayer's immediate family and shares belonging to companies, etc. in which any member of the taxpayer's immediate family has held a controlling interest are taken into consideration in making this determination.

Whether the taxpayer owns or has owned 25 percent or more of the net capital or has held a controlling interest in the business is taken into account if the paying business is that of a sole trader.

IV. TAXATION

A. *General*

The new provisions are designed exclusively to ease, not increase, taxation of the individuals in question. The scheme is thus an optional one. Any person who prefers being taxed according to the ordinary rules governing taxation of individuals who are fully liable to tax in Denmark may opt to be taxed under the ordinary rules.

If the person opts for the 30 percent rule, tax is calculated as 30 percent of the money payments payable under the service agreement. The income tax liability in respect of money payments is finally discharged upon payment of the tax, and the remuneration is not included in the taxable income.

The 30 percent tax is deducted from the money payment, i.e. salary, holiday allowance, fees, bonus, commission and any other such payments. Benefits in kind (e.g. free board and accommodation, company car, etc.) do not form part of the tax base for the 30 percent tax. Consequently, such benefits will be taxed according to the ordinary rules applying to persons who are fully liable to taxation.

The employee is also subject to ordinary tax liability in respect of any other income, and to wealth tax according to the usual rules applying to persons who are fully liable to taxation.

B. *Deductions*

In consideration of the easier tax rules, any employment expenses are not deductible from income which is subject to 30 percent taxation, nor from any other income, including the value of a free company car, etc. which is subject to ordinary income tax. Any other negative income may not be set off against income which is subject to 30 percent tax, nor can earned-income relief in respect of income taxed at 30 percent be converted into relief deductible from any other income.

C. *Previous taxation under the scheme*

Where a taxpayer has previously been in receipt of income taxed according to the 30 percent rule and his full tax liability to Denmark has subsequently ceased, the taxpayer may again choose to be subject to the 30 percent taxation when concluding a new service agreement in Denmark, provided all conditions are still met. However, the total maximum period of the 30 percent rule, i.e. 36 months, will be reduced by any previous periods of such taxation. The right to choose the 30 percent rule again will lapse after ten years from the commencement of the first employment period subject to the 30 percent rule.

D. *Termination of 30 percent taxation and reassessment*

The 30 percent tax rule will terminate (i.e. the beneficial treatment will be cancelled) and tax will be clawed back if within one month after the termination of the employment subject to 30 percent taxation, the taxpayer does not either

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take up new employment subject to taxation at the same rate or terminates his full tax liability to Denmark.

Where the taxpayer enters into a new qualifying employment agreement within one month after the termination of his previous employment, and where the earnings under both agreements may be taxed according to the rule, there is no requirement that the tax liability in Denmark should be incurred in connection with the commencement of the employment. Thus, the taxpayer is not required to leave Denmark and thereby discontinue the tax liability during the period between two agreements in order to remain entitled to the 30 percent taxation. When a new agreement is concluded, however, the 36-month period is not extended.

The taxpayer may extend an employment agreement expiring at the end of the total period of 36 months for up to 12 months, giving rise to a reassessment. The employee may remain on the job for the additional 12-month period but he will be taxed under the ordinary rules of taxation. However, there will not be a clawback of tax. The recapture rules will only apply if the taxpayer fails to leave Denmark within one month after the end of the extended employment. During the extension period the taxpayer will be taxed according to the ordinary rules.

Where taxation is terminated, any remuneration and allowances treated for tax purposes according to the 30 percent rule will be included in the taxpayer's income for the relevant income years. In other words, underpaid taxes are recaptured. Any taxes already paid will be treated as taxes withheld on a provisional basis for the year at issue.

During the period of the agreement the taxpayer may choose to revert to the ordinary tax rules, either with retroactive effect as from the commencement of the employment, or with effect for the future only. If the taxpayer opts to be taxed under the ordinary rules, he may not later opt for the 30 percent taxation during the same agreement. Where the taxpayer chooses to be subject to the ordinary tax rules in respect of the future, the conditions for avoiding recapture of taxes will still apply. If the employee chooses to be subject to the ordinary tax rules with retroactive effect, however, any 30 percent tax paid will be treated as taxes withheld on a provisional basis for the income years in question.

V. EFFECTIVE DATES

The 30 percent rule has been notified to the European Community in pursuance of the EC Treaty, Article 93 paragraph (3) on aid granted by states. The EC Commission has announced that it does not find the Bill incompatible with the provisions of the EC Treaty.

The rules on 30 percent taxation apply to service agreements concluded after the effective date of the provisions, i.e. agreements concluded after 27 June 1992. Generally, the provisions only apply to income earned after the effective date of the agreement.

Even though the employee may be subject to full Danish tax liability prior to conclusion of the agreement and prior to the effective date of the provisions, so that the condition that tax liability should be incurred in connection with the commencement of the employment is not met, the 30 percent rule may nevertheless apply to the first employment which is subject to the 30 percent rule. In such a case the maximum 36-month period for application of the 30 percent tax rule is reduced in proportion to the period from incurring tax liability to the commencement of the employment to which the rule is desired to apply. Thus the scheme will also be available, although for a shorter period, to a person arriving in Denmark before 27 June 1992 who subsequently concluded a service agreement provided such person qualifies for the 30 percent rule.

To accommodate persons who were present in Denmark on 1 June 1991 and persons who arrived in Denmark and were employed in Denmark after that date, special transitional rules apply to income earned after 1 June 1991. The scheme applies only to agreements concluded within one month after the effective date of the rule, i.e. on or before 27 July 1992.

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FRANCE:

MAJOR MEASURES CONCERNING INTERNATIONAL TAXATION: THE FINANCE ACT 1993 AND TRANSFER OF ASSETS ABROAD

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The 1993 French Finance Act has been enacted, and this article discusses the main measures affecting international tax law.

Contents

I. Corporate Tax Rate
II. Participation Exemption
III. CFC Legislation
IV. UCITS
V. Business Licence Tax
VI. Special Three Percent Tax on French Real Estate
VII. Transfer of Assets in a Foreign Jurisdiction
VIII. Enterprise Zones

I. CORPORATE TAX RATE

The standard rate of corporation tax is reduced to 33.33 percent for profits realized during accounting periods opened on or after 1 January 1993. This provision constitutes the final step in the reduction of the corporation tax rate. It applies to all enterprises subject to corporation tax, i.e. all corporations and corporate entities subject to corporation tax under the normal rules or upon election,[1] and non-resident companies carrying on business activities in France.

This reduction does not modify the amount of the *avoir fiscal* attached to any regular distribution of dividends by companies subject to corporation tax. The avoir fiscal remains equal to 50 percent of the dividends distributed by French corporations, and represents a full refund of upstream corporate tax. Nor does the reduction amend the rules for the *précompte mobilier* (equalization tax).

It should be noted that the equalization tax is levied either on profits which have not suffered corporation tax at the normal rate or on any distribution of reserves which exist for more than five years. The amount of the equalization tax remains equal to one-third of the profits before distribution (i.e. 50 percent of the distributed dividend).[2] Consequently, corporations which distribute dividends derived from profits taxed at the rate of 33.33 percent will no longer be subject to the equalization tax provided the profits have been realized during the five years before the distribution. In addition, the distribution no longer gives rise to the additional corporation tax.[3] The avoir fiscal attached to any regular distribution now corresponds to 100 percent of the corporation tax paid out of the same profits. Thus the reduction of the corporation tax to 33.33 percent and the existence of the avoir fiscal of 50 percent of the distribution totally eliminates the double taxation of profits (unless a French corporation elects for the participation exemption regime). This is discussed in more detail below.

II. PARTICIPATION EXEMPTION

Under the participation exemption, dividends received by a French parent company from foreign or domestic subsidiaries were excluded from the parent company's income to the extent of 95 percent of the gross dividends. To qualify as a "parent" corporation the French company must own at least ten percent of the share capital of the subsidiary, or if the holding is less than ten percent the shares must have cost at least Ffr. 150 million. Further, the shares in the subsidiary must be subscribed by the French parent or acquired by it (in which case the parent company must commit to hold its interest for at least two years). For the determination of profits deriving from accounting periods opened as from 1 January 1993, the French participation exemption regime is amended as follows:

1. Certain entities (e.g. general partnerships, limited partnerships, joint ventures) may elect to be subject to corporate taxation in France. Once such an election is made, however, it is generally irrevocable.

2. Different rules apply in the case of the distribution of long-term capital reserves.

3. Previously, the standard rate of corporate income tax was different, depending on whether the profits after tax were distributed or remained in the company. For profits realized during a financial year between 1 January 1989 and 31 December 1991, which had suffered corporation tax at the rate of non-distributed income, an additional tax was levied to have the profits taxed at an effective rate of 42%, if the profits happened to be distributed. Because the standard rate of corporation tax was harmonized for financial years as from 1 January 1992, the additional corporation tax was:
   - 0% of the net distributed income for profits of financial years opened in 1991;
   - 5/58 of the net distributed income for profits of financial years opened in 1990;
   - 3/58 of the net distributed income for profits of financial years opened in 1989.

   This appeared to be a simple system, but the conditions for application were complex. The 1993 Finance Act abolishes the double standard rate of corporation tax for:
   - any regular distribution paid during financial years opened as from 1 January 1993;
   - other income deemed to be distributed during the financial year which precedes the first one opened as from 1 January 1993.

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- application of the regime is now optional;[4]
- the taxation of a notional amount of expenses incurred in respect of the dividend (generally five percent of the dividend plus any tax credit attached to it) is abolished;
- the minimum participation (ten percent) is strictly interpreted;[5]
- in making the ten percent determination shares without any voting rights are not taken into account.

As stated above, under the old regime dividends received under the participation exemption were exempt for 95 percent of their amount. The remaining five percent – or actual expenses if lower – were deemed to correspond to the expenses incurred in connection with the participation, and as such were taxable. The new provision abolishes the five percent rule so that dividends received in accounting periods beginning on or after 1 January 1993 are 100 percent exempt. As a result, the proceeds enjoying the participation exemption regime, which are deducted from the taxable income of the recipient company, are equal to the total amount received during the accounting period.

Because the avoir fiscal is equal to 100 percent of the upstream corporate tax the participation exemption no longer offers advantages in all cases. In practice, however, the participation exemption regime is more favourable in the following cases:

- if the parent company is in a loss position;
- if the dividends do not enjoy a tax credit sufficient to offset the French corporate income tax (dividends distributed by foreign subsidiaries);
- if the dividends are distributed by a subsidiary included in the French tax unity regime, and if the dividends are paid out of profits or long-term capital gains realized during the period the distributing company was a member of the group (in such a situation, the dividends cannot enjoy the avoir fiscal).

IV. CFC LEGISLATION

A. *Previous wording*

Under the old provisions of the French tax code (CGI) Section 209 B, if a French enterprise subject to corporation tax owned, directly or indirectly, at least 25 percent of the shares or stock of a company located in a low-tax jurisdiction, it was taxable in France on the profits derived by its subsidiary (proportionally to its interest therein) whether or not distributed and whether or not remitted to France. The results were taxed separately, which led to their effective taxation, even though the French company would be in a loss-making position.

Paragraph II of Section 209 B provides that this regime does not apply if the French company offers evidence that the transactions of the foreign entity did not have as their main effect the parking of profits in a country enjoying a privileged fiscal regime. This is deemed to be the case generally if the foreign company carries out mainly an industrial or commercial activity, and it realizes its transactions primarily on the local market.

The provisions of Section 209 B are derogatory to normal French rules, as French law generally ignores the concept of worldwide taxation as far as corporations are concerned, and for tax purposes recognizes the separate legal capacity of subsidiaries.

B. *Amendments*

The 1993 Finance Act extends the scope of the regime instituted by Section 209 B, as follows:

- the minimum level of shareholding is reduced from 25 percent to ten percent (or to a participation which cost at least Ffrs. 150 million);
- establishments without legal personality belonging to the French company are henceforth targeted, thus extending the scheme to permanent establishments abroad;
- to rights held in any entity, whatever form;
- valuation of the ten percent interest is by reference to financial rights or voting rights;[6]
- the indirect control concept is codified and made precise in the law;[7]
- the tax regime relevant to such non-resident entity is determined by examining the actual tax burden borne by the non-resident and not by looking at the overall tax regime in the jurisdiction where the non-resident is located;
- French rules continue to apply in computing the taxable result in France, but the benefit of provisions granting special allowances or deductions, write-offs in excess of standard depreciation or accelerated tax depreciation, may no longer be claimed, nor may the favourable taxation provided for in respect of certain proceeds of patent rights.

C. *Timing*

The regime aims at participations acquired and structures implemented as from 30 September 1992, the date the draft Finance Bill was submitted to the French Government for consideration.

The provisions of the current regime should remain unchanged as far as existing participations are concerned for purposes of the taxation of income of accounting periods opened before 1 January 2003. However, for indirect control, the concept of a low tax regime and the exclusion of certain favourable rules for the determination of the foreign result taxable in France, the new provisions apply as from the determination of the results of accounting periods ended 31 December 1992.

4. Although this may be arguable, until now the French tax authorities have considered that the participation exemption was not granted upon election but rather was a compulsory regime. The option appears to be linked to no particular obligation and should result from the action of the company in its annual tax return. The option may be modified each financial year.
5. Thus, if further to a reorganization the stake decreases below 10%, the affiliation privilege will no longer apply.
6. However, the taxable profit in France is proportional to that part of the capital or financial rights belonging to the French parent company.
7. Because the notion of indirect control was previously not provided in the law but rather in a decree, it was questionable whether a taxpayer could raise arguments about its binding effect.

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In the case of existing participations of at least ten percent (and lower than 25 percent), any acquisition or subscription to the share capital, the effect of which would increase or even maintain the level of the participation, may lead to the applicability of Section 209 B.

D. *Comments*

As the regime provided by Section 209 B is derogatory to French general principles, it should be strictly interpreted.

1. Privileged regime

It appears that the French revenue authorities envisage applying this provision to entities located in tax treaty countries and enjoying a favourable tax regime. As the Finance Act targets entities subject to a privileged fiscal regime in the sense of CGI Section 238 A, a question is raised about the scope of this provision. Section 238 A provides that persons are regarded as subject to a privileged tax regime in a state or territory if they are not taxable there or if they are subject to tax on income or proceeds "notably lower" than in France.[8]

The concept of privileged regime should be examined in light of comments by the French revenue authorities and court cases.

(a) *Comments of the French tax authorities*

On 26 June 1975, the French fiscal administration declared that the existence of a privileged fiscal regime is established:[9]

- if there is no tax on income or on profits derived from professional activities; or
- if the income, profits or remuneration sourced in the state are not subject to tax in the state; or
- if the recipient is not subject to tax in the foreign state or is subject to a tax notably lower than in France.

With regard to the latter test, a comparison between the French tax regime and that of the foreign state should be made. This comparison must consider taxes taken in their entirety, taxes of the same nature, and the existence of particular tax regimes.[10]

The comparison must be on tax considered as a whole. The French tax administration insisted that the goal of Section 238 A is to prevent the transfer of income to tax havens, i.e. territories characterized notably by the absence of taxation or by privileged tax regimes based on the nature or source of certain income or the status of the recipient. The determination is made by looking at the specific burden borne by the company and not between particular tax regimes, such as the regime in France and the one in the foreign country.[11]

(b) *Jurisprudence*

In a case dated 25 January 1989, the "Commissaire au Gouvernement" Philippe Martin (counsel to the Administrative Supreme Court), emphasized the necessity of examining the "fiscal profile of the non-resident recipient of the remuneration by reference to its specific legal status" for comparison purposes, and not by reference to the overall characteristics of the fiscal regime of the foreign country.[12]

2. Compatibility of Section 209 B with EC law

If the non-resident company is located in an EC country and if a favourable regime has been approved by the EC authorities, it may be argued, without total certainty, that Section 209 B is not compatible with EC law.

3. Compatibility of Section 209 B with tax treaties

Under tax treaties, the income of a non-resident company may be subject to tax in France if such company has a permanent establishment in France (or if the right to tax is attributed to France by virtue of a treaty). Section 209 B allows France to tax a non-resident company even if the latter has no permanent establishment in France. Thus, it may be argued that Section 209 B is incompatible with tax treaty provisions. The French tax authorities could respond that the liability to tax does not fall on the foreign company but rather on the French company.[13] However, it is the income of the foreign company which is subject to tax, even if it is in the name of the French company; this appears to be a means of assessment of corporation tax, the French Government having practical difficulties recovering income tax directly from a non-resident company.

The issue of compatibility is not settled and has never been brought before the courts. Although it is difficult to predict the attitude of the courts, it may be noted that the treaty entered into between Mexico and France of 7 November 1991, recently ratified by French Parliament, includes a specific provision that the treaty does not forbid France from applying Section 209 B.

IV. UCITS[14]

Shares or stock of French or foreign UCITS owned by French companies subject to corporation tax[15] must be estimated at their fair market value at the end of each accounting period. The difference between the purchase price or the subscription price and the evaluation at the end of the accounting period is

8. "Notably lower" means that the tax borne by the non-resident is at least one-third lower than the tax liability which would have resulted in France.
9. 26 June 1975 4 C-8-75.
10. E.g. companies not subject to tax by virtue of a provision of law.
11. This is subject to eventual comments from the French tax authorities, further to the amendments in the 1993 Finance Act.
12. Although the case is issued by a Court of Appeal, it should be noted that on 30 January 1992 this court decided that a privileged tax regime is established solely by comparing the levels of assessment that the taxpayer may have suffered (independently of the tax he has effectively suffered). This case appears rather confusing and not in accordance with the strict wording of the legal provision; however, it should be taken into consideration although the Supreme Court may decide otherwise in the future.
13. In fact in a Guideline issued 6 March 1992 the tax administration declared that Sec. 209 B is in conformity with tax treaties and EC law as well.
14. The term "UCITS" is used to encompass investment companies, investment funds.
15. Companies organized under the insurance legislation do not fall within the scope of this provision, although they are subject to corporation tax. However, this exemption does not cover reinsurance companies (A.N. 22 October 1993, at 4182).
Company shareholders subject to corporate income tax in a transparent entity must also follow the new rules. As a result, transparent entities which are subsidiaries (whether or not directly) of entities subject to corporation tax are covered by this new provision.

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included in the taxable income of the said accounting period. This provision applies to accounting periods ending on or after 1 November 1992.[16]

This new regime applies to any investment fund, whether or not resident in France.

The securities covered by the new provision include:
- interests in UCITS, except for certain venture capital funds;
- stock in investment companies (i.e. so-called "SICAVs");
- shares, stock or interests in foreign investment funds.

The new regime applies to shares, stock or interests in investment funds owned directly or indirectly in France by the relevant enterprises. It also includes a specific provision for securities held indirectly by a subsidiary established abroad. The regime applies to any interest held by a person or entity established abroad, and which enterprise owns directly or indirectly stock, shares or rights if the assets of this person or entity are mainly comprised of investment fund units subject to the new regime or if its activity consists mainly of the management of such securities for its own account.

This provision, which is designed to avoid the parking abroad of proceeds in UCITS of French enterprises, requires some comment. The provision applies regardless of the form of the foreign entity which owns the securities, as the legislation is aimed at a person or an entity. This may lead to including individuals or companies in which the French corporation has rights (subsidiaries or individuals holding proceeds owned by the French entity), and entities which may or may not have legal capacity (e.g. trusts, groupings). This implies a broad scope. In fact, the relevant item is the nature of the activity of the foreign entity. To fall within the scope of the provision, one of the following tests should be met:
- either the assets are comprised mainly of interests in investment funds subject to the new regime;[17] or
- the activity consists primarily of the management of such securities for its own account.[18]

The law does not provide any details on indirect shareholdings.

Two categories of securities do not fall within the scope of this new provision:
(1) securities UCITS which principally invest in stock ("OPCVM actions"). The new provision does not apply to interests in French or EC investment funds which simultaneously meet the following tests:
   - at least 90 percent of the market value of the assets owned by the investment fund is permanently comprised of stocks, investment certificates or cooperative investment certificates issued by EC resident companies, subject to corporation tax under normal rules or to a corporation tax comparable to the French tax;
   - as regards the nature of the proceeds, the securities which constitute the numerator of the 90 percent ratio are remunerated by dividends to which an "avoir fiscal" is attached.[19]
(2) interests in venture capital funds ("FCPR").

This exception applies if the enterprise commits itself to retain the interests in the UCITS for at least five years from the date of purchase. However, if the interests are transferred within five years, the enterprise is subject to tax at the standard rate on the proceeds of the transfer and it is also subject to a specific tax, calculated by applying to the tax which should have been paid during each previous accounting period a rate of 0.75 percent per month of delay. This tax should be paid voluntarily by the entity within three months from the end of the financial year in which the interests were transferred. It is not clear whether the tax is also payable during a loss year.

The spirit of the new legislation is to take into account the annual estimation of interests in UCITS, regardless of the fact that the gain or loss would be generated upon the effective transfer of the securities.

The legislation is exclusively of a fiscal nature, i.e. regardless of the accounting treatment.

As far as interests held indirectly through a person or an entity situated abroad are concerned, two remarks should be made:

(1) *Annual estimation*: if the foreign entity falls within the scope of the new regime, it must determine the difference of the estimation as regards the securities it holds. The difference is then taxable in the hands of the French corporation proportionately to its direct or indirect rights in the foreign entity. Once determined, the difference must be allocated; it is deemed to impact the value of the shares or interests of the French corporation in the person or entity situated abroad.

(2) *Depreciation allowance*: under the new regime, a loss impacts directly on the taxable income of the French corporation. If simultaneously the rights in the foreign entity decrease in value, a depreciation allowance should be posted for accounting purposes; such a reserve is deductible for tax purposes only for the portion exceeding the loss already taken into account under the new tax regime.

Example:

A French company owns 60 percent of a foreign subsidiary acquired for 1,000. The value of those securities is 950 on 31 December 1993. On the same date, the interests in the UCITS owned by the foreign subsidiary are estimated at 190, although their value was 200 on 31 December 1992.

The parent corporation posts a depreciation allowance of 50 for the share capital of its subsidiary.

16. The difference in the estimation prior to 1 July 1992 is in principle not taken into account and remains taxable upon transfer of ownership of the securities.
17. Subject to further comments, this condition should be met if the gross market value of the securities in question represent 50% or more than the total fair market value of all the assets owned by the person or the entity at the end of the financial year of the French enterprise.
18. This is the case if the activity constitutes the main part of the economic activity of the company.
19. To the extent that currently, there are almost no UCITS stocks which can meet the above tests, a one-year period is granted to existing mutual funds to fulfil these conditions;

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If the new legislation applies, the parent company deducts for tax purposes the following negative difference on the interest in the UCITS:

200 – 190 = 10
10 x 60% = 6

The depreciation allowance is accordingly deductible (for tax purposes) up to 44, i.e. 50 – 6.

V. BUSINESS LICENCE TAX

Taxpayers carrying on commercial, industrial or professional activities are subject to a business licence tax.[20] The tax is based on 16 percent of the annual or deemed rental value of the taxpayers' fixed assets and on 18 percent of gross salaries. The tax applies regardless of whether the user is the owner of the assets in question.[21]

The 1993 Finance Act introduces two amendments:

– the base for business licence tax purposes does not change if upon the termination of a lease of movable property, including a purchase option, the asset is purchased by the lessee;
– the base of the business licence tax remains unchanged in lease-back transactions.

This amendment targets a practice in which an enterprise transferred part of its assets to a leasing company for a residual value and leased them under a new lease agreement with an option to purchase. The enterprise remained taxable under the business licence tax on these assets as it used them, but the base was recomputed from the amount provided in the lease agreement. As this amount was generally the cost price in the balance sheet of the company using the asset before the lease-back transaction, the transaction involved a reduction in the base of the licence tax.

As from 1993, the fair market value of equipment or real property, which is under a lease with an option to purchase or a true lease concluded after 1 January 1991 by the same taxpayer, cannot be lower than the value which was existing on the date of the transfer. In other words, assets which are no longer owned by the taxpayer who retains disposition of them for his professional activities remain taxable at the same base.

Enterprises which fall within the scope of this provision must modify their return before 1 May 1993 for additional taxation.

VI. SPECIAL THREE PERCENT TAX ON FRENCH REAL ESTATE

Since 1983, France has levied a special tax of three percent on the value of real property situated in France which is owned by non-resident companies. The effectiveness of this tax has been limited due to certain decisions of the French Supreme Civil Court. However, the French Government introduced an amendment to the provision in the 1993 Finance Act to improve the effectiveness of the real estate tax. The amendment provides that all corporate entities, wherever their registered office, which own directly or through interposed persons, real property in France or which benefit from real property rights over such assets, are subject to the annual three percent tax. By removing the reference to "a seat outside France", it is believed that CGI Article 990 D no longer conflicts with the non-discrimination clause in tax treaties.

According to the new provision, French resident corporate entities fall within the scope of the three percent tax. Bearing in mind the reason for introducing the tax (i.e. to combat tax evasion and that the French Government does not want to increase the administrative burden for French revenue), the 1993 Finance Act provides for two additional exemptions:

– corporate entities having their effective seat in France and other corporate entities situated in a country which has concluded a tax treaty with France containing a non-discrimination clause, provided they file or commit themselves to file an annual tax return (before 16 May of each year), which includes a description of the real estate and the identity of the shareholders or partners;
– corporate entities which are listed on an official stock exchange.

Details will be made public by a decree or comment of the French tax authorities.

Previously, if a non-resident individual owned a company subject to the three percent tax, the individual was not subject to inheritance tax on the transfer to his heirs of the company stock. This exemption has been abolished.

VII. TRANSFER OF ASSETS IN A FOREIGN JURISDICTION

An enterprise which transfers assets abroad to a third party or any type of entity (including a trust), for the purpose of managing the assets or to ensure meeting existing or future obligations of the enterprise, is subject to corporate income tax in France on income and gains derived therefrom. This provision is targeted at any asset transferred directly or indirectly by the company or through a third party. However, certain transfers (e.g. pursuant to insurance contracts) do not fall within the scope of the provision.

The provision is worded in general terms so it is feared that it may be extensively applied by the French tax authorities, although Parliament, during the discussions of the draft Finance Act, stated that only transactions such as the issuance of (repackaged) subordinated perpetuals (TSDI) and defeasance transactions were targeted. The provision does not refer to the accounting and/or legal analysis.

A. *Scope of the provision*

The notion of transfer is not defined so any kind of transfer may be targeted, regardless of the legal transaction supporting it. However, the relevant factor in determining whether a

20. An exemption from the tax is provided for small traders, certain professions, certain agricultural and certain publishing entities. See CGI Arts. 1449-1466.
21. However, it may not exceed 3.5% of added value.

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transaction falls within the scope of the provision should be the reason for the transfer. Although vague, a transfer in order to manage the asset in the interest of the enterprise would at first glance imply that the transfer does not take place for consideration and that the enterprise has a true right to the assets or retains control of them.

The concept of transfer to ensure meeting an existing or future obligation implies that the recipient of the assets is bound to fulfil the obligations of the transferor. These two concepts are not exclusive. The law expressly excludes transfers resulting from the performance of insurance contracts (it does not refer to reinsurance).

B. *Assessment*

The income is determined separately, although taxation is not independent. In other words, and contrary to the provisions of CGI Section 209 B, income generated by the management or sale of assets located abroad is included in French taxable income.

C. *Formalities*

The enterprise must file with its regular annual tax return:

- a particular form describing all characteristics of the transferred assets and the assets purchased to replace them, the recipient of the assets and the country or territory where the resident is established; and
- the return including income and gains derived from the management or sale of the assets.

If an enterprise does not fulfil these requirements, the French tax authorities are entitled to assess the enterprise on the basis of a notional profit, plus penalties for late payment and a fine of 40 percent of income tax not paid.

This provision enters into force for the determination of income in respect of financial years opened as from 1 January 1992 for proceeds generated during this financial year or the previous one.

VIII. ENTERPRISE ZONES

Two new enterprise zones have been created in the Valenciennes region (North of France). New corporations which invest in these zones are entitled to a tax credit in the amount of 22 percent of the investments realized during the first three years following their creation.

IFA NEWS

CANADIAN BRANCH

The Canadian Branch Annual Conference will be held 10 May 1993 in Toronto. Topics for discussion include Canada-US current developments and foreign direct investment by Canadians.

HONG KONG BRANCH

The Annual General Meeting will be held 27 September 1993 to discuss the National Reports. The November branch meeting will focus on source rules: experience to date.

KOREA BRANCH

The Korea branch now holds a monthly study meeting to discuss developments in international tax. An annual seminar is also held each December – the seminar is divided into a panel discussion and a presentation by a government official. Seminar papers are published in the Korean language.

US BRANCH

The Boston region hosted an interesting, informative and well attended annual meeting on 4-5 March. The 40 speakers and panellists included acknowledged experts among practitioners and academics. In addition, the Chief of the Joint Committee Staff, Harry Gutman and former International Tax Counsel, Jim Mogle provided valuable comments during the luncheon and technical sessions. The technical session on the first day comprised several panel discussions focusing primarily on recent US developments and issues, including developments relating to outbound transactions, judicial and administrative developments, the new treaties with Mexico and the Netherlands and the Section 482 regulations. The second day took on a more international flavour as speakers from Canada, France, Germany, Mexico, the Netherlands and the United Kingdom took the floor. Among the topics for discussion were the new US–Mexico and US–Netherlands tax treaties, combining operations from countries with classical and integrated tax systems and European income tax developments of interest to US tax advisors. A number of the papers presented during the meeting will be published in an upcoming issue of the *Bulletin*.

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EUROPEAN COMMUNITY:

CORPORATE INCOME TAX HARMONIZATION IN THE NINETIES

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Contents

I. Introduction
II. The Three Milestones
A. The Single European Market
B. The Treaty on European Union
C. The Ruding Report
III. Factors Affecting the Development of Corporate Tax Harmonization in the EC
A. The legal factor
B. The economic factor
C. The political factor
D. The theoretical factor
IV. Which Harmonization?
V. Conclusion

I. INTRODUCTION

The establishment of the Single European Market on 1 January 1993, the conclusion of the Treaty on European Union and the publication of the "Report of the Committee of Independent Experts on Company Taxation" (hereinafter referred to as the Ruding Report), together with the Commission's reaction to that Report are the major events which will influence the development of the harmonization of corporate income tax laws of the EC member states.

This article examines the implications of these events for corporate tax harmonization, identifies the crucial factors linked with these events and which affect the future of corporate tax harmonization in the EC and, finally, considers the future of corporate tax harmonization.

II. THE THREE MILESTONES

A. *The Single European Market*

The internal market, established in the EC from January 1993 requires:
- undistorted flow of capital from one member state to another,
- elimination of obstacles to cross-border transactions,
- adherence to the principle of free competition,
- improvement of economic efficiency, and
- abolition of the laws of the member states that discriminate against EC physical or legal persons.

The disparities in the corporate tax laws of the 12 countries do not meet these requirements.[1]

More specifically, the differences between the 12 corporate tax laws influence the flow of investment, impede cross-border operations, affect the competitiveness of competing companies (since the corporate tax component cost of capital differs among member states resulting in a different tax burden), undermine economic efficiency by contributing to waste and misallocation of resources and in certain cases have a discriminatory effect (unrelieved advance corporate tax or précompte, imputation credits not offered to non-residents). Given that other non-tax obstacles which influence cross-border operations are being removed, "...differences between member states' tax rules may well assume a greater importance in influencing transborder investment and merger decisions and the allocation of resources within the Community".[2]

Failure to eliminate these distortions will undermine the single market, thus creating a pseudo-single market replete with tax-induced distortions. Hence, having identified the existence of disparities between the 12 corporate tax laws as the cause of such distortions, the solution lies in the abolition of the disparities through harmonization of the 12 laws.

B. *The Treaty on European Union*

The Treaty on European Union (concluded in Maastricht) which is facing problems with its ratification in two member states (Denmark, United Kingdom) contains certain provisions that may have implications for corporate taxation in the EC. Assuming that the Treaty will finally become a part of EC law[3] it is worth outlining those

1. See Ruding Report, Chapters 2, 4, 5 and 6.
2. Ruding Report, at 29.
3. The commitment of the ten member states to the Treaty and their determination to adhere to it may lead to a division within the EC if the two "dissident" member states do not solve their problems.

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provisions which are likely to affect the developments in corporate taxation towards the harmonization process.

First, Article G(5) of the Treaty[4] which establishes the principle of subsidiarity implies that any future legislative intervention on the part of the EC in the field of corporate taxation should be restricted to cases where there is a real and absolute need for centrally imposed legislative measures. Such measures should deal with those elements of corporate taxation which, because they affect the achievement of the real single market and therefore transcend the frontiers of the member states, can be dealt with more effectively by the EC than by the member states acting separately. What remains to be considered and what will cause controversy is the decision on what can be left to member states.

Second, introduction of the principle of fiscal discipline by Article G(25) of the Treaty[5] will have repercussions on national corporate tax policies. As a result, the governments of member states will rely more on taxes than borrowing if they want to finance their spending programmes, and therefore revenues from corporate taxation will become more important, particularly for states which already rely heavily on corporate tax revenues.[6]

Third, the centralization of monetary policy through the establishment of the European Central Bank and the adoption of a single currency from 1 January 1997 or 1 January 1999 will have a spill-over effect on tax policy, since the former is strongly linked with the latter.[7] In view of this, the monetary convergence of the 12 cannot tolerate their present fiscal divergence. Any movement towards a monetary union pursuant to the provisions of the Treaty cannot succeed without a parallel movement towards fiscal union which implies the assimilation of different tax regimes, including corporate income taxation.

C. *The Ruding Report*

The Ruding Report is expected to become the starting point for a debate on corporate taxation in the EC. Although one may question some of the specific recommendations included in the last Chapter of the Report (e.g. the necessity for centrally imposed bands of statutory corporate income tax rates) the Report contains some very important points.

First, it notes that the importance of the corporate tax factor in investment-making within the EC is gradually growing as other "barriers to the location of investment are dismantled".[8] Second, the Report concludes that some of the differences between corporate income tax laws cause distortions to the functioning of the internal market.[9] Third, it indicates that "it is unlikely that such differences will be reduced much further through independent action by Member States".[10] Finally, the Report recommends that action be taken at the Community level and that such action should strive to remove tax obstacles to cross-border operations, that common rules for a minimum tax base be introduced and maximum transparency *vis-à-vis* tax incentives be achieved.[11]

Despite the significance of the findings and conclusions of the Report the EC Commission has shown reluctance towards the full implementation of the Report's recommendations. The Commission's comments on the Report in Sections 48 and 49 of the Communication, the lack of a timetable for action and the implied absence of a long-term objective raise serious doubts about the Commission's strategy on corporate tax harmonization.

III. FACTORS AFFECTING THE DEVELOPMENT OF CORPORATE TAX HARMONIZATION IN THE EC

A. *The legal factor*

The first factor that will affect any future development in corporate taxation is the legal framework within which such development has to take place. This legal framework is formulated by the EC Treaty, in particular by Articles 3b,[12] 100[13] and 220. Given that the latter is of restricted importance (it can be used as the legal basis for coordination measures, especially tax conventions), the focus is on Article 100.

Article 100 plays a pivotal role in corporate tax harmonization, since it constitutes the legal basis for the adoption of centrally imposed measures. Consequently, application of Article 100 to corporate tax harmonization means that: (1) the object of harmonization can be laws, regulations or administrative provisions concerning corporate taxation, (2) the harmonization of rules concerning corporate taxation must be essential for the establishment or the proper functioning of the common market, (3) the instrument by which harmonization is carried out is the directive,[14] (4) corporate tax directives are proposed by the Commission, and after the consultation with the European Parliament and the ECOSOC, the Council of Ministers may adopt them acting unanimously.

Two fundamental problems with Article 100 are that it requires that the provisions under harmonization must "directly affect" the establishment or the proper functioning

4. It will be inserted in the Treaty of Rome as Art. 3b.
5. Especially by the new Art. 104c of the Treaty of Rome and by the Protocol on the Excessive Deficit Procedure.
6. See Ruding Report, Tables 8.2 and 8.3, at 170-171.
7. See the analysis by P. Werner, "Report to the Council and the Commission on the Realization by Stages of Economic and Monetary Union in the Community", *Bulletin of the EC*, Supplement 3/1970; also the Council's Resolution of 22 March 1971 adopting the Werner Report (1971 OJ, C28) and P. Isard, "Corporate Tax Harmonization and European Monetary Integration", 41 *Working Document of the Centre for European Policy Studies* (1990).
8. Ruding Report, at 29.
9. See Ruding Report, Chapters 2, 3, 4, 5 and 6.
10. Ruding Report, at 201-202; see also Chapter 7.
11. Ruding Report, at 202.
12. The "subsidiarity clause" inserted by Art. G(5) of the Treaty on European Union; see *supra* note 4.
13. As amended by Art. G(21) of the Treaty on European Union.
14. Conventions under Art. 220 and Regulations in exceptional cases under Art. 235 are the other options.

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of the common market, and it requires unanimity. The first problem can be overcome if it is accepted that the requirement does not mean "of a certain causality, but a certain intensity of effect".[15] The second problem cannot be overcome as the EC Treaty remains in effect, and it is very difficult to achieve the required unanimity given the various interests of member states.

Thus if a proposed measure is outside the legal framework as defined by the EC Treaty the chances for its adoption and implementation would be practically nil. It would be fundamentally wrong to adhere to a solution which might be perfect from a theoretical perspective but which could not be put into effect because it is incompatible with existing EC legal regime. This by no means should be interpreted as an argument in favour of the retention of the EC Treaty in its present form.

Conversely, if the existing legal framework has drawbacks they should be identified and the need for an amendment in the future should not be disregarded. However, it should be noted that amendments to the EC Treaty are not easily agreed upon and agreement in any case requires protracted negotiations. Given the fact that the Treaty was recently amended and that the problem of corporate taxation in the EC requires an immediate solution, the existing legal framework must be used to resolve the issues.

B. *The economic factor*

The future of EC corporate tax harmonization inevitably depends on economic developments and in particular on the progress of economic integration. The validity of this view has been historically proved since the 1969 proposed corporate tax directives were tabled before the Council when the Community had just achieved the stage of Customs Union (1 July 1968), even though the proposed measures corresponded to the needs of a single market. Thus, when the EC embarked on the establishment of that market the need for those measures became obvious and imminent leading to their adoption (July 1990).

Furthermore, the Ruding Committee, recognizing the close links between its proposed corporate tax measures and the process of economic and monetary union (as the latter was decided at Maastricht), allocated those measures to three phases which coincide with the three stages of economic and monetary union.[16] However, the possible adoption of a single currency is inconceivable as the experience of federal states has shown, but such a centralization of economic and monetary policy will have to be supplemented by similar developments in tax policy because of the interdependence between economic-monetary policy and tax policy.[17] Additionally, such a centralization of economic and monetary policy will hardly be legitimized without resolving the democratic deficit problem that is apparent in the EC.

C. *The political factor*

As has been suggested,[18] the links between economic and political developments and particularly between economic and political integration are exceptionally strong. The political evolution of the EC is, and will be, influenced by the way in which economic and monetary union progresses. If the latter reaches an advanced stage,[19] the demand for closing the democratic deficit and achieving a greater degree of democratic accountability may lead to a political structure very similar to the federal one, or at least may force the Community to confront certain issues (such as legitimization of non-accountable or indirectly accountable institutions to make decisions) which it has thus far skilfully avoided.

Whatever measures are selected to deal with the problem of EC corporate taxation must be in accordance with political developments or they will not have any effect, and the measures must also be politically acceptable by the member states in order to be put into effect.

D. *The theoretical factor*

The environment in which corporate tax harmonization will develop in the 1990s dictates the theoretical principles by which any harmonization measures should abide in the future. In fact some of these principles can be included in the factors discussed above[20] but their importance as a whole justifies a separate reference.

The first principle which was discussed above is subsidiarity. The second is tax neutrality which encompasses five conditions:

(1) the decision as to the location of an investment must not be influenced by corporate tax laws (locational neutrality);
(2) the legal form of the enterprise must not be influenced by corporate tax law provisions which favour certain types of enterprises;[21]
(3) corporate tax law provisions must not treat direct investment more favourably than indirect investment (neutrality with respect to the type of investment);
(4) corporate taxation must not affect the means of financing[22] of an enterprise by giving preferences (neutrality toward the financing of investments);
(5) there must be not be discrimination between foreign or domestic investment made by a resident of a state or discrimination between domestic investment made by a resident or a non-resident (international neutrality).

Total tax neutrality exists when all of the above conditions are fulfilled – corporate tax harmonization must achieve as

15. C.D. Ehlermann, Lecture given in Edinburgh University on 18 November 1977, and published as Appendix 3(b) to the 22nd Report of the House of Lords Committee on the European Communities.
16. Ruding Report, at 13.
17. Provided that the single currency era will become reality, since there are still serious doubts.
18. See D. Wyatt-A. Dashwood, *The Substantive Law of the EEC*, 2d ed., (London, 1988), at 13.
19. For example, a centralized planning of monetary and fiscal policy.
20. For example, economic efficiency is included in the economic factor, political acceptability in the political factor.
21. E.g. the corporate tax law of a country may favour public companies over limited partnerships.
22. Equity financing, debt financing, retention and reinvestment of profits.

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much neutrality as possible. If some but not all of the conditions for tax neutrality are met in a particular case partial tax neutrality is achieved.

The third principle is economic efficiency which denotes the most productive use of resources at the lowest possible cost. This is one of the most important criteria used to determine whether the resources of a country are used in such a way to guarantee steady and constant economic development. Application of this principle to investments made by companies can determine whether or not a project is economically efficient. An investment is regarded as economically efficient if the following requirements are met:

(1) the investment is made by a company which is most qualified to carry out the project;
(2) the investment is made in an area which has the resources necessary to carry out the project;[23] and
(3) there are no other factors which can influence the economic climate.[24]

The fourth principle is that of equity which extends beyond its classical form (horizontal-vertical equity) to include the multinational aspect resulting from the establishment of the internal market. Thus two new forms of equity should be accepted, i.e. inter-individual equity which concerns EC nationals (including companies) and calls for equitable treatment among individuals who receive income exposed to several tax jurisdictions, and international or inter-jurisdictional equity. The latter suggests a fair distribution of corporate taxes between the member state in which a company resides and the member states in which a part or the entire taxable income of the company accrues. It is worth noting that the principle in question is linked with the classical dispute between the country of residence and the country of source about the right to tax. The latter is given the chance to tax profits first, whereas the former has the privilege of determining a company's final tax liability.

The fifth principle is flexibility which denotes that the corporate tax structure which emerges from the harmonization of national tax laws should be adaptable to the economic, political and legal developments taking place within the EC and to the corporate tax trends of a specific time.

The next principle, certainty, is one of the most important principles to which every efficient tax structure adheres. Certainty requires that a tax system not be subject to continuous and consecutive changes and not raise doubts in the taxpayers minds as to whether or not a tax law is enforceable. Thus the scope and content of tax rules should be clear and any ineffective or outdated provisions or other problems should be identified by studying the performance of a tax system over a period of time and dealt with by appropriate tax reform. This by no means excludes "on the spot reactions" to serious problems which are likely to threaten the functioning of a tax system, causing a loss of revenue.[25]

Finally, corporate tax harmonization should adhere to the principles of administrative feasibility and political acceptability, and must always have an anti-avoidance and anti-evasion orientation.

IV. WHICH HARMONIZATION?

Before mentioning the type of corporate tax harmonization the EC needs it is worth outlining the reasons for which this article rejects the other two instruments of fiscal integration, namely (corporate) tax unification and (corporate) tax coordination.

Corporate tax unification can certainly provide a solution to the corporate tax dilemma in the EC through the imposition of uniform rules. Consequently, in a hypothetical case where the disparities between the national corporate tax laws cause a distortion to the single market these disparities can be eliminated by the adoption of a single rule via a regulation. However, this method, if extensively applied, may lead to a situation where every aspect of corporate taxation would be regulated by uniform rules adopted at the EC level and nothing would be left to the competence of the individual member states. Such a centralized corporate tax model is nothing more than a single European corporate tax law.

The first reason for rejecting corporate tax unification is that although it satisfies most of the above principles it is not consistent with the legal framework, i.e. the EC Treaty. The EC Treaty permits the harmonization of corporate tax laws through Article 100[26] and directives, whereas regulations, which are the instruments for unification, are allowed in exceptional cases under Article 235. Thus unification measures in the field of corporate taxation are the exception not the rule under the present form of the EC Treaty.

Secondly, corporate tax unification does not correspond to the present economic situation of the EC (economic factor). Conversely, it presupposes a centralized economic structure according to which major economic policy decisions are taken at a central level and there is no room for diversities and variations. As a result, this need for uniformity dictates the use of unification measures. It must be emphasized, however, that the EC has not reached such stage and it is not absolutely certain that it will. If the EC does achieve this advanced stage of economic integration, tax unification measures may prove to be necessary, although any comment about corporate taxation during that stage seems very risky and highly speculative for the time being.

Thirdly, there is no compatibility between corporate tax unification and the current political structure of the EC (political factor). The uniformity and centralization that characterize tax unification cannot be politically acceptable by the member states and cannot be justified insofar as the "democratic deficit"[27] in the most powerful institutions as regards decision-making remains so great. In modern democratic states

23. There are cases of deliberate deviations from this rule, for example, for reasons of regional policy.
24. For example, taxation, political circumstances bureaucracy, lack of infrastructure, etc.
25. For example, when a government amends tax provisions aiming at closing loopholes or clarifying those provisions.
26. The exact wording of the article refers to the approximation but this word has the same meaning as harmonization.
27. A term used in EC documents and EC law to denote the gap between the power an institution has in respect of decision-making and the accountability of that institution to the people.

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decisions (concerning direct taxation in particular) are taken by the democratically elected national parliament, whereas in a hypothetical corporate tax unification process decisions on corporate taxation will be taken by the Council of Ministers, an institution not directly accountable to Europeans in contrast to the European Parliament.

Finally, due to the transfer of competence from the national level to the Community (supranational) level, tax unification implies that recourse to it should not be sought unless the use of harmonization measures is considered to be inadequate. Thus far what has been called into question is not the adequacy of corporate tax harmonization measures but the necessity for the adoption of such measures. Taking into account that corporate tax harmonization induces controversy over its applicability one can easily conclude that the applicability of corporate tax unification will give rise to more controversy.

Turning to the second instrument of fiscal integration (tax coordination) and applying it to corporate taxation in the EC the comment can be made that corporate tax coordination falls short of the needs of the EC. First, it lacks the binding effect[28] of the other two instruments (unification-harmonization) of fiscal integration, and it corresponds to looser political and economic circumstances than those currently existing in the EC.

Secondly, corporate tax coordination cannot meet the needs of the theoretical factor mentioned above. This is attributed to the function of coordination which aims at securing the concerted coexistence of corporate tax laws of different states in cases where there is ground for conflict[29] or there is a need for combined legal action.[30] What becomes obvious is that corporate tax coordination has little or no contribution to the assimilation of the corporate tax laws of the member states which is fundamental for the elimination of the disparities existing between these laws and the proper functioning of the common market.

Taking into consideration that corporate tax coordination is too little for the problem caused by the different corporate tax laws of the member states and that corporate tax unification is too much the only solution remaining is corporate tax harmonization. But what kind of harmonization?

First, the process of harmonization should be a "horizontal harmonization" in the sense that it should bring national corporate tax laws into alignment with a view to adapting them to the needs of the common market. Further, it is obvious that since there is no special provision in the EC Treaty for corporate tax harmonization there is no case for "vertical corporate tax harmonization".

Secondly, the lack of a special provision for corporate taxation or for direct taxation in the EC Treaty means that corporate tax harmonization can only be positive.[31] Consequently, it must include all measures which are taken according to the EC Treaty and which harmonize national corporate tax laws with the purpose of facilitating the establishment and proper functioning of the common market.

Thirdly, corporate tax harmonization in the EC should not be "single-phased" but should be carried out in more than one stage (gradual harmonization). This approach is also favoured by the Ruding Committee which recommended the adaptation of the corporate harmonization process to the three stages of economic and monetary union.

Fourthly, "total harmonization" of corporate taxation should be avoided in light of the principle of subsidiarity. The consequence of the application of this principle to corporate taxation is that the EC is entitled to take harmonization measures with regard to corporate tax issues when dealing with these issues at the national level is deemed inadequate or ineffective. Thus, the proposed harmonization must be "partial harmonization" and oriented towards those aspects of corporate taxation which pose problems to the establishment or functioning of the common market.

Finally, the most important choice that has to be made in relation to the form of the proposed corporate tax harmonization is whether the harmonization process should be imposed by the EC or led by the market.[32] The solution lies in the middle and can be named the "hybrid solution" which would opt for minimum imposed harmonization. As a result, harmonization measures taken at the Community level should target the disparities between the 12 corporate tax laws which constitute tax obstacles to cross-border operations[33] and should produce common rules for a minimum tax base (elaborating the 1988 Preliminary Draft Proposal for a Directive on the Harmonization of Rules Determining the Taxable Profits of Undertakings). The harmonization of statutory corporate tax rates should be left to market forces and intense consideration should be given to a possible need for a change from separate accounting to formula apportionment due to an expected increase in multijurisdictional activities, and to a possible need for a common system of integration of corporate with personal income taxation.

V. CONCLUSION

The fact that it took 21 years for some corporate tax harmonization measures to be adopted[34] and that three proposed directives which are of vital importance for the proper functioning of the single market have been on ECOFIN's agenda for one and a half years[35] casts doubt on the prospects of cor-

28. For example, the Arbitration Convention is not so binding compared to the two adopted corporate tax Directives.
29. E.g. between the law of the source state and that of the residence state.
30. Cooperation against tax evasion, etc.
31. "Negative harmonization" presupposes the existence of "standstill-clauses" in the Treaty with which national laws comply.
32. "Imposed" or "top-down" approach in contrast to "competitive" or "market-led" or "bottom-up" approach.
33. See Ruding Report, at 203-206. Such an approach includes intra-Community tax treaty network as well as an attempt to assimilate the content of the tax treaties EC countries have with non-EC countries so as to avoid the creation of tax havens within the EC for non-EC companies.
34. The mergers directive, the parent-subsidiary directive and the arbitration convention were adopted in 1990.
35. The proposed directive on interest and royalty payments, the proposed directive on the offsetting of losses and that on the carryover losses (the latter was proposed in 1984 for the first time and was relaunched as a supplement to the proposed directive on the offsetting of losses).

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porate tax harmonization. The "principle of an open market economy with free competition" that was inserted in the EC Treaty (Article 3a) by Article G(4) of the Treaty on European Union will suffer serious tax distortions unless appropriate measures are taken in time. Furthermore, the close interrelation between corporate tax harmonization and the economic and political developments in the EC means that the pace of the latter will be reflected in the former. As a result, if the provisions of the Treaty on European Union are implemented and the EC moves towards an economic and monetary union within a truly single market the need and the pressure for corporate tax harmonization measures will be great. Conversely, if the process of economic and monetary union reaches a deadlock the future of corporate tax harmonization will be bleak.

CUMULATIVE INDEX – 1993 Nos. 1-3

I. ARTICLES

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Hong Kong:
Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

John Prebble:
100 Years of Income Tax 59

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

United States:
Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

United States/Netherlands:
Wim Wijnen
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96

IV. CONFERENCE DIARY 39, 149

V. BIBLIOGRAPHY

- Books 49, 100, 150
- Loose-leaf services 51, 103, 154
- List of addresses of the major publishing houses appearing in the Bibliography 53
- Conference Diary 149

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BIBLIOGRAPHY

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 53-56 of the January 1993 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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INVESTMENT IN SIERRA LEONE.
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SANDFORD, Cedric; HASSELDINE, John.
The compliance costs of business taxes in New Zealand.
Wellington, The Institute of Policy Studies. 1992, pp. 159.
The objective of this study is to measure the compliance costs of the principal business taxes imposed by the central government. Business taxes comprise PAYE (including other withholding taxes), fringe benefit tax, goods and services tax and income tax on sole proprietors, partnerships, companies and trusts.
(B. 57.810)

EUROPE

HOLDING COMPANIES IN EUROPE.
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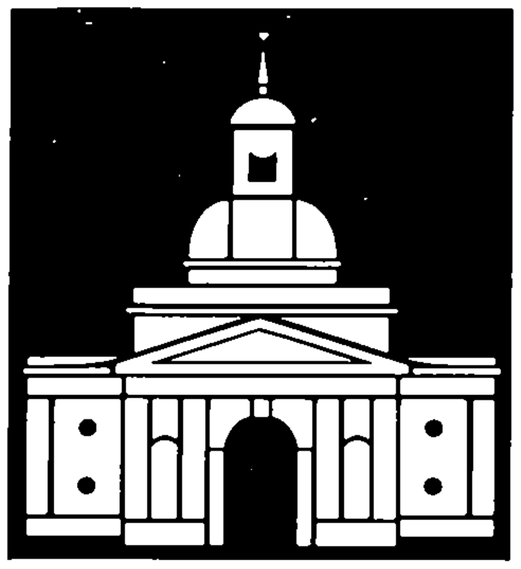
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CONTENTS

VOL. 47 NO. 5 **MAY 1993**

INTERNATIONAL: US TAX CONSIDERATIONS IN INTERNATIONAL DERIVATIVE PRODUCTS — 235 — *Stanley C. Ruchelman*

Mr. Ruchelman looks at the tax rules currently applicable to innovative derivative products in the international financial markets. The focus begins on notional principal contracts, mark-to-market election and currency gains and losses. Other provisions are also covered, including the treatment of currency gains and losses in currency swap transactions and synthetic currency instruments created by the combination of loans and hedges. Finally, other international tax issues are addressed, such as the treatment of cross-border securities lenders, transfer pricing for investment banks and tax planning for foreign-based groups that may wish to manage funds in the United States.

CANADA: THE PROPOSED NEW SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT RULES – AN UPDATE ON RESEARCH INCENTIVES — 255 — *Ingrid Sapona*

Recent draft legislation and regulations aim to make the tax incentives applying to scientific research and experimental development (SR & ED) less restrictive. The changes expand and clarify the tax incentives available for SR & ED, and make it easier for some taxpayers to claim an investment tax credit.

PEOPLE'S REPUBLIC OF CHINA: THE NEW LAW ON TAX ADMINISTRATION — 263 — *Jinyan Li*

The Law on the Administration of Tax Collection ("ATC Law") came into effect as from 1 January 1993. The ATC Law applies to individuals, Chinese enterprises, foreign-invested enterprises and enterprises doing business in China. Its provisions include rules for general tax administration, tax collections, tax auditing and penalties for non-compliance.

SINGAPORE: 1993 BUDGET: REWARDS FOR GOING ABROAD AND REBATES FOR GST AT HOME — 278 — *Lee Fook Hong*

The tax changes announced in the 1993 budget are designed to promote overseas investment and encourage the repatriation of foreign earnings. More dependence, however, will be placed on broad-based indirect taxes with the proposed introduction of the GST in 1994.

HONG KONG: BUDGET 1993/94: HONG KONG CONTINUES TO ACHIEVE REMARKABLE GROWTH — 283 — *Ian W. Harris*

The primary aim of the new budget is to maintain fiscal prudence while reducing the tax burden as far as possible for the largest number of tax-paying households. The result: changes to the salaries tax estate duty and stamp duty. Additionally, the Financial Secretary announced two measures to improve the tax system, i.e. introduction of a composite tax return and a perceived anti-avoidance proposal in respect of the taxation of royalties.

JAPAN:
TAX HAVEN AND FOREIGN TAX CREDIT RULES: 1992 AMENDMENTS AND THEIR IMPACT ON DUTCH HOLDING COMPANIES — 286 *Ebel Magnin and Eero Rautalahti*

Japan tightened its tax haven legislation in 1992, causing considerable difficulties in tax planning for Japanese multinationals. At the same time, the complex Japanese system of foreign tax credits was amended to allow credit for taxes paid by second-tier affiliates. This article summarizes the current legislation and analyses three scenarios designed to enable Japanese multinationals to continue using Dutch holding vehicles and at the same time to utilize the second-tier indirect foreign tax credit.

INDIA:
1993/94 BUDGET — 294 *G.K. Kawatra*

This article summarizes the most important measures relating to direct taxes as they affect foreigners.

IFA NEWS 254

BIBLIOGRAPHY 297
- Books 297
- Loose-leaf services 302

CONFERENCE DIARY 285

CUMULATIVE INDEX 304

WHAT'S NEW FROM IBFD?

A Guide to the European VAT Directives:

Commentary on the Value Added Tax of the European Community

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INTERNATIONAL:

US TAX CONSIDERATIONS IN INTERNATIONAL DERIVATIVE PRODUCTS

Stanley C. Ruchelman

Contents

I. Introduction

II. Notional Principal Contracts
- A. Definition
- B. Payments
  1. Periodic payments
  2. Unfixed amount at year-end
  3. Non-periodic payments
  4. Termination payments
- C. In terrorem rule for swaps
- D. In terrorem rule for caps and floors
- E. Anti-abuse rules

III. Mark-To-Market Election
- A. Conditions for election
- B. Effective date

IV. Coordination with Other Provisions
- A. Straddle rules
  1. Straddle definitions
  2. Loss deferral
  3. Effect on notional principal contracts
- B. Foreign currency gains and losses
  1. Background
  2. Application of Section 988 to a notional principal contract
  3. Forward and futures contracts and non-equity options
  4. Dual currency debt instruments
  5. Currency swaps
  6. Off-market currency swaps
- C. Foreign currency hedges – Section 988(d)
  1. Tax treatment of hedged transaction
  2. Qualifying debt instrument
  3. Hedge
  4. Integrated economic unit
  5. Legging in and out
- D. Source of income
  1. Notional principal contracts
  2. Currency swaps
  3. Interest on deemed loans
  4. Withholding tax on deemed interest
  5. Effectively connected income
- E. Allocation and apportionment of expense
  1. Background
  2. Integration with interest
  3. Interest on deemed loans

V. Cross-Border Securities Lending
- A. Treatment of lender
- B. Cross-border substitute payments
- C. Proposed regulations

VI. Advance Pricing Agreement
- A. Potential double taxation
- B. Advance pricing agreements

VII. US Tax Planning for the Foreign-Based Group
- A. Fixed and determinable income
- B. Effectively connected income
- C. Principal office
- D. Interest rate swaps

VIII. Conclusion

I. INTRODUCTION

A basic tenet of US tax law is that the tax consequences arising from a transaction are controlled by that transaction's economic substance, not its form. While not codified, this general principle has been part of the tax law for virtually one-half century.[1] At its heart is the recognition that the economic substance of a transaction must be the controlling factor in determining a person's tax.

Economic substance is a difficult concept to define, especially where the facts are complex, the transaction is on the cutting edge, and no clear answer is apparent. In these circumstances, courts have resolved the controversy by establishing a reference point from which the transaction may be examined.[2] Under this approach, the economic circumstances of a taxpayer prior to entering a transaction must be compared with the circumstances that exist after all steps of the transaction are completed. The difference in economic position is explained by reference to transactions that are relatively straightforward or which have been seen before. In essence, the tax effect of the old and new transactions should not be dissimilar if their only significant difference is form.[3]

Those who develop derivative products – including all forms of notional principal contracts, swaps, collars, floors, caps, swap options, options, short sales, wash sales, hedges, forward contracts, futures contracts and others – share a goal to stretch the boundaries of the financial products industries. They are constantly looking forward. Unfortunately, those who tax plan, account for or examine the tax ramifications of those products continue to look backward at products that already exist. For them, the proper tax results are couched in history.

Mr Ruchelman is an attorney whose practice is based in New York City. He advises clients on the tax effect of cross-border transactions Mr Ruchelman lectures on the subject of international taxation and has co-authored numerous journal articles addressed to this subject. He received a B.A. Degree from Brooklyn College (1968) and a J.D. Degree from George Washington University (1972).

This article is based on a paper delivered at a conference entitled: "Innovative Derivative Products in International Financial Markets", held in New York, 15-16 October 1992, and sponsored by the American Conference Institute.

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3. *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938).

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This article will explain the tax rules that are currently applicable to innovative derivative products in the international financial markets. The article will focus initially on notional principal contracts, mark-to-market election that is available to dealers and traders, and currency gains and losses. It will cover other provisions including the treatment of currency gains and losses in currency swap transactions and synthetic currency instruments created by the combination of loans and hedges. Finally, it will address other international tax issues such as the treatment of cross-border securities lenders, transfer pricing for investment banks and tax planning for foreign-based groups that may wish to manage funds in the United States.

II. NOTIONAL PRINCIPAL CONTRACTS

Proposed regulations have been issued by the IRS addressed to the taxation of notional principal contracts.[4] The purpose of the proposal is to provide a method of accounting that will clearly reflect income for both parties so that the results of a notional principal contract reported in the income tax returns of each will reflect the economic substance of the contract as understood by the IRS.[5] In this regard, the proposed regulations principally address the time for recognizing income and expense. Certain notional principal contracts are viewed to result in a distortion of income flows, and if allowed, enable a taxpayer to level its taxable income through the manufacture of deductions or to capture the benefit of expiring credits and deductions through the acceleration of income. In each instance, the economic effect of the immediate recognition of income or expense can be reversed over time. This is illustrated in the following example, where the role of the swap intermediary is ignored.

> On 1 January 1992, Corporation G enters into an interest rate swap agreement with an unrelated counterparty, Corporation H, under which, for a term of five years, Corporation G is obligated to make annual payments at 11 percent and Corporation H is obligated to make annual payments at LIBOR on a notional principal amount of $ 100 million. At the time Corporation G and Corporation H enter into this swap agreement, the rate for similar on-market swaps matches LIBOR with a fixed rate of 10 percent. To compensate for this difference, on 1 January 1992 Corporation H pays Corporation G a premium (referred to in the proposed regulations as a yield adjustment fee) of $ 3,695,897. The amount of the yield adjustment fee was determined as the present value, at 11 percent compounded annually, of five annual payments of $ 1,000,000 (1% rate differential x $ 100,000,000).[6]

This example illustrates that Corporation G can be viewed to recognize income immediately if that were needed to avoid the loss of a deduction or a credit. At the same time, Corporation H made a payment that, in the absence of other rules, would seem to reduce income immediately. By addressing the timing issues, the regulations attempt to limit the distortions of income and loss recognition. In this way, an attempt is made to give economic substance to the contemplated series of payments.

The proposed regulations will first be effective officially when published in final form. Nonetheless, they reflect the views of the IRS and have been followed by prudent investors and swap dealers.

A. *Definition*

The proposed regulations provide that a notional principal contract is a financial instrument that calls for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[7] Notional principal contracts include interest rate swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, total return swaps, equity index swaps and similar agreements. Where a master agreement to enter into a series of swap agreements exists, each confirmation is treated as a separate notional principal contract.

With one major exception, a contract described in Internal Revenue Code (IRC) Section 1256(b) is not a notional principal contract.[8] Although not in the proposed regulations, a notional principal contract that is traded on a board of trade such as the Chicago Board of Trade is likely both a notional principal contract and a Section 1256(b) contract. This may have attractive results for a foreign-based group.

A contract under which neither party's obligations are determined by reference to a variable specified index is not a notional principal contract.[9] The term "specified index" refers to any one or more of the following:

- a single fixed interest rate, price or amount;
- an interest rate that is made known publicly and offered currently to unrelated borrowers in private lending transactions by a financial institution;
- an interest rate that reflects an average (based on a statistically significant sample) of current yields on a class of publicly-traded debt instruments;
- a price or index of prices of publicly-traded stock, securities, commodities or other publicly-traded property;
- an amount or index of amounts that reflects the total return on one or more publicly-traded stocks or securities;
- an interest rate, price, index or amount that is more or less than a specified index by a constant number of percentage or basis points, dollars or other units in which the specified index is measured;
- an interest rate, price, index or amount that is expressed as a fixed multiple of a specified index;
- any other interest rate, price, index or amount that is designated by the IRS; and
- an amount that is arrived at through any average or combination of the above.

An option or forward contract that entitles or obligates a person to enter into, extend, cancel or change the terms of a notional principal contract is not, itself, a notional principal

4. Proposed Reg. §§1.446-3 and 1.446-4.
5. Proposed Reg. §1.446-3(b).
6. Proposed §1.446-3(e)(3)(iii), *Example 5*.
7. Proposed Reg. §1.44603(c)(1)(i).
8. A Sec. 1256 contract is defined in the IRC to mean any regulated futures contract, any foreign currency contract, any non-equity option and any dealer equity option. Gains on these contracts are reported as 60% long-term and 40% short-term and losses are subject to the loss deferral rule of IRC Sec. 1092(b) where offsetting positions are maintained in property.
9. Proposed Reg. §1.446-3(c)(1)(ii).

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contract. However, payments made under such an option or forward contract may be characterized as a non-periodic payment if the option or forward contract is exercised. Non-periodic payments are discussed below.

B. *Payments*

As previously mentioned, the proposed regulations address the timing of income and expenses for periodic and non-periodic payments. The relevant net income (or net deduction) from a notional principal contract for a taxable year must be included in or deducted from gross income for that taxable year. For this purpose, the relevant net income (or deduction) is the total of all of the periodic and non-periodic payments that are recognized from that contract for the taxable year. Rules, discussed more fully below, control the period in which recognition of these payments occurs. Neither the making of a payment currently nor the accrual of an obligation to make a series of future payments will result automatically in revenue or expense recognition. Prepayments prior to the swap period are generally disregarded. Thus, no portion of a payment by a party is recognized prior to the first year to which any portion of a payment by the counterparty relates. This is illustrated by the following example.

> On 1 November 1991, Corporation F pays an unrelated counterparty, Corporation E, $ 600,000 for a contract which obligates Corporation E to make a payment to Corporation F each quarter beginning 1 January 1992, equal to one-quarter of the excess, if any, of three-month LIBOR over 9 percent with respect to a notional principal amount of $ 25 million. Both Corporation E and Corporation F are calendar year taxpayers.
>
> Because no portion of the premium paid for the cap relates to the period prior to 1 January 1992, neither party can accrue any income or deduction with respect to the cap for the period from 1 November 1991 through 31 December 1991.[10]

1. Periodic payments

Periodic payments are payments made or received pursuant to a notional principal contract that (i) are payable at fixed periodic intervals of one year or less during the entire term of the contract and (ii) are based on a single specified index. Payments made or received pursuant to a notional principal contract do not fail to be periodic payments solely because the interval that precedes the first or last payment under the contract is shorter than, or not more than 90 days longer than, the fixed periodic interval between each of the other payments under the contract. This provision accommodates the regulatory definition with industry practice under which settlement dates are not necessarily coordinated with cash flows. As a result, the initial and final payment period may be longer or shorter than other periods. However, if a particular payment period is more than 90 days longer than others, the payment is not a periodic payment. If it is not a periodic payment, the rules for either non-periodic payments or termination payments apply.

For any taxable year, a taxpayer is required to recognize only the ratable daily portion of a periodic payment which is related to that taxable year. This is illustrated by the following example.

> On 1 April 1992, Corporation A enters into a contract with an unrelated counterparty, Corporation B, under which Corporation A is obligated to make a payment to Corporation B each 1 April for a term of five years beginning 1 April 1993. Each payment is to be in an amount equal to LIBOR determined on the immediately preceding first day of April, multiplied by a notional principal amount of $ 100 million. Under the contract, Corporation B is obligated to make a payment to Corporation A on each of the days in an amount equal to 8 percent multiplied by the same notional principal amount. Corporation A and Corporation B are calendar year taxpayers that use the accrual method of accounting. On 1 April 1992, LIBOR is 7.80 percent.
>
> All of the payments to be made by Corporation A and Corporation B are viewed to be periodic payments because they are each based on a single specified index and are payable at fixed periodic intervals of one year or less throughout the term of the contract. Under the terms of the swap agreement, Corporation B is obligated to make a payment of $ 8,000,000 (8% x $ 100,000,000) to Corporation A and Corporation A is obligated to make a payment of $ 7,800,000 (7.80% x $ 100,000,000) to Corporation B.
>
> The ratable daily portions for 1992 are the amounts of these periodic payments that are attributable to Corporation A and Corporation B's taxable year ending 31 December 1992. In each case under these facts, this portion is 275 days out of a potential 365 days. The ratable daily portion of the 8 percent fixed leg is $ 6,027,397 (275 days ÷ 365 days x $ 8,000,000) and the ratable daily portion of the floating leg is $ 5,876,712 (275 days ÷ 365 days x $ 7,800,000).
>
> The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or $ 150,685 ($ 6,027,397 – $ 5,876,712). Accordingly, Corporation A has net income of $ 150,685 from this swap for 1992, and Corporation B has a corresponding net deduction of the same amount. The unrecognized balance of $ 49,315 ($ 200,000 – $ 150,685) that is made on 1 April 1993, will be included in the net income or net deduction from the notional principal contract reported by Corporations A and B for 1993.[11]

2. Unfixed amount at year-end

If the amount of a periodic payment is not determinable at the end of a taxable year because the value of the specified index is not fixed until a date that occurs after the end of the taxable year, the ratable daily portion of a periodic payment must still be determined. The year-end closes a measuring period for income tax purposes. Allowing unlimited deferral until the amount becomes fixed in a succeeding year would be viewed by the IRS to be an abuse.

The proposed regulations adopt a two-step procedure to determine the ratable daily portion when the amount is not known by year-end. First, the portion that relates to the taxable year which ends in the middle of the accrual period under the notional principal contract is based on the specified index that would have applied if the value were fixed as of the last day of the taxable year. The second step occurs in the following taxable year. Any difference that arises due to a change in the specified index between the last day of the taxable year and the date on which the payment becomes fixed is taken into account as an adjustment to the income or

10. Proposed Reg. §1.446-3(e)(3)(iii), *Example 1(e)*.
11. Proposed Reg. §1.446-3(e)(2)(iii), *Example 1*.

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deduction reported in the succeeding taxable year.[12] This is illustrated by the following example.

> Assume that the facts are the same as in the preceding example, except that Corporation A's obligation to make payments based upon LIBOR is determined by reference to LIBOR on the day each payment is due. LIBOR is 8.25 percent on 31 December 1992, and 8.16 percent on 1 April 1993. Thus, under the contract, the obligation of Corporation A is premised on a payment of 8.16 percent. However, the effect of the transaction for income tax purposes (i.e. for computing the tax liability of Corporations A and B for taxable year 1992) must be determined as of 31 December 1992, when the amount of the payment is not yet known.
>
> The two-step procedure must be followed in computing the 1992 and 1993 tax returns. For income tax purposes, the ratable daily portion of the periodic payment from Corporation A to Corporation B will be based initially on the value of LIBOR on 31 December 1992. Thus, in the first step, the ratable daily portion of the floating leg is $ 6,215,753 (275 days ÷ 365 days x 8.25% x $ 100,000,000) while the ratable daily portion of the fixed leg is $ 6,027,397 (275 days ÷ 365 days x $ 8,000,000). The net amount for 1992 on this swap is $ 188,356 ($ 6,215,753 – $ 6,027,397). Accordingly, for 1992, Corporation B reports $ 188,356 of net income from the swap in 1992, and Corporation A reports a net deduction of $ 188,356.
>
> However, the actual net payment that is made by Corporation A in 1993 is based on an index that is different from the index used to compute tax for 1992. The actual net payment to Corporation B is $ 160,000 ($ 8,160,000, on the floating leg, – $ 8,000,000, payment on the fixed leg). For purposes of determining net income or deduction from this contract for the year ended 31 December 1993, Corporation B and Corporation A must include an adjustment to correct the net income and deduction recognized in 1992. This is the second step. In this instance, the adjustment is $ 67,808 (275 days ÷ 365 days x ($ 8,250,000 presumed payment on the floating leg – $ 8,160,000 actual payment on the floating leg) and is accounted for as net income by Corporation A and as net deduction by Corporation B.
>
> The net periodic payment recognized for 1993 is $ 39,452 (90 days ÷ 365 days x $ 160,000). Hence, for 1993, Corporation A reports net income of $ 28,356, reflecting the ratable portion of its periodic payment (a deduction of $ 39,452) and the adjustment for 1992 (income of $ 67,808). In a similar way, for 1993, Corporation B reports a net deduction of an equivalent amount ($ 28,356). This is comprised of the ratable portion of its receipt of a periodic payment (income of $ 39,452) and the adjustment for 1992 (a deduction of $ 67,808).[13]

3. Non-periodic payments

A non-periodic payment is any payment made or received pursuant to a notional principal contract that is not a periodic payment or a termination payment.[14] Examples of non-periodic payments are the premium for a cap or floor agreement (even if it is paid in instalments), the yield adjustment fee (or premium) for an off-market interest rate swap agreement, and as previously mentioned, the premium for an option to enter into a swap which is treated as a non-periodic payment only if and when the option is exercised. If a non-periodic payment takes the form of instalment payments of an amount determined at the settlement of the notional principal contract, the instalments must be divided between the discounted current value of the premium and the additional amounts that relate to the right to make the non-periodic payment in instalments.[15]

A non-periodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.[16] For any taxable year, a taxpayer is required to recognize only the ratable daily portion of a non-periodic payment which is related to that taxable year. The amount recognized is included in or deducted from the taxpayer's gross income.

The timing of income and deductions from the contract depends upon the type of notional principal contract involved and its economic characteristics. The proposed regulations are premised on the assumption that notional principal contracts resemble other financial instruments and the amount of a non-periodic payment made pursuant to the notional principal contract corresponds to the value of those instruments, adjusted to reflect a discount for early payment or a premium for late payment.

(a) *Swaps*

A non-periodic payment that relates to a swap must be recognized over the term of the contract by allocating it in accordance with the values of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the IRS will respect the forward prices, interest rate and compounding method used by the parties to determine the amount of the non-periodic payment, if reasonable. It is understood that the premium for an off-market swap is frequently determined by reference to the present value of a stream of payments equal to the difference between the payments that arise from the off-market terms of the swap and the payments that would have been due under a swap at par. The difference is discounted using the interest rate under the fixed rate leg. This is illustrated in the following example.

> Assume that the terms of a notional principal contract interest rate swap at par calls for a five-year swap of 8 percent interest in return for interest at LIBOR. Corporation A enters into an off-market swap with Dealer B calling for standard five-year terms, but with the swap of 6 percent interest in return for interest computed at LIBOR. If the periodic payments are made on a semi-annual basis, the yield adjustment fee that will be required is $ 1,677,520. That is the present value of a stream of ten semi-annual payments reflecting one-half the difference of the fixed payment interest at par (8 percent) with the fixed payment under the off-market arrangement (6 percent). The need for dividing the difference in half reflects the semi-annual nature of the payment under the income stream. Here, the difference is $ 2.5 million (2% x $ 25 million x 5 years = $ 5 million ÷ 2). The stream of payments is $ 250,000 for each of the ten semi-annual periods and the discount rate is 8 percent, the standard rate at par.

(b) *Alternative for swaps*

As an alternative, a non-periodic payment made or received with respect to an interest rate swap – and only an interest rate swap – may be allocated to each period of the swap contract by assuming that the non-periodic payment represents

12. Proposed Reg. §1.446-3(e)(2)(B).
13. Proposed Reg. §1.446-3(e)(2)(iii), *Example 3*.
14. Proposed Reg. §1.446-3(e)(3)(i).
15. Proposed Reg. §1.446-3(e)(3)(iii), *Example 3*.
16. Proposed Reg. §1.446-3(e)(3)(ii).

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the present or future value, determined under the constant yield to maturity method, of a series of equal payments made throughout the term of the swap contract (the "level payment constant yield to maturity method").[17]

Under this method, an up-front payment may be allocated by dividing each equal payment into two components. These are the principal recovery and time value components. The principal recovery components are treated as periodic payments made on each date that periodic payments are required of the party making the non-periodic payment. If no periodic payments are made by that party, deemed payments are made on each date that the swap contract calls for periodic payments from the other party.

Generally, the calculation must use semi-annual compounding and a discount rate equal to the overpayment rate established under IRC Section 6621(a)(1) on the date the non-periodic payment is fixed. However, if the parties actually use the level payment constant yield to maturity method to determine the amount of the non-periodic payment, the calculation may employ the actual interest rate and compounding method used in that determination. This is illustrated in the following example.

> On 1 January 1992, Corporation G enters into an interest rate swap agreement with an unrelated counterparty, Corporation H, under which, for a term of five years, Corporation G is obligated to make annual payments at 11 percent and
>
> Corporation H is obligated to make annual payments at LIBOR on a notional principal amount of $ 100 million. At the time Corporation G and Corporation H enter into this swap agreement, the rate for similar on-market swaps matches to a fixed rate of 10 percent. To compensate for this difference, on 1 January 1992 Corporation H pays Corporation G a yield adjustment fee in the amount of $ 3,695,897. Corporation G provides Corporation H with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 11 percent compounded annually, of five annual payments of $ 1,000,000 (1% x $ 100,000,000). Corporation G and Corporation H are calendar year taxpayers.
>
> This contract is an interest rate swap and the yield adjustment fee is a non-periodic payment. The method used to allocate that payment is the level payment constant yield to maturity method. Under this method, the yield adjustment fee (premium) may be recognized over the life of the agreement using the discount rate and compounding method adopted by the parties. With annual compounding at 11 percent, the ratable daily portions are:

Year	Level Payment	Time Value Component	Ratable Daily Portion
1992	$ 1 mil.	$ 406,549	$ 593,451
1993	$ 1 mil.	$ 341,269	$ 658,731
1994	$ 1 mil.	$ 268,809	$ 731,191
1995	$ 1 mil.	$ 188,378	$ 811,622
1996	$ 1 mil.	$ 99,098	$ 900,902
Total	$ 5 mil.	$ 1,304,103	$ 3,695,897

> The net of the ratable daily portions of the 11 percent payments by Corporation G, the ratable daily portions of the LIBOR payments by H, and the ratable daily portions of the yield adjustment fee paid by Corporation H equals the annual net income or deduction from the contract for both Corporation G and Corporation H. The time value components are needed to compute the ratable daily portions of the yield adjustment fee paid by Corporation H, but do not otherwise affect the parties' method of accounting for this contract.[18] Since the time value component has neither been paid nor accrued, it is given no further effect for income tax purposes.

(c) *Caps or floors*

If a non-periodic payment relates to a cap or a floor, the payment must be recognized over the term of the agreement by allocating it in accordance with the values of a series of cash-settled option contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Accordingly, straight-line and accelerated amortization methods are not permissible. However, the proposed regulations emphasize the importance of the Black-Scholes[19] method of option pricing under which the risk value increases as the period is lengthened. This tends to defer recognition of the payment to later years. Allocations which vary significantly from the Black-Scholes method may not be reasonable. For example, an allocation of value to the front end of a series of options would exist if, in the instance of a three-year option, the cost of a two-year option acquired at the end of the first year is subtracted from the cost of a three-year option. This method is not acceptable.[20]

The allocation method for a non-periodic payment in the case of a cap or floor is illustrated in the following example.

> On 1 January 1992, when LIBOR is 8 percent, Corporation F pays unrelated party Corporation E $ 600,000 for a contract which obligates Corporation E to make a payment to Corporation F each quarter equal to one-quarter of the excess, if any, of three-month LIBOR over 9 percent with respect to a notional principal amount of $ 25 million. Both Corporation E and Corporation F are calendar year taxpayers. Corporation E provides Corporation F with a schedule of allocable premium amounts that indicates the cap was priced according to a variation of the Black-Scholes option pricing formula and that the total premium is allocable to the following periods:

1992	$ 55,000
1993	$ 225,000
1994	$ 320,000
Total	$ 600,000

> The $ 600,000 cap premium paid by Corporation F to Corporation E is a non-periodic payment. Although the cap has been allocated under a modified version of the Black-Scholes formula, the schedule generated by Corporation E's proprietary model is not inconsistent with the economic substance of the cap, and may be used by both Corporation E and Corporation F for calculating their ratable daily portions of the cap premium. Corporation E recognizes the ratable daily portion of the cap premium as income, and Corporation F recognizes the ratable daily portion of the cap premium as a deduction based on the pricing schedule.

(d) *Alternative method for caps or floors*

At the time the proposed regulations were published, the IRS published a draft form of a revenue procedure providing for an alternative recognition method for notional principal con-

17. Proposed Reg. 1.446-3(e)(3)(ii)(D)(1).
18. Proposed Reg. §1.446-3(e)(3)(iii), *Example 5*.
19. Black and Scholes, "The Pricing of Options and Corporate Liabilities", 81 *J. Pol. Econ.* 637 (1973).
20. See proposed Reg. §1.446-3(e)(3)(iii), *Example 4*.

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tracts that are caps or floors. The revenue procedure will be effective when the proposed regulations become final. If elected, the alternative method applies only to interest rate caps and floors that are based on a specified index that is known publicly and offered currently to unrelated borrowers in private lending transactions by a financial institution or that reflects an average (based on a statistically significant sample) of current yields on a class of publicly-traded debt instruments. For this purpose, both an index that reflects an average of the foregoing indices or is expressed as a fixed number of basis points above or below such indices or such average is acceptable.

For each taxable year in which the taxpayer enters into an interest rate cap or floor agreement, it may elect to use the optional method for all interest rate cap and floor agreements entered into in that year. The election is irrevocable for the year and is made by attaching a statement to a timely filed federal income tax return.

Amortization tables are set forth to derive a schedule of annual amortization rates to be applied to the unadjusted amount of the premium paid or received for an interest rate cap or floor agreement. One table lists a series of factors corresponding to the years covered by the interest rate cap agreement and the number of basis points by which the cap rate differs from the specified interest rate index. A second table relates to interest rate floor agreements and sets forth factors for years covered and basis points by which the specified interest rate index differs from the floor rate.

(e) *Limitations on alternative methods*

The regulations caution that none of the optional methods to amortize any non-periodic payment made or received with respect to the hedged notional principal contract will be available to a taxpayer that hedges a notional principal contract, either directly or through a related party, by purchasing, selling or otherwise entering into other notional principal contracts, futures, forwards, options or other financial instruments.[21] Moreover, the IRS may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole. Unfortunately, no illustration of the economic substance is provided.

The optional method for caps or floors may not be used by dealers or traders.[22] It is not available to any cap or floor which, at the inception of the contract, falls outside of the range of rates specified in the appropriate table.[23]

4. Termination payments

A payment that extinguishes or assigns all or a proportionate part of the rights and obligations of any party under a notional principal contract is a termination payment.[24] A termination payment may be made between the original parties to the contract, in which case the termination payment is an extinguishment, or it may be made between one party to the contract and a third party. In that instance, the payment is an assignment.

Except as otherwise provided in IRC Section 1092 relating to deferrals of losses that arise where offsetting positions are maintained with respect to property, both parties to a notional principal contract recognize a termination payment that is received or made with respect to that contract in the year of the extinguishment or assignment.[25] This may be illustrated by the following example.

> On 1 January 1992, Corporation P enters into an interest rate swap agreement with an unrelated counterparty, Corporation O under which, for a term of seven years, Corporation P is obligated to make annual payments based on 10 percent and Corporation O is obligated to make semi-annual payments based on LIBOR. The notional principal amount of the contract is $ 100 million. Corporation P and Corporation O are both calendar year taxpayers. On 1 January 1994, when the fixed rate on a comparable LIBOR swap has fallen to 9.5 percent, Corporation P pays Corporation O $ 1,895,393 to terminate the swap.
>
> The payment from Corporation P to Corporation O extinguishes the swap contract and is a termination payment. Corporation P recognizes a loss of $ 1,895,393 in 1994 and Corporation O recognizes $ 1,895,393 of income or gain in 1994.[26]

The termination payment is an immediate taxable event for both of the original parties to the notional principal agreement. If the payment is not made to an original counterparty, but instead is made to an assignee, the result is unchanged. The original counterparty is deemed to have income or gain from the payment. In addition, any payments that have been made or received previously pursuant to a notional principal contract, but that have not been recognized by the time of the termination payment, are also recognized in the year of the extinguishment or assignment. An assignee treats a termination payment as if it were a non-periodic payment made for the notional principal contract that is in effect after the assignment. Thus, the full taxable event for the assignee is deferred. These rules are illustrated by the following example:

> On 1 January 1992, Corporation O pays Corporation P a yield adjustment fee to enter into the seven year interest rate swap. Corporation P and Corporation O included the ratable daily portions of that non-periodic payment in their net income or deduction from the contract for 1992 and 1993. As of 1 January 1994, $ 300,000 of the non-periodic payment has not yet been recognized by Corporation P and Corporation O.
>
> On 1 January 1994, Corporation P pays an unrelated party, Corporation R, $ 1,895,393 to assume all of Corporation P's rights and obligations under the swap with Corporation O. In return for this payment, Corporation R agrees to pay 10 percent of $ 100 million annually to Corporation O and to receive LIBOR-based payments from Corporation O for the remaining five years of the swap.
>
> The payment from Corporation P to Corporation R terminates P's interest in the swap contract with Corporation O and is a termination payment. Corporation P recognizes a loss of $ 1,895,393 in 1994. However, it also recognizes income from the remaining $ 300,000 of the previously unrecognized yield adjustment fee it

21. Proposed Reg. §1.446-3(e)(4)(ii).
22. Proposed revenue procedure §3.02.
23. Proposed revenue procedure §3.01.
24. Proposed Reg. §1.446-3(e)(6)(i).
25. Proposed Reg. §1.446-3(e)(6)(ii).
26. Proposed Reg. §1.446-3(e)(6)(vi), *Example 1*.

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received in 1992. At the same time, Corporation O recognizes $ 1,895,393 of income or gain in 1994 even though it receives no payment. However, Corporation O also recognizes $ 300,000 of loss from the previously unrecognized yield adjustment fee. The net income of Corporation O as of the date of the termination payment is $ 1,595,393. It may be capitalized into the basis in the notional principal contract and may be amortized over the remaining term of the swap agreement as if it made a non-periodic payment.

The payment that Corporation R, the assignee, receives from Corporation P is a non-periodic payment received in connection with the interest rate swap. The proposed regulations conclude that the payment is not a significant non-periodic payment in relation to the present value of the stream of fixed payments. Accordingly, the in terrorem rules discussed below for swaps are inapplicable and Corporation R can amortize the $ 1,895,393 over the remaining five-year term of the swap agreement.

The balance of the rules for termination payments are relatively simple. If only a proportionate part of a party's rights and obligations is extinguished or assigned, then only that proportion of the unrecognized payments is recognized. The termination rules do not apply to any contract that is integrated with other property or debt which may be controlled by IRC Section 988(d). Finally, substance controls over form, and the IRS may treat any economic benefit that is given or received by a taxpayer in lieu of a termination payment as a termination payment.

C. *In terrorem rule for swaps*

The regulations contain two principal in terrorem rules. One is applicable to swaps and the other to caps or floors. Under the first rule, a swap that involves significant non-periodic payments is treated in substance as including one or more loans, which must be accounted for by both parties to the contract as part of the swap.[27] The proposed regulations do not expressly define when non-periodic payments are viewed to be significant. However, examples indicate that a non-periodic payment clearly is not considered to be significant when it is less than 10 percent of the discounted present value of the total fixed payments required under the contract.[28] On the other hand, a non-periodic payment clearly is considered to be significant when it amounts to more than 66 percent of the discounted present value of the total fixed payments.[29]

Where this rule applies, the non-periodic payment is considered to be an interest-bearing, self-amortizing loan. The principal is considered to be repaid as the loan is amortized under the fixed payment constant yield-to-maturity method previously discussed. However, in comparison to the optional method discussed above where the time value component is ignored for tax purposes, here the time value component is viewed to be interest and is treated as such for all purposes of US tax law.

As the principal of the deemed loan is amortized and the element for the time value is determined, the deemed recipient (i.e. the person making the up-front payment) is considered to make additional swap payments in an amount equal to the amortized principal and the interest for the period. The following example illustrates how this is accomplished.

On 1 January 1992, Corporation M and Corporation N enter into an interest rate swap contract. The corporations are unrelated. Under the terms of the contract, Corporation N agrees to make five annual payments to Corporation M equal to the rate of interest under LIBOR multiplied by a notional principal amount of $ 100 million. In return, Corporation M agrees to pay Corporation N 6 percent of $ 100 million annually, plus $ 15,163,147 on the settlement date, also 1 January 1992. At the time Corporation M and Corporation N enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10 percent, and the amount of the initial payment was determined as the present value, at 10 percent compounded annually, of five annual payments from Corporation M to Corporation N of $ 4,000,000 (4% of $ 100,000,000), each.

Although the parties have characterized this transaction as an interest rate swap, the proposed regulations conclude that the $ 15,163,147 payment from Corporation M to Corporation N is significant when compared to the present value of the total fixed payments due under the contract, i.e. the present value of $ 30 million. Accordingly, the transaction is recharacterized in accordance with its substance. The proposed regulations treat the payment as a $ 15,163,147 loan from Corporation M to Corporation N that Corporation N repays in instalments over the term of the agreement. In addition, the interest rate swap between Corporation M and Corporation N is revised for tax purposes to include a notional provision under which Corporation M is required to pay the amortized principal back to Corporation N as part of its fixed payments on the swap in exchange for the LIBOR based payments by N.

The loan is amortized using the level payment constant yield to maturity method by finding the level payments needed to amortize the $ 15,163,147 payment over five years. The level payment may be determined in this case using the parties' deemed discount rate of 10 percent and annual compounding. Corporation M and Corporation N must account for the principal and interest as follows:

Year	Deemed Level Payment	Deemed Interest Component	Principal Component
1992	$ 4 mil.	$ 1,516,315	$ 2,483,685
1993	$ 4 mil.	$ 1,267,946	$ 2,732,054
1994	$ 4 mil.	$ 994,741	$ 3,005,785
1995	$ 4 mil.	$ 694,215	$ 3,305,785
1996	$ 4 mil.	$ 363,636	$ 3,636,364
Total	$ 20 mil.	$ 4,836,853	$ 15,163,147

Corporation M recognizes interest income, and Corporation N claims an interest deduction, each taxable year equal to the interest component of the deemed instalment payments on the loan. The principal components are needed to compute the interest component of the level payment for the period, but do not otherwise affect the parties' income or deductions from this contract.

Corporation N makes swap payments to Corporation M based on LIBOR, and receives swap payments from Corporation M at a fixed rate that is equal to the sum of the stated fixed rate and the rate calculated by dividing the annuitized annual loan payments (i.e. the sum of the principal and interest, here $ 4 million) by the notional principal amount. Thus, the fixed rate on this swap is 10 percent, which is the sum of the stated rate of 6 percent and the rate calculated by dividing the annual loan payment of $ 4,000,000 by the notional principal amount of $ 100,000,000, or 4 percent. The 10 percent swap payments from Corporation M to Corporation N and the LIBOR swap payments from Corporation N to Corporation M are included in the parties' net income or deduction from the contract for each taxable year.

27. Proposed Reg. §1.446-3(e)(4)(iii).
28. Proposed Reg. §1.446-3(e)(4)(v), *Example 2*.
29. Proposed Reg. §1.446-3(e)(4)(v), *Example 3*.

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D. *In terrorem rule for caps and floors*

The second in terrorem rule relates to caps and floors that are significantly in the money on the date the cap or floor is entered. A cap is said to be in the money if it appears that a payment will be received because the floating leg of the transaction exceeds the fixed leg. A floor is in the money if the floating rate is less than the fixed leg.

If the current value of the specified index in a cap agreement exceeds the cap rate by a significant amount, or the floor rate exceeds the current value of the specified index in a floor agreement by a significant amount, then the cap or floor is treated as including one or more loans. As a result, the time value component of a cap or floor that is significantly in-the-money is recognized as interest for tax purposes. In general, the portion that is treated as interest is computed by multiplying (i) the ratable daily portion of the premium that is recognized for the taxable year by (ii) the discount rate used by the parties to determine the amount paid for the cap or floor compounded from the date the premium is paid to the earlier of the date such option contracts expire or the end of the taxable year. However, the amount treated as interest cannot exceed the net income or deduction from the cap or floor for the taxable year. For this purpose, a significant amount is more than 25 basis points.

E. *Anti-abuse rule*

The regulations contain an anti-abuse rule[30] which reflects an admission by the IRS that no matter how the rules are drafted, investment bankers may be able to devise an instrument that will accelerate tax benefits in unanticipated circumstances. Under the anti-abuse rule, none of the foregoing rules are to apply if a taxpayer enters into a transaction that is not a customary commercial transaction, the rules discussed above would produce a material distortion of the taxpayer's income from that transaction, and the taxpayer would not have entered into the transaction but for that material distortion. Only the IRS may apply the anti-abuse rule when necessary to clearly reflect the income from the transaction.

II. MARK-TO-MARKET ELECTION

Dealers and traders of derivative financial products may elect to account for those instruments at market value.[31] An entity is considered to be a dealer or a trader in derivative financial instruments if it maintains an established place of business from which one of two activities are carried on. The first activity relates to the making of a market in derivative financial instruments.[32] The entity must regularly and actively offer to enter into, offset, assign or otherwise terminate positions in these instruments with customers in the ordinary course of its trade or business. The second activity relates to the regular and active course of conduct by which the taxpayer engages in the frequent and substantial trading of derivative financial instruments for the principal purpose of deriving gains and profits from trading those instruments rather than from periodic income.[33] Periodic income includes dividends, interest, net income from notional principal contracts or long-term appreciation.

A. *Conditions for election*

To make the election, certain conditions must be met. First, the entity must have purchased or entered into the instrument in its capacity as a dealer or trader.[34] Alternatively, the instrument must have been purchased or entered into as a hedge of another financial instrument that the dealer or trader holds or intends to hold in its capacity as a dealer or trader.

Second, the dealer or trader must value all of the derivative financial instruments that it holds in its capacity as a dealer or trader (or as hedges of such instruments) at market for purposes of computing net income or loss on its applicable financial statement and its income tax return.[35] The definition of an applicable financial statement is the same as provided for alternative minimum tax purposes. Thus, it includes statements filed with the SEC, certified financial statements used for credit purposes and a financial statement submitted to a government regulator.[36]

Third, for tax return purposes, the dealer or trader and all related persons must account for the securities and commodities that they hold in their capacity as dealers or traders (or as hedges of such securities or commodities) either on the basis of cost or on the basis of market value, but not at the lower of cost or market value.[37] A relatively standard definition is provided for the term "related person". Under this definition, a person is related if it would be treated as a related person under the tests of either IRC Sections 267(b) or 707(b). Although these provisions describe various relationships, they address in substantial part relationships in which greater than 50 percent common ownership exists among various entities. Thus, for example, an individual is related to a corporation in which he owns more than 50 percent of the value of the outstanding stock; two corporations are related if they are members of the same controlled group determined by reference to more than 50 percent common ownership; and a corporation and a partnership are related if the same persons own more than 50 percent of the value of the outstanding stock of the corporation and more than 50 percent of the capital or profit interests in the partnership.[38]

Finally, a description of the methods employed to value each class of derivative financial instruments must be attached to the income tax return filed by the dealer or trader for each year in which the election is in effect and the method elected must be used consistently in subsequent years.[39] Of course, another method may be authorized by the IRS pursuant to a written request for a change of accounting method.

30. Proposed Reg. §1.446-3(f).
31. Proposed Reg. §1.446-4(a).
32. Proposed Reg. §1.446-4(b)(1).
33. Proposed Reg. §1.446-4(b)(2).
34. Proposed Reg. §1.446-4(a)(1).
35. Proposed Reg. §1.446-4(a)(2).
36. Reg. §1.56-1(c) as it applies to years beginning in 1987, 1988 and 1989.
37. Proposed Reg. §1.446-4(a)(3).
38. IRC Sec. 267(b).
39. Proposed Reg. §1.446-4(a)(4) and (5).

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B. *Effective date*

As with the regulations addressed to the recognition of income from notional principal contracts, this regulation is effective when published in final form. If the mark-to-market election is made, the loss deferral rules applicable to straddles will not apply. Those rules are discussed below.

III. COORDINATION WITH OTHER PROVISIONS

As mentioned previously, the proposed regulations relating to notional principal contracts address issues of timing for the recognition of net income and net deductions. However, they affect other provisions of US tax law, ranging from the loss deferral rules for straddles where offsetting positions in property are maintained, to Subpart F under which income of controlled foreign corporations may be accelerated, to the allocation and apportionment of deductions. This portion of the article will discuss those rules.

A. *Straddle rules*

IRC Section 1092 contains several provisions that limit the benefits allowed to taxpayers that invest in straddles. One of those provisions mandates the deferral of losses when less than all of the offsetting positions in property are sold or otherwise disposed of. For persons other than dealers or traders that have a mark-to-market election in effect, the loss deferral provision is problematic.

1. Straddle definitions

For US income tax purposes, a straddle is the holding of offsetting positions in actively traded personal property. Both positions are liquid and each fluctuates inversely in relation to the other. The positions need not be identical so as to eliminate all risk from change in value. Thus, for tax purposes the term "straddle" is broad enough to include what is commonly referred to in the market as a spread. In general, personal property is any property or interests in personal property that may result in gain or loss on disposition. While US currency is not considered personal property for these purposes, an interest rate futures or option contract is considered to be personal property if the contract is actively traded. US dollars, Swiss francs, English pounds sterling, German marks, Japanese yen, Australian dollars, Canadian dollars and ECUS (European Currency Units) are actively traded on a board of trade.

Under proposed regulations, actively traded property includes any personal property for which there is an established financial market.[40] An established financial market for these purposes includes the following:

- a national securities exchange registered under the Securities Exchange Act of 1934;
- an exchange that is exempt from registration because of its limited volume of transactions;
- a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;
- a foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law where it is organized;
- an interbank market; and
- an interdealer market that is characterized by a system of general circulation which regularly disseminates price quotations or pricing information by identified dealers, brokers or traders.[41]

Proposed regulations designate a notional principal contract as personal property of a type that is actively traded if an established financial market for similar contracts exists, thereby allowing for the notional principal contract to be actively traded. The proposed regulations also state that the rights and obligations of a party to a notional principal contract constitute an interest in personal property.[42] The proposed regulations state that when final regulations are adopted, they will be effective for notional principal contracts entered into on or after 8 July 1991.

2. Loss deferral

If a taxpayer holds an offsetting position in a straddle, any loss incurred from closing one of the positions is deferred to the extent that there is unrecognized gain in an offsetting position.[43] The loss deferral rule also applies to successor positions, offsetting positions to loss positions and offsetting positions to successor positions.[44] If the deferral rule applies, the loss may be deducted in subsequent years, but only if no unrecognized gain exists in offsetting positions during the subsequent year.[45] The foregoing demonstrates that the loss deferral rule can exacerbate the deferral of deductions that is otherwise required under the recognition rules for non-periodic payments. This is illustrated in the following example.

> Corporation P purchases an interest rate floor from a recognized swap dealer on 1 January 1992. Under the floor, the counterparty is obligated to make a payment to Corporation P if LIBOR is less than 6 percent on specified dates. The notional principal amount of the contract is $ 100 million. Corporation P is calendar year taxpayer.
>
> Corporation P pays $ 600,000 upon settlement of the contract, of which $ 55,000 is recognized on a ratable daily basis in 1992. During 1992, Corporation P maintains an interest in a portfolio of floating and fixed rate interest bearing instruments. Also during 1992, LIBOR does not drop below the floor rate.
>
> Of the $ 600,000 paid by Corporation P, $ 55,000 is recognized in 1992 and is a net deduction under the contract. However, if the floor agreement is viewed to be an offsetting interest in property (i.e. the portfolio of debt instruments) which has at least $ 55,000 of unrecognized gain, no portion of the premium is deductible in 1992. The net loss on the contract will be deferred until the offsetting position is recognized.

An exception to the loss deferral rules is provided for identified straddles.[46] An identified straddle is treated as a unit for income tax purposes. Thus, the recognition of a loss leg on

40. Proposed Reg. §1.1092(d)-1(a).
41. Proposed Reg. §1.1092(d)-1(b).
42. Proposed Reg. §1.1092(d)-1(c)(1).
43. IRC Sec. 1092(a)(1)(A).
44. Reg. §1.1092(b)-1T(a)(2).
45. IRC Sec. 1092(a)(1)(B).
46. IRC Sec. 1.1092(a)(2)(A)(i).

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the straddle is not deferred because of the existence of unrecognized gain in a position that is outside the straddle.[47] For a straddle to be an identified straddle, four tests must be met. All the positions of the straddle must be acquired on the same day. All the positions of the straddle must be identified clearly in the taxpayer's records as being part of an identified straddle. (The designation must be made before the end of the day on which the identified straddle positions were acquired.) All the positions of the straddle must be disposed of on the same day (or held at year-end). The straddle cannot include positions that are part of a larger straddle.[48]

3. Effect on notional principal contracts

While it is clear that a large network of swap dealers exists and that notional principal contracts are traded on the Chicago Board of Trade, it is not clear whether a swap agreement that is not purchased or sold through a dealer intermediary is actively traded. If it is, presumably the loss deferral rules could apply to the extent that the notional principal contract offsets other property having unrecognized gain. It is anticipated that the IRS will address this issue in final regulations.

B. *Foreign currency gains and losses*

The proposed regulations relating to notional principal contracts do not override the rules issued under IRC Section 988 with regard to currency swaps. Those rules relate to the recognition of gains and losses attributable to the movement of currency values. To the extent that the notional principal contract is also a Section 988 transaction, the recognition rules under IRC Section 988 remain applicable.

1. Background

As a general rule, a foreign currency gain resulting from a Section 988 transaction is treated as ordinary income. A foreign currency gain is defined in general to mean the gain or loss arising from a Section 988 transaction to the extent the gain or loss is attributable to the movement in value of a non-functional currency in relation to a taxpayer's functional currency between a booking date and a payment date.[49] For US corporations, the US dollar is generally treated as the taxpayer's functional currency. However, if a qualified business unit (QBU) is maintained outside the United States, a different currency may be treated as the functional currency of the QBU. In that instance, a QBU's functional currency is the currency of the economic environment in which a significant portion of its operations are carried on.[50] Tests are provided in the regulations to determine the appropriate functional currency of a QBU.

If the amount that a taxpayer is entitled to receive or is required to pay is either denominated in a non-functional currency or is determined by reference to the value of one or more non-functional currencies, a Section 988 transaction includes any of the following:

- acquiring a debt instrument or becoming the obligor under a debt instrument;[51]
- accruing (or otherwise taking into account) any item of income or expense that is to be paid or received after the date of accrual;[52]
- entering into or acquiring a forward contract, futures contract, option or similar financial instrument (except for regulated futures contracts and non-equity options) if the underlying property to which the contract relates is, itself, a non-functional currency or a debt instrument denominated in foreign currency;[53] and
- disposing of non-functional currency.[54]

2. Application of Section 988 to a notional principal contract

IRC Section 988 applies to a notional principal contracts only if the underlying property to which the instrument ultimately relates is money (i.e. functional currency), non-functional currency or property the value of which is determined by reference to an interest rate. Thus, a currency swap is included, but a swap referenced to a commodity or equity index is outside the definition.[55] This is illustrated by the following example in which the taxpayer is a US entity that reports income under the accrual method of accounting using the calendar year as its taxable year.

> On 1 January 1989, Corporation X purchases at original issue a three-year bond for £ 74,621.54 maturing on 31 December 1991, at a stated redemption price of £ 100,000. The bond provides for no stated interest. The bond has a yield to maturity of 10 percent compounded semi-annually and has £ 25,378.46 of original issue discount. On these facts, the acquisition of the bond is a Section 988 transaction. The accrual of original issue discount with respect to the bond is a Section 988 transaction with respect to the translation of original issue discount and the determination of exchange gain or loss upon receipt of those amounts.[56]
>
> On 11 May 1989, Corporation X purchases a one year note at original issue for its face amount of $ 1,000. The note pays interest in dollars at the rate of 4 percent compounded semi-annually. The amount of principal received by Corporation X upon maturity is equal to $ 1,000 plus the equivalent of the excess, if any, of (a) the Financial Times One Hundred Stock Index (the FT 100) determined and translated into US dollars on the last business day prior to the maturity date, over (b) £ 2,150, the "stated value" of the FT 100, which is equal to 110 percent of the average value of the index for the six months prior to the issue date. That amount is translated into US dollars at the exchange rate of £ 1 = $ 1.50. On these facts, the purchase by Corporation X of the instrument is not a Section 988 transaction because the index used to compute the principal amount received upon maturity is determined with reference to the value of stock and not non-functional currency.[57]

47. IRC Sec. 1092(c)(2)(C).
48. IRC Sec. 1092(a)(2)(B).
49. IRC Sec. 988(b).
50. IRC Sec. 985(b).
51. IRC Sec. 988(c)(1)(B)(i); Reg. §1.988-1(a)(2)(i).
52. IRC Sec. 988(c)(1)(B)(ii); Reg. §1.988-1(a)(2)(ii).
53. IRC Sec. 988(c)(1)(B)(iii); Reg. §1.988-1T(a)(2)(iii).
54. IRC Sec. 988(c)(1)(C)(i); Reg. §1.988-1T(a)(1)(i).
55. Reg. §1.988-1(a)(ii)(3)(B).
56. Reg. §1.988-1(a)(2)(iii)(B), *Example 4*.
57. Reg. §1.988-1(a)(2)(iii)(B), *Example 9*.

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3. Forward and futures contracts and non-equity options

While a forward, futures or non-equity option is covered by Section 988, the instrument must not be of a kind that would be marked to market under IRC Section 1256 if held on the last day of the year.[58] If it is, its acquisition or disposition is not a Section 988 transaction unless so elected. The election enables a taxpayer to use those types of instruments as a hedge without risking a mismatching of the instrument with the underlying asset being hedged because of differences in character. The election to have these instruments covered must be made on or before the first day a contract is held for the year. Once made, it is binding on all succeeding years.

4. Dual currency debt instruments

In 1991, the original issue discount regulations were revised to address the treatment of certain debt instruments that are issued after 20 February 1991, for cash or publicly-traded property.[59] The affected instruments provide for non-contingent payments at least equal to the issue price and one or more contingent payments determined in whole or in part by reference to the value of a publicly-traded stock, securities, commodities or other publicly-traded property.

The regulations require, in general, that the instrument must be separated into contingent and non-contingent components and thereafter treated as two separate instruments. The non-contingent element is generally treated as a separate element of an investment unit and the stated redemption price at maturity for original issue discount purposes is determined without reference to the contingent payments. The contingent component is treated as if its issue price were equal to the balance remaining after the hypothetical issue price of the non-contingent component is removed from the issue price. This is illustrated by the following example.

> On 1 April 1991, Corporation A purchases Corporation B's contingent instrument at original issue for cash in the amount of $ 1,000,000. The instrument, with a term of five years, calls for a non-contingent payment at maturity of $ 1,000,000 and a contingent payment at maturity in an amount derived by multiplying $ 1,000,000 by the percentage increase, if any, in a nationally known composite price index of publicly-traded stocks over the term of the instrument. There is no publicly-traded property that is substantially equivalent to the right to the contingent payment. The mid-term, Applicable Federal Rate with semi-annual compounding for April 1991 is 8.15 percent and the parties agree to discount the separate non-contingent debt instrument at 9 percent compounded semi-annually.
>
> On these facts, the non-contingent payment of $ 1,000,000 at maturity is treated as a separate non-contingent debt instrument for purposes of the original issue discount rules. Based on a discount rate of 9 percent compounded semi-annually, the issue price of the separate non-contingent debt instrument equals $ 643,927.68. The stated redemption price at maturity is $ 1,000,000.
>
> The contingent payment is treated as the equivalent of a cash settlement option on the index. The portion of the $ 1,000,000 issue price that is allocated to the contingent component equals $ 356,072.32 ($ 1,000,000 – $ 643,927.68). The contingent payment is treated in the same manner as a payment pursuant to a cash settlement option on the index.[60]

Where the contingent component is expressed in terms of a foreign currency index, the original issue discount rules are applied first and the foreign currency gain rules of IRC Section 988 are applied thereafter.[61] Thus, if the contingent component in the above example is denominated in terms of the FT 100, the contingent and non-contingent components are separated. Thereafter, a determination is made regarding any potential currency gain. In the example, no currency gain would exist because the contingent element is based on a stock index and is unrelated to foreign currency values. However, currency gain or loss would exist potentially if, instead of being tied to an equity index, the contingent payment would be based on a basket of foreign currency values.

If a debt is a dual currency or multiple currency instrument and the amount of non-functional currency units is fixed, the instrument is non-contingent.[62] A dual currency debt instrument is a debt instrument with respect to which the qualified periodic interest payments are denominated in or determined by reference to a single currency, the stated redemption price at maturity is denominated in or determined by reference to a different currency, and the amount of all payments in each currency is fixed on the issue date.

A dual currency debt instrument is separated into two component hypothetical debt instruments, each of which is treated separately. First, a hypothetical zero coupon bond is considered to exist. This hypothetical bond is denominated in the currency of the stated redemption price at maturity. The stated redemption price at maturity is discounted at an appropriate rate for loans in that currency to determine the hypothetical issue price.

In addition, a second hypothetical instrument is considered to exist. This second instrument is a hypothetical instalment obligation denominated in the currency of the qualified periodic interest payments. The difference between the stated redemption price at maturity of the actual dual currency debt instrument and the hypothetical issue price of the hypothetical zero coupon bond (translated at the spot rate on the issue date) is considered to be the principal amount of an instalment obligation. Section 988 applies to each hypothetical debt instrument created to the extent it is denominated in a non-functional currency. This is illustrated by the following example.

> On 1 January 1993, Corporation X issues a three-year bond priced at par with a principal amount of $ 100. Under the bond, Corporation X is obligated to make payments of $ 5.28 on 31 December of each year, and upon maturity, to repay SwF 200 in satisfaction of the principal due. The spot rate on 1 January 1993 is SwF 1 = $ 0.50.
>
> The debt instrument is a dual currency debt instrument. The dual currency debt instrument must be separated into two hypothetical debt instruments. The first is a hypothetical Swiss franc denominated zero coupon bond with a stated redemption price at maturity of SwF 200, discounted at an appropriate rate in that currency, which may be 5 percent compounded annually. The hypothetical

58. IRC Sec. 988(c)(1)(D).
59. Proposed Reg. §1.1275-4(g).
60. Proposed §1.1275-4(g)(5), *Example*.
61. Proposed Reg. §1.988-1(a)(3)(i).
62. Proposed Reg. §1.988-4(a)(4).

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issue price for this instrument is SwF 172.77. The second hypothetical instrument is a three-year dollar denominated, self-amortizing instalment obligation with annual payments of $ 5.28, a principal amount of $ 13.62 ($ 100 – $ 86.38, which is the dollar denominated value of Swiss francs at an exchange rate of SwF 1 = $ 0.50), and a yield to maturity of 8 percent compounded annually. The issuance of a hypothetical dollar denominated instalment obligation is not a Section 988 transaction for a US corporation such as Corporation X. However, the issuance of the hypothetical Swiss franc zero coupon bond is a Section 988 transaction.[63]

A multi-currency instrument is subject to similar rules, but the order in which the computations are made is not clear.[64]

5. Currency swaps

Exchange gain or loss is determined for notional principal contracts other than currency swaps according to the taxpayer's method of accounting, so long as that method clearly reflects income.[65] The rules for currency swaps appear in the Section 988 regulations. In general, these regulations apply solely for purposes of determining the realization, recognition and amount of exchange gain or loss.[66] They do not apply for purposes of determining the source of such gain or loss or to characterize the gain or loss as interest. In general, the gain or loss realized with respect to a currency swap contract is characterized as exchange gain or loss, not as interest income or expense.

For purposes of the currency rules, a currency swap contract is a contract involving different currencies between two or more parties under which each is required to exchange periodic interim payments on or prior to the maturity of the contract and to exchange the swap principal amount upon maturity of the contract.[67] For this purpose, the swap principal amount is an amount of two different currencies which is used to determine the periodic interim payments. An exchange of periodic interim payments occurs when payments in one specified currency are made in return for payments in a different specified currency. The payments in each currency must be computed by reference to an interest index applied to the swap principal amount.

Except for certain abuse rules and transactions that are known as Section 988 hedges, the payments made under the swap are treated as having been made pursuant to a hypothetical borrowing denominated in the currency of the payment. Payments received under the swap are treated as having been received pursuant to a hypothetical loan that is denominated in the currency in which payments are received. The hypothetical issue price for each of those transactions is the swap principal amount. The hypothetical stated redemption price at maturity is the total of all payments (exclusive of the initial exchange of the swap principal amount) under the hypothetical borrowing or loan other than periodic interest payments.

For purposes of determining economic accrual under the currency swap, a semi-annual compounding convention is generally required unless the currency swap contract indicates otherwise.

The amount treated as exchange gain or loss by the taxpayer with respect to the periodic interim payments for the taxable year is the amount of hypothetical interest income and exchange gain or loss attributable to that interest income which may exist between the accrual date and the payment date. That sum is reduced by the hypothetical interest expense and exchange gain or loss attributable to the interest expense from such hypothetical borrowing.[68] These rules may be illustrated by the following examples.

Corporation C computes income under the accrual method of accounting. It uses the calendar year as its taxable year. The dollar is its functional currency.

On 1 January 1989, Corporation C enters into a currency swap with Corporation J. Under the terms of the swap, the principal amounts are $ 150 and £ 100. £ 100 is the equivalent of $ 150 on the effective date of the contract, assuming a spot rate of £ 1 = $ 1.50. The swap agreement provides that on 31 December 1989 and 31 December 1990, Corporation C is required to make payments equal to 10 percent of the dollar-principal amount and Corporation J is required to make payments equal to 12 percent of the sterling-principal. On 31 December 1990, Corporation C is required to pay to Corporation J the $ 150 principal amount and Corporation J is required to pay to Corporation C the £ 100 principal amount.

For purposes of this example, it is assumed that the spot rates for sterling are £ 1 = $ 1.50 on 1 January 1989, £ 1 = $ 1.40 on 31 December 1989, and £ 1 = $1.30 on 31 December 1990. It is also assumed that the average rates are £ 1 = $ 1.45 for 1989 and £ 1 = $ 1.35 for 1990.

Solely to determine the realization of Corporation C's currency gain or loss, Corporation C treats its dollar payments as if they were made pursuant to a dollar-borrowing in which the issue price is $ 150, the stated redemption price at maturity is $ 150, and the yield to maturity is 10 percent. Corporation C treats the sterling payments from Corporation J as payments received pursuant to a sterling-loan in which the issue price is £ 100, the stated redemption price at maturity is £ 100, and the yield to maturity is 12 percent. Corporation C computes its hypothetical accrued sterling-interest income at the average rate for the accrual period and determines its exchange gain or loss on the day payment is received.

Accordingly, Corporation C accrues $ 17.40 (£ 12 x $ 1.45 average rate) of interest income in 1989 and $ 16.20 (£ 12 x $ 1.35 average rate) of interest income in 1990. Corporation C also computes hypothetical exchange losses of $ 0.60 on 31 December 1989, which is derived by subtracting $ 17.40 (£ 12 x $ 1.45 average rate) from $ 16.90 (£ 12 x $ 1.40 spot rate), and $ 0.60 on 31 December 1990, the loss incurred when $ 16.20, the interest computed under the average rate (£ 12 x $ 1.35), is subtracted from $ 15.60, the interest computed under the spot rate (£ 12 x $ 1.30). All hypothetical interest income and exchange losses are characterized and sourced as exchange gain and loss. Finally, Corporation C is treated as having paid $ 15 ($ 150 x 10%) of hypothetical interest on 31 December 1989, and again on 31 December 1990. These items of hypothetical interest expense are characterized and sourced as exchange loss.

In total, Corporation C has a net exchange gain of $ 1.80 ($ 17.40 – $ 0.60 – $ 15.00) with respect to the periodic interim payments in 1989 and a net exchange gain of $ 0.60 ($ 16.20 – $ 0.60 – $ 15.00) with respect to the periodic interim payments in 1990. Corporation C also realizes an exchange loss on 31 December 1990 with

63. Proposed Reg. 1.988-1(a)(6), *Example 12*.
64. Proposed Reg. §1.988-4(a)(5).
65. Reg. §1.988-2(e)(1).
66. Reg. §1.988-2(e)(2).
67. Reg. §1.988-2(e)(2)(ii).
68. Reg. §1.988-2(e)(2)(iii)(A).

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respect to the exchange of the swap principal amount. This loss is determined by subtracting the value of the units of swap principal paid of $ 150 from the value of the units of swap principal received, $ 130 at the exchange rates then in effect.[69]

6. Off-market currency swaps

An "off-market currency swap" is a currency swap contract under which the present value of the payments to be made is not equal to the present value of the payments to be received on the day the taxpayer enters into or acquires the contract.[70] A premium payment is required to balance the positions.

The regulations acknowledge that there are two potential reasons why the present values of the swap payments will not be equal.[71] The first is that the swap exchange rate is not the spot rate on the date the agreement is entered. Here, the swap principal will be valued at an off-market exchange rate. The second possible reason is that the interest indices used to compute the periodic interim payments do not reflect current values on the day the transaction is entered. Here, the periodic payments will be off-market. Whichever reason applies, the swap requires a premium payment from one party to the other to bring the transaction into balance. The regulations address the rules under which this payment is recognized for tax purposes.

Under the regulations, the payment must be amortized in a manner which places the taxpayer in the same position it would have been in had the currency swap been entered at par either as to the currency exchange rate or the interest rate. If the currency exchange rate is off par, the premium attributable to the difference between the swap exchange rate and the spot rate must be measured as of the date of the contract. The premium is the amount required so that the present value of the amounts to be paid will equal the present value of the amounts to be received. That premium is taken into account and recognized as income or expense on the same date the swap principal amounts are taken into account for currency gain or loss purposes.[72] For this purpose, the swap exchange rate is the single exchange rate set forth in the contract at which the swap principal amounts are determined. If the swap exchange rate is not clearly set forth in the contract, the IRS may determine the rate.

On the other hand, if the premium is required to balance an interest index that is not at par, the difference in the values of the periodic interim payments is amortized in a manner that is consistent with the principles of economic accrual. Thus, it is amortized on a daily basis using a constant yield.[73]

Any premium amount taken into account is treated as exchange gain or loss. Similar rules apply to discounts. The rules for off-market currency swaps is illustrated in the following example.

> Corporation X reports income under the accrual method of accounting and the dollar is its functional currency. It uses the calendar year as its taxable year.
>
> On 1 January 1989, Corporation X enters into a three-year currency swap contract with Corporation Y. The swap agreement provides that the swap principal amount is $ 100 and SwF 200, its Swiss franc equivalent translated at a swap exchange rate of $ 1 = SwF 2. There is no initial exchange of the swap principal amount. The interest rates used to compute the periodic interim payments are 10 percent compounded annually for US dollar payments and 5 percent compounded annually for Swiss franc payments.
>
> Thus, under the currency swap, Corporation X agrees to pay Corporation Y $ 10 (10% x $ 100) on 31 December of 1989, 1990 and 1991 and to pay Corporation Y the swap principal amount of $ 100 on 31 December 1991. In turn, Corporation Y agrees to pay Corporation X SwF 10 (5% x SwF 200) on 31 December of 1989, 1990 and 1991 and to pay Corporation X the swap principal amount of SwF 200 on 31 December 1991. The average rate for 1989 and the spot rate on 31 December 1989, is $ 1 = SwF 2.5.
>
> On these facts, Corporation X realizes an exchange loss of $ 6 on 31 December 1989. This is comprised of $ 10 of loss attributable to the $ 10 periodic interim payment paid to Corporation Y and $ 4 of gain, the value of SwF 10 received from Corporation Y. If the value of the Swiss Franc had not gone down in the example, Corporation X would have had a $ 5 loss.
>
> On 1 January 1990, Corporation X transfers its rights and obligations under the swap contract to Corporation Z, an unrelated corporation. Corporation Z uses the dollar as its functional currency, reports income in accordance with the accrual method of accounting and has the calendar year as its taxable year. On 1 January 1990, the exchange rate is $ 1 = SwF 2.50. The relevant dollar interest rate is 8 percent compounded annually and the relevant Swiss franc interest rate is 5 percent compounded annually.
>
> Because of the movement in exchange and interest rates, the agreement between Corporation X and Corporation Z to transfer the currency swap requires Corporation X to pay Corporation Z $ 23.56. This would be considered to be a termination payment under a notional principal contract, but is merely a swap discount under the currency swap rules.
>
> Corporation X may deduct the loss of $ 23.56 in 1990. The loss is characterized as a currency loss and is sourced in the United States.
>
> Corporation Z is required to recognize the receipt of the $ 23.56 payment as follows. To the extent the payment is attributable to movements in exchange rates ($ 20 of principal and $ 4 of periodic interim payments), the payment is taken into account as exchange gain on 31 December 1991, the date the swap principal amounts are exchanged. This amount must be discounted to its present value. The discount rate for this purpose is the rate called for in the currency swap contract for dollar periodic interim payments. Here, that rate is 10 percent. (This computation ignores the change in interest rates.) Corporation Z requires $ 2 on 31 December 1990 and a total of $ 22 on 31 December 1991. The present value of $ 2 on 31 December 1990 and $ 22 on 31 December 1991 discounted at the rate of 10 percent is $ 20 ($ 1.82 + $ 18.18).
>
> In addition, Corporation Z is required to amortize the portion of the $ 23.56 payment attributable to movement in interest rates under principles of economic accrual over the term of the currency swap agreement. This is $ 3.56, the present value of the $ 4 excess periodic interim payments Corporation Z is required to make because the currency swap agreement does not reflect current interest rates on the day Corporation Z acquired the swap contract. The discount rate is the appropriate dollar interest rate as of 1 January 1990. Corporation Z includes $ 1.71 in income on 31 December 1990 and $ 1.85 on 31 December 1991.[74]

69. Reg. §1.988-2(e)(5), *Example 1*.
70. Reg §1.988-2(e)(3)(i).
71. Reg. §1.988-2(e)(3)(i).
72. Reg. §1.988-2(e)(3)(ii)(A).
73. Reg. §1.988-2(e)(3)(ii)(B).
74. Reg. §1.988-2(e)(5), *Example 3*.

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The foregoing example illustrates that an effect of the off-market swap rules is to defer the recognition of income by a counterparty when a party to a currency swap makes a payment that would be characterized as a termination payment in the context of a notional principal contract. Also, the off-market currency swap rules are currently silent where the premium is significant with regard to the stream of payments that are to be received under the swap. (However, they except to provide that for purposes of IRC Section 956, relating to investments in US property that may accelerate the imposition of US tax for US shareholders of a CFC, the IRS may treat any prepayment of a currency swap as a loan.) Proposed regulations provide that the in terrorem rules for notional principal contracts under which swaps with significant non-periodic payments are treated as loans will apply to all currency swaps (whether on-market or off-market) once final regulations are effective.[75]

C. *Foreign currency hedges – Section 988(d)*

IRC Section 988(d) addresses the circumstances in which a US taxpayer is an obligor or obligee under a foreign currency denominated debt instrument and wishes to hedge its position.[76]

1. Tax treatment of hedged transaction

If a transaction constitutes a qualified hedging transaction, the qualifying debt instrument and the hedge are integrated and treated as a single transaction during the period that the transaction is a qualified hedging transaction.[77] Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction are subject to the capitalization requirements for interest and carrying costs that appear in IRC Section 263(g), the loss deferral and other rules of IRC Section 1092 or the mark-to-market and 60/40 rules of IRC Section 1256 for that period. An exception exists for a straddle, which remains subject to those rules.

The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument for income tax purposes. The denomination of the synthetic debt instrument is the same as the currency paid under the terms of the hedge to acquire the currency used to make payments under the qualifying debt instrument.[78] Where the qualifying debt instrument is a lending, the denomination of the synthetic debt instrument is the same as the currency received under the terms of the hedge in exchange for amounts received under the qualifying debt instrument. To illustrate, the hedge is a forward contract to acquire sterling for dollars, and the qualifying debt instrument is a borrowing denominated in sterling, the synthetic debt instrument is considered a borrowing in dollars.

The term of the synthetic debt instrument is the period beginning on the identification date and ending on the date the qualifying debt instrument matures or an earlier date on which the qualifying debt instrument or hedge is disposed of or otherwise terminated.[79] Unless otherwise clearly indicated, the accrual period is six months.

The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date.[80]

Where the qualifying debt instrument is a borrowing, the stated redemption price at maturity is determined on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument.[81] Where the qualifying debt instrument is a lending, the stated redemption price at maturity is determined on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument.

Interest income from a synthetic debt instrument is sourced by reference to the qualifying debt instrument.[82] The character for purposes of Section 904 of interest income from a synthetic debt instrument is determined by reference to the character of the interest income from qualifying debt instrument.

Special rules are provided to integrate hedge income/expense and interest income/expense when the taxpayer is a foreign person that is engaged in a trade or business in the United States to which the interest is effectively connected[83] and to separate the interest income/expense and the hedge income/expense when the interest income is not effectively connected with a trade or business in the United States.[84]

2. Qualifying debt instrument

A qualifying debt instrument is a borrowing, other than one arising from an account payable or receivable generated by an expense or an item of income, that may be denominated in or determined by reference to non-functional currency. It includes dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments.[85] If less than the entire instrument is hedged, a portion of an instrument may qualify if payments of interest and principal are proportionally protected.

3. Hedge

A hedge may be a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument or series or combination thereof. When the hedge is integrated with the debt instrument, the calculation of a yield to maturity under original issue discount principles may be computed in the currency in which the synthetic debt instrument is denominated under the rules discussed above.[86]

75. Proposed Reg. §1.988-2(e)(3)(iv).
76. Reg. §1.988-5(a)(1).
77. Reg. §1.988-5(a)(9)i)(A).
78. Reg. §1.988-5(a)(9)(ii)(A).
79. Reg. §1.988-5(a)(9)(ii)(C).
80. Reg. §1.988-5(a)(9)(ii)(C).
81. Reg. §1.988-5(a)(9)(ii)(D).
82. Reg. §1.988-5(a)(9)(iii).
83. Reg. §1.988-5(a)(9)(i)(B).
84. Reg. §1.988-5(a)(9)(i)(C).
85. Reg. §1.988-5(a)(3).
86. Reg. §1.988-5(a)(4)(i).

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4. Integrated economic unit

A debt instrument and a hedge are considered to be an integrated economic transaction if certain tests are met. First, all payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the hedging transaction.[87] Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge such that the synthetic debt instrument is not classified as a contingent payment debt instrument.

Second, the hedge must be properly identified.[88] To comply with this requirement, a taxpayer must establish a record showing:

- the date the qualifying debt instrument and hedge were entered into;
- the date the qualifying debt instrument and the hedge are identified as a qualified hedging transaction;
- the amount of currency gain (and information relating to its source and character) that may have arisen with regard to the debt prior to the establishment of the hedge; this gain is deferred until maturity and is discussed below, in connection with legging-in transactions;
- a description of the qualifying debt instrument and the hedge; and
- a summary of the cash flow resulting from treating the qualifying debt instrument and the hedge as a qualified hedging transaction.[89]

The identification must occur not later than the date on which the financial instrument (or instruments) constituting the hedge is settled or closed.

Third, none of the parties to the hedge may be related. The standard by which a party is deemed to be related is based on IRC Sections 267(b) and 707(b) which were discussed above.[90]

Finally, if the hedging transaction relates to a QBU outside the United States, both the qualifying debt instrument and the hedge must be properly reflected on the books of the QBU throughout the term of the qualified hedging transaction.[91]

5. Legging in and out

The term "legging in" means that a hedge is entered into after the date the qualifying debt instrument is acquired.[92] If a taxpayer legs into integrated treatment, exchange gain or loss is realized with respect to the qualifying debt instrument. The gain or loss is determined by reference to changes in exchange rates between the date the instrument was acquired (or the date the obligor assumed its obligations) and the leg-in date. Recognition of the gain or loss is deferred until the date the qualifying debt instrument matures or is otherwise disposed of. The source and character of such gain or loss is determined on the leg-in date as if the qualifying debt instrument were actually sold or otherwise terminated by the taxpayer.

The term "legging out" of integrated treatment means the disposition or termination of all or a part of the qualifying debt instrument or hedge prior to the maturity of the qualified hedging transaction.[93] Legging out includes a change in a material term of the qualifying debt instrument or hedge. The change may be the exercise of an option to change the interest rate or the maturity date of the instrument or the exercise of an option to change the interest or exchange rates underlying the hedge.

If a taxpayer disposes of or terminates a qualified hedging transaction by disposing of or terminating both the qualifying transaction and the hedge on the same day, the taxpayer is considered to have disposed of or otherwise terminated the synthetic debt instrument. This transaction is not a leg-out.

If a taxpayer legs out of integrated treatment, the transaction is treated as a qualified hedging transaction until the leg-out date. The qualifying debt instrument is treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated and any gain or loss from the identification date to the leg-out date is realized and recognized. The spot rate on the leg-out date is used to determine exchange gain or loss thereafter. Proper adjustment to the principal amount of the debt instrument must be made to reflect any gain or loss taken into account.

If the qualifying debt instrument is disposed of or otherwise terminated, the hedge is treated as having been sold for its fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized. The spot rate on the leg-out date is used to determine exchange gain or loss on the hedge thereafter.

The part of the qualified hedging transaction that has not been terminated cannot be part of a qualified hedging transaction for any period subsequent to the leg-out date.

If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the terminated instrument, a wash sale rule is triggered. No loss is recognized on the retained position if during the 61-day period beginning 30 days before the leg-out date the taxpayer enters into another transaction that hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument.

D. *Source of income*

The source of income is important for both enterprises that are based in the United States and enterprises based abroad. For a US entity, the source of income is an important factor in determining the portion of its US tax that may be offset by foreign tax credits.[94] For foreign entities, the source of income controls the jurisdiction of the United States to impose tax. In general, a foreign entity is subject to US tax only on its US-source income[95] and its income that is effectively connected with the conduct of a trade or business in the

87. Reg. §1.988-5(a)(5)(i).
88. Reg. §1.988-5(a)(5)(ii).
89. Reg. §1.988-5(a)(8).
90. Reg. §1.988-5(a)(5)(3)(iii).
91. Reg. §1.988-5(a)(5)(3)(iv).
92. Reg. §1.988-5(a)(6)(i).
93. Reg. §1.988-5(a)(6)(ii).
94. IRC Secs. 901-904.
95. IRC Sec. 881(a).

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United States.[96] Only certain types of foreign-source income may be treated as effectively connected income.[97]

1. Notional principal contracts

In general, the source of income or loss from notional principal contracts is determined by reference to the residence of the taxpayer.[98] If a taxpayer conducts business through a QBU outside its country of residence, the source of notional principal income and loss will be the location of the QBU if the notional principal contract is properly recorded on the books of the QBU.[99] To be properly recorded, the personnel of the QBU must participate in negotiating or acquiring the notional principal contract. The source rule is illustrated by the following example.

> Corporation X is a domestic corporation that reports income under the accrual method of accounting. It uses the calendar year as its taxable year. On 1 January 1990, Corporation X enters into an interest rate swap contract with Corporation Z, an unrelated foreign corporation. Corporation X does not have a QBU outside the United States. Under the contract, Corporation X is required to pay Corporation Z fixed rate dollar amounts, and Corporation Z is required to pay X floating rate dollar amounts, each determined solely by reference to a notional dollar denominated principal amount specified under the contract.
>
> On these facts, the contract is a notional principal contract. During 1990 Corporation X reports net income from the notional principal contract income $ 100. In addition, Corporation X receives $ 5 from Corporation Z because payments are received more than 30 days late.
>
> The source of Corporation X's $ 100 of net income from the interest rate swap agreement is domestic. The $ 5 fee is not notional principal contract income. Its source may be foreign if the fee is a payment for the use of money and the equivalent of interest.

2. Currency swaps

If a notional principal contract is a Section 988 transaction because it relates to a non-functional currency, as is the case in a currency swap, the source rules of IRC Section 988 apply to determine the source of income.[100] In general, the source rule of a currency gain or loss is determined by reference to the residence of the taxpayer or the QBU on whose books the currency gain is recorded.[101] However, if the notional principal contract is part of a Section 988(d) hedge transaction that creates a synthetic debt instrument, the currency gain or loss on the swap leg will be integrated with qualified indebtedness, and to the extent of that integration, the source of the resulting income will be controlled by the identity of the borrower under the qualified indebtedness (see discussion above). To maintain the primacy of the integration concept of the hedging rules, the source rules of Section 988 take precedence over the source rules for notional principal contracts with regard to currency swaps.

3. Interest on deemed loans

If the notional principal contract is a currency swap with significant non-periodic payments or a cap or floor that is significantly in the money, the premium payment is treated as a loan (See the discussion of the in terrorem rules above. If those in terrorem rules cause a contract to include a loan feature, the loan is treated as a loan for all purposes of US tax law). As a result, there will be a hypothetical payment of interest or original issue discount as the loan is deemed to be repaid. That deemed payment of interest or original issue discount is technically income from US sources if the recipient of the premium is a US person or a US branch of a foreign corporation.[102] If the deemed recipient of the interest, i.e. the party that paid the premium, is a foreign person, US-source interest income will be subject to 30 percent withholding tax unless a benefit is extended under an income tax treaty or the interest is considered to be interest on an item of portfolio indebtedness.

4. Withholding tax on deemed interest

The deemed payor technically will be required to collect and pay over US withholding tax at the statutory rate.[103] Failure to comply with the US rules will cause the withholding agent and any officer and director considered to be a "responsible person" to be liable for the tax.

Even when an applicable income tax treaty may eliminate the tax in principle, there are compliance requirements for both the payor and the recipient of the interest. For example, in the absence of a properly completed Form 1001 which notifies the withholding agent of the applicable income tax treaty benefit, the IRS may contend that the 30 percent tax should have been withheld at the time of payment. Failure to collect tax may result in the imposition of an interest charge on the unpaid withholding tax from the due date until the first day of the next succeeding year.

5. Effectively connected income

If the taxpayer is a foreign corporation and the notional principal contract arises from the conduct of a trade or business in the United States, the income will be taken into account in computing effectively connected income.[104] As discussed more fully below, trade or business in the United States requires more than the carrying on of investment and trading activities for a foreign corporation's own account.

E. *Allocation and apportionment of expense*

Notional principal contracts must be taken into account by taxpayers when determining US or foreign-source taxable income. For US entities, the expenses allocated to foreign-source income must be computed. For foreign entities that are engaged in a trade or business in the United States, taxable income must be computed. Each computation requires that expense must be determined.

96. IRC Sec. 882(a).
97. IRC Secs. 864 and 865.
98. Reg. 1.863-7(b)(i).
99. Reg. §1.863-7(b)(2).
100. Reg. §1.867-7(a).
101. IRC Sec. 988(a)(3)(A).
102. IRC Secs. 861(a)(1)(A) and 884.
103. IRC Secs. 1441 and 1442.
104. Reg. §1.863-7(b)(3).

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1. Background

As mentioned above, US taxpayers that wish to claim the benefit of the foreign tax credit are required to determine the expenses which are allocable and apportionable to the foreign-source gross income. This enables a taxpayer to compute its foreign-source taxable income. Only US tax that is attributable to foreign-source taxable income may be offset by the foreign tax credit. Increases in the level of expenses allocated to foreign-source gross income directly reduce foreign-source taxable income. As a result, the amount of US tax that may be offset by foreign tax credits is also reduced.

Interest expense must be allocated and apportioned on a group- wide basis even if no consolidated income tax return is filed by all US members of an affiliated group. The expense is apportioned between the group's foreign-source and domestic-source income in substantial part on the basis of the tax book values of its assets and the income that may be produced by those assets. Assets that can generate foreign-source income attract an apportionment of interest expense.

Foreign entities that are engaged in a US trade or business can reduce their US tax by increasing the level of expenses. Interest expense that is allocated to the US business is one expense that may reduce taxable income.[105]

2. Integration with interest

Under a rule that is applicable to interest equivalents, any deductible expense or loss that is incurred in a transaction or in a series of integrated or related transactions in which the use of funds is secured for a period of time must be allocated and apportioned if the expense or loss is substantially incurred in consideration of the time value of money.[106] In essence, the net income or expense of a notional principal contract must be taken into account for purposes of determining the amount of interest expense that must be allocated and apportioned. This is illustrated by the following example.

> Corporation X is a domestic corporation with a dollar functional currency. On 1 January 1987, Corporation X enters into a dollar interest rate swap contract with Corporation Y, an unrelated domestic corporation.
>
> Under the terms of the agreement, Corporation X agrees to pay Corporation Y floating rate interest with respect to a notional principal amount of $ 100 for five years. In return, Corporation Y agrees to pay Corporation X fixed rate interest at 10 percent with respect to a notional principal amount of $ 100 for five years.
>
> On the settlement day, Corporation Y prepays the fixed leg of the swap by making a lump-sum payment of $ 37 to Corporation X. This lump-sum payment represents the present value of five $ 10 swap payments. Because Corporation X secures the use of $ 37 in this transaction, any net swap expense arising from the transaction represents an expense incurred substantially in consideration of the time value of money.
>
> Assuming this lump-sum payment is not otherwise characterized as a loan from Corporation Y to Corporation X, Corporation X must amortize the $ 37 lump-sum payment. Any net swap expense incurred by Corporation X over the term of the loan with respect to this transaction (i.e. the excess, if any, of Corporation X's annual swap payment to Corporation Y over the annual amortization of the $ 37 lump-sum payment) represents an expense equivalent to interest expense. The result would be the same if Corporation X sold the fixed leg to a third party for $ 37.[107]

3. Interest on deemed loans

If the notional principal contract is a currency swap with significant non-periodic payments or a cap or floor that is significantly in the money, the premium payment is treated as a loan (see the discussion of deemed interest income above). If the time value component is treated as interest expense for the payor it must be taken into account for purposes of the allocation and apportionment regulations.[108]

As with a net deduction from a notional principal contract that is the equivalent of interest expense, the allocation and apportionment of interest expense on a deemed loan likely will have the practical effect of limiting the benefit of the foreign tax credit under US tax law for a US entity.

VI. CROSS-BORDER SECURITIES LENDING

In a typical short sale transaction, a party borrows shares in return for an undertaking to return identical property at a later date. The borrowed shares are sold to a third party. Even though the shares have been borrowed, the sale is given legal effect. If a dividend is paid on borrowed stock or if interest is paid on borrowed interest-bearing debt securities, the new owner is the party legally entitled to the payment from the disbursing agent. In addition to returning equivalent property, the borrower/seller of the securities must pay to the lender/old owner an equivalent amount in lieu of the dividend or the interest.

A. *Treatment of lender*

For the lender/old owner, the transaction is given non-recognition treatment even though there has been a legally effective exchange of the securities in return for the promise of the borrower/seller to return the securities, provided that certain requirements are met.[109] In general, a written agreement must be in effect calling for (i) the return to the lender/old owner of securities which are identical to those that were lent to the borrower/seller, (ii) the payment to the lender/old owner of amounts equivalent to all interest, dividends, and other distributions to which the owner of the securities is entitled, (iii) the maintenance by the lender/old owner of the risk of loss or opportunity for gain with regard to the securities, and (iv) the termination of the loan upon notice of not more than five business days given by the lender/old owner. If these conditions are met, the transfer of ownership in the securities in return for the obligation of the borrower is acknowledged, but gain is not recognized on the borrowing or the repayment of the securities and the borrower is given a carry-over basis.

105. See Reg. §1.882-5. If too much expense is allocated to the US business, the branch profits tax of IRC Sec. 884 may apply.
106. Reg. §1.861-9T(b)(1)(i).
107. Reg. §1.861-9T(b)(1)(ii), *Example 3*.
108. Reg. §1.861-8 and following sections.
109. IRC Sec. 1058.

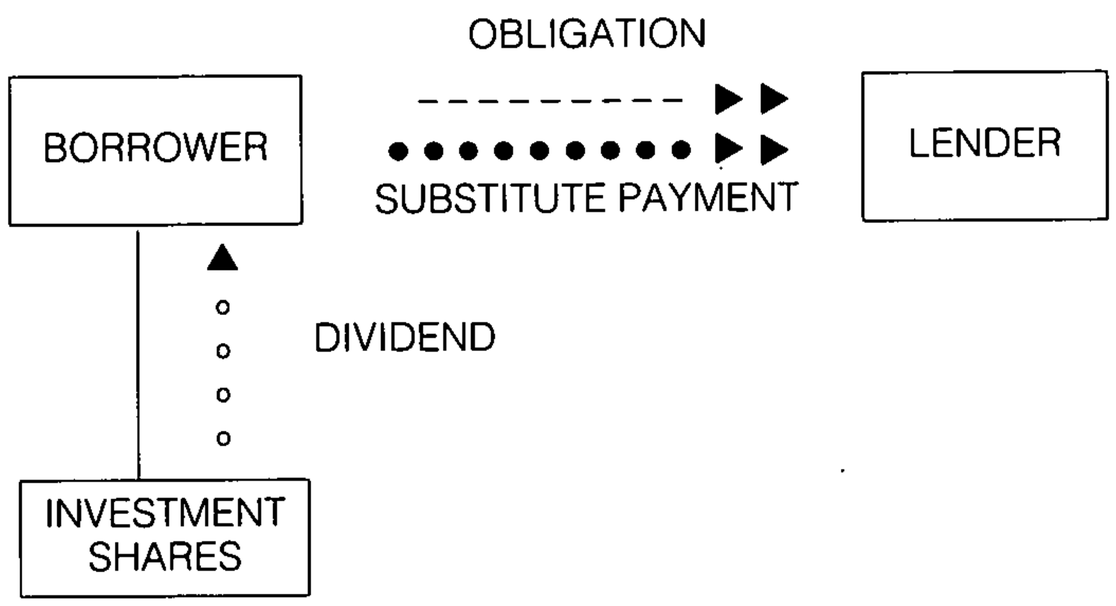
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B. *Cross-border substitute payments*

These rules have resulted in a tax saving opportunity for UK pension funds that receive substitute payments under securities lending transactions. US-source dividend income received by the foreign pension funds generally is subject to a 15 percent US withholding tax. Because the funds are exempt from tax in the United Kingdom, the withholding tax is a real cost. By taking advantage of the securities lending rules, UK pension funds have been able to convert taxable dividend income into a substitute payment. It is not clear whether a substitute payment is a dividend for tax treaty purposes. The pensions treated the substitute payment as so-called other income. Under the US/UK income tax treaty, other income of a UK resident is not subject to US tax.

Under the practice that was adopted, a brokerage house borrowed the security in return for the standard undertaking. It was treated as the owner and it received the dividend. Although the dividend might have been taxable income, the brokerage house was entitled to an offsetting deduction for the substitute payment to the lender/old owner. If the brokerage house balanced its position and sold the security to a customer under a short sale order executed on behalf of that customer, the brokerage house received a substitute payment which was passed on to the UK pension fund.

The transaction is illustrated by the following diagram.



C. *Proposed regulations*

In 1992, revisions to regulations were proposed affecting the source of income, the tax of foreign persons on investment income and the interpretation of treaties. The proposals affect the character and source of the substitute payments and are intended to limit the foregoing benefits.

For purposes of the source rule, the substitute payments are to be treated as US-source dividend income if made with regard to borrowed shares of stock[110] or as US-source interest income if made with regard to borrowed notes, bonds, debentures or other evidences of indebtedness.[111] This treatment is afforded to substitute payments made under securities lending transactions described in IRC Section 1058(a) or substantially similar transactions. Where provision of US income tax treaties refer to US domestic law for purposes of defining the term "dividend", substitute payments on borrowed shares of stock are to be included in the definition.

Substitute payments are subject to US withholding tax.[112] However, substitute interest payments may be treated as interest on portfolio indebtedness if the underlying debt obligation would be viewed to generate that type of income in the hands of the foreign person.[113] Subject to certain exceptions, interest on portfolio indebtedness is exempt from US tax in the hands of a foreign person. A Form W-8 must be provided to the withholding agent. Substitute payments are not entitled to the dividends received deduction under IRC Section 243 and are not eligible for the exclusion extended to tax-free municipal bond interest under IRC Section 103.

The regulations are to be effective with regard to transfers of securities made more than 30 days after adoption in final form. For transfers made prior to that date, a facts and circumstances test will apply.

VII. ADVANCE PRICING AGREEMENT

Tax authorities in virtually all jurisdictions have begun to review the way income from cross-border transactions is reported. They are concerned that a party entering into a multinational transaction is not paying a fair share of local tax with regard to that transaction.[114]

A. *Potential double taxation*

A dealer serving as an intermediary in the sale of a cross-border derivative product faces a real possibility of double taxation of the same profits. Regardless of where profits are booked for management or financial accounting purposes, two or more jurisdictions could contend that each has the primary right to impose tax. The problem may be illustrated by the following example.

> Investment Bank B is a dealer in derivative products. It maintains offices that are fully staffed in Hong Kong, London and New York. The offices may be branches of one corporation or may be locally incorporated affiliates of a larger group. The personnel assigned to these offices act independently to seek out customers. However, they act in concert to match the offsetting needs of those customers for foreign currency. When two customers are matched, the investment bank's London office books the counter position with each customer leaving an effectively balanced position, but for its spread. Fees also are paid by both customers and Bank B reports a profit.
>
> Whether Bank B's international operations are conducted through separately incorporated subsidiaries or through local office of one corporation, the tax exposure remains the same. No matter which office or entity formally books the profit, total profits from the transaction are exposed to tax wherever services were performed, customer relationships maintained or the financial product developed.
>
> Under the internal laws or practice in those jurisdictions, each may have a legitimate claim to tax the predominant share of the aggregate profits. To illustrate, one jurisdiction may emphasize the

110. Proposed Reg. §1.861-3(a)(6).
111. Proposed Reg. §1.861-2(a)(7).
112. Proposed Reg. §1.1441-2(a)(1).
113. Proposed Reg. §1.881-2(b)(2).
114. To put this in perspective, many of the international tax examiners recently added to the staff of the New York District Office of the IRS are alumni of the tax shelter groups that were formed during the 1980s.

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value inherent in the financial product itself. Under this view, the party owning the proprietary rights to the product should receive a royalty or an override fee for the use of the idea. Another jurisdiction may emphasize formal booking procedures, contending that form and substance are identical in this circumstance. A third may emphasize the importance of the client relations that are necessary to close a transaction.

If the tax authorities in each jurisdiction succeed in their assertions, the customary mechanism to limit the effect of double taxation – foreign tax credits in some jurisdictions, exemption of foreign-source income in other jurisdictions – may not provide adequate relief.

B. *Advance pricing agreements*

The IRS has adopted a mechanism to resolve this type of issue. It is known as the Advance Pricing Agreement (APA),[115] and in conjunction with procedures under income tax treaties known as Competent Authority Agreements, the mechanism affords taxpayers an opportunity of paying tax only once on worldwide profits.

The basic premise of the APA is that an agreement can be reached with taxpayers in applying the methodology by which profits are allocated among the members of a multinational enterprise. While the procedure has been established with a principal focus on manufacturers and distributors, APAs have been entered with at two investment banks, Sumitomo Bank Capital Markets Inc. and Barclays Bank PLC. In each instance, the APA relates to the internal pricing of derivative financial products such as cross currency swaps and interest rate swaps and allows profits from these products to be allocated among group members. As the methodology for apportioning profits is agreed in advance, the risk of double taxation disappears.

It is understood that the pricing agreement allows for profits to be computed under the mark-to-market rules such as those applicable to dealers or traders of derivative products. Those profits will be allocated to each relevant jurisdiction based on the volume of deals for each office and the number of personnel involved in the selling effort. It also is understood that a Competent Authority Agreement has been reached with Inland Revenue in the United Kingdom under which it has acquiesced in the internal pricing methodology. In addition, Sumitomo has announced that the Inland Revenue in Hong Kong has accepted the methodology of the APA.

VIII. US TAX PLANNING FOR THE FOREIGN-BASED GROUP

With planning, a foreign-based group not otherwise engaged in a trade or business in the United States should be able to trade freely in notional principal contracts without incurring a US tax liability. The income should be neither US-source fixed and determinable annual and periodical income – which is subject to 30 percent tax on the gross amount paid – nor income that is considered to be effectively connected with the conduct of a trade or business in the United States. The latter income is subject to graduated rates of tax that are imposed on net income or alternative minimum income.

A. *Fixed and determinable income*

Except for the deemed interest element that attaches to a non-periodic payment treated as a loan under the in terrorem rules for certain forms of notional principal contracts and which are discussed above, it is unlikely that income from notional principal contracts will be treated as US-source income. Under Reg. §1.863-7, that income should be foreign-source income in the hands of a foreign corporation. A similar rule should apply to currency swaps except to the extent the swap is attributable to a transaction that is effectively connected with the conduct of a trade or business in the United States.

B. *Effectively connected income*

With planning, trading stocks and securities and carrying on ancillary activities in the United States should not be considered to be the equivalent of carrying on a trade or business. The income tax regulations provide that the term "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in stocks or securities for the taxpayer's own account.[116] For this purpose, the term "security" means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing. The effecting of transactions in stocks or securities includes buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer. Any other closely related activity such as obtaining credit for the purpose of effectuating such buying, selling or trading is covered by the same rule.

It does not matter whether these transactions are effected by or through employees of the taxpayer who are present in the United States while effecting the transactions, or a broker, commission agent, custodian or other agent of the taxpayer in the United States. The answer will not change even if the employee or agent has discretionary authority to make decisions regarding trading activity or if a large volume of transactions are effected.

If, however, the principal business of the corporation is trading for its own account and the corporation is relatively widely held or is partly held by US persons, the principal office of such corporation must not be in the United States at any time during the taxable year.[117]

C. *Principal office*

In determining the location of a foreign corporation's principal office, a comparison is made of the activities (other than trading in stocks or securities) which the corporation conducts from its office located in the United States with the activities it conducts from offices located outside the United States. A foreign corporation is considered to have only one

115. Rev. Proc. 91-22, 1991-11 I.R.B. 11, as corrected by Rev. Proc. 91-22A, 1991-22 I.R.B. 27.
116. Reg. §1.864-2(c)(2)(i).
117. Reg. §1.864-2(c)(2)(iii).

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principal office, and an office outside the United States will be considered to be the principal office if it is a general business office in which management carries on all or a substantial portion of the following activities:
- communication with shareholders (including the furnishing of financial reports);
- communication with the general public;
- solicitation of sales of its own stock;
- acceptance of the subscriptions of new stockholders;
- maintenance of its principal corporate records and books of account;
- audit of its books of account;
- disbursement or payment of dividends, legal fees, accounting fees, and officers' and directors' salaries;
- publication of the offering and redemption price of the shares of stock issued by it;
- conduct of meetings of shareholders and board of directors; and
- redemptions of its own stock.

D. *Interest rate swaps*

In a private letter ruling issued on 24 October 1991, and distributed to the public in April 1992,[118] the IRS addressed whether trading in interest rate swaps was an activity that was closely related to trading in stocks and securities. If so, the trading activity would not be the equivalent of conducting a US trade or business under the above standard.

In the ruling, a non-dealer foreign partnership traded in a variety of financial instruments including interest rate swap contacts. The trades were part of an integrated investment strategy for managing interest risk within a portfolio. The IRS ruled that the trading activities did not constitute a trade or business because they were closely related to the activity of buying and selling interest-bearing securities.

The IRS viewed the interest rate swaps as being the functional equivalent of contracts or options – instruments that are specifically covered by the regulations. According to the ruling, the tax treatment for a foreign person should not differ merely because the hedging activities are comprised of swaps rather than options. The foreign entity is not engaged in a trade or business and accordingly cannot have income that is taxed as effectively connected income.[119]

If the principal office of the entity is outside the United States, the holding in the private letter ruling should apply even though the ruling related to a foreign partnership. The tests for determining the principal office of a foreign partnership are similar to the tests for corporations.

IX. CONCLUSION

Innovation in derivative instruments continues unabated, particularly in the international context. Yet the tax rules are designed and applied by persons whose reference point is the past. For them, certainty of tax treatment is a virtue that can only be attained by looking back to past transactions. Clearly, this dichotomy can result in tension. However, like Janus, the prudent tax adviser can look in both directions. When planning for the next product development, the tax adviser can assist investment bankers who are moving forward at great speed – and can keep their pace. At the same time, when looking beyond the next product to its tax consequences, the tax adviser can turn attention to the rules that exist. This two-step approach blends the drive to create with the need for certainty. To manage tax developments affecting derivative products, both skills are needed.

118. PLR 9204015. The effect of a private letter ruling as precedent is limited to the taxpayer to whom it is issued. Nonetheless, a private letter ruling demonstrates the views of the IRS at the time of issuance and has been cited by courts and the staff of Congressional committees in explaining US tax law.
119. IRC Sec. 864(c)(1)(B).

IFA NEWS

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CANADA:

THE PROPOSED NEW SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT RULES – AN UPDATE ON RESEARCH INCENTIVES

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In its February 1992 Federal Budget the Canadian government reaffirmed its commitment to encourage scientific research and experimental development (SR & ED)[1] and announced it was studying ways of making the tax incentives applicable to SR & ED less restrictive. On 5 October 1992 draft legislation and regulations were released, which were subsequently amended and re-released on 2 December 1992. According to the Minister of Finance, these changes "will help create a framework within which Canadian companies can take on the world and win".

For the most part, the changes expand and clarify the tax incentives available for SR & ED, and make it easier for some taxpayers to claim an investment tax credit. The proposed changes do not reflect any drastic changes in the scope or nature of Canada's already generous system of tax incentives for research.

Contents

I. Overview of Incentives for Promoting SR & ED

II. Section 37 Deduction of SR & ED Expenses
- A. What is SR & ED?
- B. Expenditures on domestic SR & ED
- C. Expenditures on SR & ED carried on outside Canada

III. Investment Tax Credits for SR & ED
- A. Qualified expenditures
- B. Claiming ITCs with respect to SR & ED

IV. Refund of ITCs

V. Conclusion

I. OVERVIEW OF INCENTIVES FOR PROMOTING SR & ED

Canada's Income Tax Act (the Act)[2] contains three basic types of incentives for promoting R & D:

- deductions can be claimed for expenditures that qualify as SR & ED expenses (under Section 37 of the Act);
- investment tax credits (ITCs) can be claimed with respect to qualifying R&D expenditures (under Section 127 of the Act); and
- refundable investment tax credits can be claimed in certain circumstances (under Section 127.1).

The ability to deduct an amount with regard to qualifying SR & ED expenditures can be carried forward indefinitely and applied against future income.[3] ITCs can be carried back three years and forward ten years.[4] Furthermore, under Canada's system of refundable tax credits, individuals, certain trusts[5] and certain corporations can opt to have their ITCs refunded rather than carry them forward.[6]

II. SECTION 37 DEDUCTION OF SR & ED EXPENSES

A. *What is SR & ED?*

Before determining whether a taxpayer can claim deductions for SR & ED it is necessary to consider what types of activities constitute SR & ED, as well as what expenditures in support of SR & ED activities qualify for deduction under Section 37.

The Regulations define SR & ED as "systematic investigation or search (sic) carried out in a field of science or technology by means of experiment or analysis".[7] Currently, three basic activities are considered SR & ED under the Regulations:

- basic research, which is research performed for the advancement of scientific knowledge without a specific practical application in view;[8]
- applied research, which is research performed for the advancement of scientific knowledge with a specific practical application in view;[9] and

1. The term "Scientific Research & Experimental Development" was substituted in the 1985 federal budget for "research & development" (and consequently throughout the Income Tax Act thereafter). According to the government, this change was made to reinforce the idea that projects involving only routine engineering or routine development are excluded from the tax incentive programmes.
2. Income Tax Act (Canada), R.S. C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended [hereinafter the Act].
3. Sec. 37(1).
4. Sec. 127(9) definition of investment tax credit, specifically subpara. (c)(ii) thereunder.
5. Sec. 127.1(2) definition of refundable investment tax credit, specifically subsec. (a)(iii) thereunder.
6. Sec. 127.1(2) definitions of refundable investment tax credit and of qualifying corporation.
7. Reg. Sec. 2900(1).
8. Reg. Sec. 2900(1)(a).
9. Reg. Sc. 2900(1)(b).

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– experimental development, which is research performed for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes.[10]

Under the existing Regulations there has been uncertainty as to whether research that yields only incremental improvements in technological advancement is included in SR & ED. The Draft Regulations specifically state that such research is included in SR & ED.[11]

Work with respect to engineering, design, operations, research, mathematical analysis, computer programming, data collection (other than of a routine nature), testing and psychological research also qualify as SR & ED if performed in direct support of otherwise qualifying activities.[12] For clarification, the Draft Regulations have added the requirement that for such work to be considered SR & ED it must be commensurate with the needs of, and directly in support of, qualifying SR & ED activities.[13] Activities such as market research, sales promotion, quality control, routine testing, research in the social sciences, and prospecting and exploring for minerals, petroleum or natural gas, are specifically excluded from the definition of SR & ED.[14]

It is important for taxpayers to properly identify activities that qualify as SR & ED. Whether an activity qualifies is determined based on an examination of the nature and characteristics of the activity itself.[15] Guidance regarding identification of eligible activities can be found in Revenue Canada's Information Circular IC 84-4R2, which was issued 29 August 1988. The circular sets out Revenue Canada's administrative position concerning the criteria that must be met in order for any activity to be considered SR & ED. The criteria include: scientific or technological advancement;[16] the presence of scientific or technological uncertainty;[17] a systematic programme of investigation, i.e. from hypothesis formulation through testing and experimentation to the state of logical conclusions.[18] Revenue Canada also notes that when determining whether a particular activity constitutes SR & ED, it is not sufficient to merely look at the overall purpose of the activity or programme. Instead, what is relevant is whether the particular activity, at a technical level, is SR & ED.[19]

When considering the deductibility of expenses incurred in SR & ED it is important to distinguish between expenditures incurred for SR & ED carried on in Canada and expenditures on SR & ED carried on outside of Canada. This distinction is significant because current and capital expenditures incurred with respect to SR & ED carried on in Canada[20] (hereafter domestic SR & ED)[21] are pooled and may be carried forward indefinitely and applied against income from any other business carried on by the taxpayer, so long as the taxpayer carried on business in Canada when claimed.[22]

Expenditures incurred with respect to SR & ED carried on outside of Canada do not get pooled and can only be deducted in the year incurred,[23] i.e. they cannot be carried forward. (As will be seen below under III. "Investment Tax Credits for SR & ED", ITCs are not available with respect to expenditures on foreign SR & ED either.) The tax treatment of expenditures for domestic SR & ED and for SR & ED carried on outside Canada are discussed separately below.

It should be noted that no deduction can be claimed under Section 37 for expenditures incurred by a taxpayer to purchase the results of a scientific research programme in which the taxpayer did not participate.[24] In addition, expenditures to acquire patents and other forms of intellectual property protection related to the results of SR & ED are not deductible under Section 37. Such costs (i.e. costs for patents and certain expenditures on SR & ED) may, however, be deductible or amortizable under other provisions in the Act.[25]

B. *Expenditures on domestic SR & ED*

As noted above, domestic SR & ED expenditures are pooled. The size of the pool can vary. For example, new expenditures on domestic SR & ED get added to the pool, while deductions are made for such things as ITCs earned with respect to qualifying SR & ED expenditures.

1. Additions to the pool

Adding an amount to the pool has the effect of allowing the taxpayer a deduction for that expense.[26] Therefore, throughout this portion of the article, references to deductible expenditures mean expenses that are added to the pool.

Basically, an expenditure incurred for SR & ED carried on in Canada will qualify as a domestic SR & ED expense (and therefore be eligible for addition to the SR & ED pool) if all or substantially all (which is generally considered to be greater than 90 percent) of the expense is attributable to:[27]

10. Reg. Sec. 2900(1)(c).
11. Draft Reg. Sec. 2900(1)(c).
12. Reg. Sec. 2900(1)(d).
13. Draft Reg. Sec. 2900(1)(d).
14. Reg. Sec. 2900(1)(d)-(j).
15. Information Circular IC 86-4R2, para. 2.6.
16. Id. at para. 2.10.1.
17. Id. at para. 2.10.2
18. Id. at para. 2.10.3.
19. Id. at para 2.8.
20. Sec. 37(1).
21. It should be noted that the expression "domestic SR & ED" is not a term used under the Act. It is merely a convenient way to refer to SR & ED that is "carried on in Canada", which is the expression used throughout the Act and Regulations.
22. Preamble to Sec. 37(1). It is interesting to note that prior to the 1987 Tax Reform a carried forward amount could only be deducted by a taxpayer in a year if the taxpayer made some expenditures on SR & ED in the year the deduction was claimed.
23. Sec. 37(2).
24. Sec. 37(4).
25. For example, patents that have a limited life can be depreciated as a Class 14 asset under Canada's capital cost allowance system. A payment made to obtain a patent is added to the capital cost of the patent and can therefore be depreciated along with the cost of the patent. If, however, the taxpayer pays to acquire a business, for example, and does not obtain an existing patent, but only the right to apply for a patent, the taxpayer cannot add the acquisition cost to the cost of the property. Such amount may, however, qualify as an eligible capital expenditure, which would mean that three-fourths of the cost could be amortized on a declining balance basis at 7% per year. For more information on the tax treatment of patents, see Revenue Canada's Interpretation Bulletin IT-477.
26. Sec. 37(1).
27. Sec. 37(7)(c)(ii).

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- the prosecution of SR & ED in Canada; or
- the provision of premises, facilities or equipment for the prosecution of SR & ED in Canada.

Such expenditures on domestic SR & ED can be deducted if either the SR & ED was directly carried out by the taxpayer or if it was carried out on behalf of the taxpayer.[28] To the extent that the SR & ED is performed by someone else on behalf of the taxpayer, in order to deduct the expense (i.e. add the amount to its pool), the taxpayer must be entitled to exploit the results of the SR & ED.[29]

Generally, the SR & ED must be related to the taxpayer's business. However, a corporation can deduct SR & ED expenses it incurs for SR & ED it performs for a related corporation. This allows a corporate group to form a separate corporation to carry on the group's research while allowing the separate corporation to deduct the SR & ED expenses even though the research is not related to its own business per se.[30]

(a) *Current expenditures*

Current expenditures that are considered "directly attributable" to SR & ED carried on in Canada are also added to the pool.[31] The Regulations describe what expenditures are considered directly attributable to the carrying out of SR & ED. Among the expenses described as directly attributable are the cost of materials consumed,[32] the salaries and wages paid to or for employees who directly carry on or supervise the SR & ED,[33] and other expenditures directly related to the prosecution of SR & ED that would not have been incurred if the SR & ED were not carried on.[34] There has been some confusion in interpreting this provision. For example: if a taxpayer has a building it uses 30 percent to carry out SR & ED activities and 70 percent for administrative purposes, it could be argued the taxpayer would not be able to add any of its utility costs associated with the building to its SR & ED pool because such costs would have been incurred regardless of the SR & ED activities. This is obviously a harsh result. A change proposed in the Draft Regulations clarifies that, applicable to taxation years after 1990, a *portion* of an expenditure may be considered directly attributable to SR & ED, so long as the portion of the expenditure is directly related to the SR & ED.[35]

Currently, the Regulations also specify that expenditures incurred for the provision of premises, facilities or equipment for the prosecution of SR & ED, including the cost of maintenance and upkeep of such property[36] and other expenditures directly related to such property that would not have been incurred if the SR & ED were not carried on, can be deducted.[37] These Regulations are also being clarified to state that, applicable to the 1990 and subsequent taxation years, a *portion* of an expenditure that directly relates to the provision of premises, facilities or equipment can be deducted.[38]

The Regulations concerning expenses "directly attributable" to SR & ED have generally been interpreted to include overhead expenses. However, the compliance burden on taxpayers to support their claim for overhead expenditures related to SR & ED is significant. According to the Department of Finance, the issue of allocation of overhead expenses that could be considered "directly attributable" to SR & ED has been one of the most problematic areas for small businesses.[39] Taxpayers who are unable to effectively track overhead expenditures can take advantage of a new method of calculating the SR & ED pool (discussed below under the heading "Proposed elective method"). Under the new method, taxpayers effectively forgo the ability to add an amount to the SR & ED pool for overhead expenses, but they are permitted, instead, to claim ITCs on an amount (the prescribed proxy amount) in lieu of actual overhead expenses.

(b) *Capital expenditures*

Under the current rules, most capital expenditures incurred for domestic SR & ED are deductible if they are for SR & ED related to the taxpayer's business and so long as greater than 90 percent of the expense is attributable to the prosecution of SR & ED in Canada or to the provision of premises, facilities or equipment for the prosecution of SR & ED in Canada.[40] Certain capital expenses cannot be claimed, however.[41] For example, expenses incurred for most buildings[42] (including leasehold interests) and rental expense incurred in respect of most buildings cannot be claimed. In addition, payments made to certain non-arm's length parties, e.g. non-profit research corporations, approved research institutes or approved associations, do not qualify to the extent that the expenditure is used to acquire a building or leasehold interest in a building.[43]

Proposed changes in the legislation clarify *when* expenditures of a capital nature in respect of premises, facilities and equipment will be included in the SR & ED pool.[44] Under the proposals, such a capital expense will be deductible if, at the time the expense was incurred:

- it was intended that the premises, facilities or equipment would be used greater than 90 percent of its operating time on domestic SR & ED, or
- greater than 90 percent of the value of the property would be consumed in the carrying out of domestic SR & ED.[45]

28. Sec. 37(1)(a)(i).
29. Sec. 37(1)(a)(ii).
30. Sec. 37(1.1).
31. Sec. 37(7)(c)(ii)(B).
32. Reg. Sec. 2900(2)(a).
33. Reg. Sec. 2900(2)(b).
34. Reg. Sec. 2900(2)(c).
35. Draft Reg. Sec. 2900(2)(b) and (c).
36. Reg. Sec. 2900(3)(a).
37. Reg. Sec. 2900(3)(b).
38. Draft Reg. Sec. 2900(3)(b).
39. See "1992 Proposals for SR & ED Tax Incentives: A Ten-Year Retrospective" at 19-20, by Gerard J. Lalonde, Chief, Business, Personal and Property Income, Tax Legislation Division, Department of Finance, Ottawa, paper No. 6 presented at the Canadian Tax Foundation's Ontario Tax Conference 1992 (8-9 October 1992).
40. Sec. 37(1)(b) and (7)(c)(ii)(A).
41. Sec. 37(7)(f).
42. Expenditures on certain "special-purpose buildings", which are defined in the Regulations, qualify for deduction.
43. Sec. 37(7)(f)(ii).
44. Draft Legislation Sec. 37(7)(c)(ii)(A)(III).
45. Id.

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Because the deductibility of a capital expense is based on the intent at the time the expense is incurred, unexpected changes in circumstance should not affect the determination of what expenditures qualify for inclusion in the pool. In other words, so long as the intent when the expenditure was incurred was that the property would be used greater than 90 percent of the time on domestic SR & ED, if the use changes over time, this should not affect its inclusion in the pool. These proposals are to be applicable with respect to taxation years ending after 2 December 1992.

The maximum that can be added to the pool for capital expenditures is basically limited to the lesser of the capital expenditures made in Canada in the year and the undepreciated capital cost of the capital property as of the end of the taxation year.[46]

Capital property that was acquired by an expenditure for which the taxpayer can claim an SR & ED deduction is not eligible for depreciation under Canada's capital cost allowance (CCA) system.[47] However, like a depreciable asset subject to CCA, each such capital property is deemed to be in its own CCA class and when such a property is disposed of the taxpayer may have to recognize recapture.[48]

(c) *Proposed elective method*

The draft legislation contains a so-called elective method for determining what SR & ED expenditures can be added to the pool.[49] According to the Department of Finance's press release initially announcing the draft proposals, the elective method will be simpler for many taxpayers. Under the elective method, taxpayers basically forego their claim to overhead expenses under Section 37 in exchange for the ability to claim ITCs with regard to the "prescribed proxy amount".

The items that can be added to the pool under the elective method are basically a combination of the items currently set forth in the Act and those currently set forth in the Regulations. One big difference, however, is the removal of the ref rence to expenses of a current nature that are "directly attributable" to SR & ED.

Under the proposed elective method the following expenditures are added to a taxpayer's domestic SR & ED pool:

(1) current expenditures incurred by the taxpayer in respect of the purchase or lease of premises, facilities or equipment (other than expenditures for general purpose office equipment or furniture), so long as greater than 90 percent of the premises, facilities or equipment are used for domestic SR & ED;[50]

(2) expenditures in respect of the prosecution of domestic SR & ED carried out on behalf of the taxpayer;[51]

(3) capital expenditures incurred for the provision of premises, facilities or equipment (other than expenditures for general purpose office equipment or furniture) if, at the time the expense was incurred, it was intended that either:
   - the premises, facilities or equipment would be used greater than 90 percent of its operating time on domestic SR & ED, or
   - greater than 90 percent of the value of the property would be consumed in the carrying out of domestic SR & ED;[52]

(4) expenditures on salary, wages or related benefits of employees directly engaged in domestic SR & ED to the extent that such amounts can reasonably be considered to relate to such work, having regard to the time spent by the employee on the SR & ED, including time spent in the management of SR & ED;[53]

(5) expenditures on materials consumed in the prosecution of domestic SR & ED;[54] and

(6) one-half of current expenditures in respect of the purchase or lease of premises, facilities or equipment (other than general purpose office equipment or expenditures described in item (1) above), so long as the premises, facilities or equipment are used more than 50 percent in domestic SR & ED.[55]

According to the explanatory notes accompanying the proposals, expenditures of a general overhead nature are not accounted for under the elective method, even if such expenses would normally be considered directly attributable to the prosecution of domestic SR & ED or the provision of premises for the prosecution of domestic SR & ED.[56] The Department of Finance points out, however, that to the extent that a taxpayer chooses to use the new elective method, the taxpayer will be eligible for tax relief with regard to overhead expenses through the prescribed proxy amount mechanism available under the ITC provisions. (The prescribed proxy amount, which is only available to taxpayers who use the elective method, is explained below under the heading: "Prescribed Proxy Amount".)

Obviously, there are trade-offs in choosing the elective method. First, the taxpayer's SR & ED pool will be smaller because of the exclusion of overhead expenses under the elective method. Of course, such amounts not added to the SR & ED pool can still be deducted as business expenses. (This, in itself, may create another trade off: for corporations in a loss position, amounts deducted as normal business expense will increase a corporation's losses. Such business losses can be carried forward seven years.[57] On the other hand, amounts included in the SR & ED pool, to the extent that they are not used to offset income in the current year, can be carried forward indefinitely.) However, to the extent that a taxpayer does not have a sophisticated information system for tracking such expenses, using the elective method will

46. Sec. 37(1)(b).
47. Reg. Sec. 1102(1)(d).
48. Sec. 37(6). Recapture will be recognized if the proceeds of disposition are greater than the cost of the property and any deductions under Sec. 37(1)(b) previously taken with respect to that property.
49. Draft Legislation Sec. 37(7)(c)(ii)(B).
50. Draft Legislation Sec. 37(7)(c)(ii)(B)(I).
51. Draft Legislation Sec. 37(7)(c)(ii)(B)(II).
52. Draft Legislation Sec. 37(7)(c)(ii)(B)(III).
53. Draft Legislation Sec. 37(7)(c)(ii)(B)(IV).
54. Draft Legislation Sec. 37(7)(c)(ii)(B)(V).
55. Draft Legislation Sec. 37(7)(c)(ii)(B)(VI).
56. See the Technical Notes accompanying the draft proposals, especially regarding new Sec. 37(7)(c)(ii)(B).
57. Sec. 111(1)(a).

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entitle the taxpayer to special treatment (i.e. ITCs) with regard to a portion of its overhead-type expenses.

The alternative method is to be applicable to taxation years ending after 2 December 1992. To take advantage of the alternative method, a taxpayer will have to file the appropriate election form annually with its tax return.[58]

2. Deductions from the pool

Certain amounts must be subtracted from the SR & ED pool. For example, government assistance the taxpayer received or is entitled to receive in respect of SR & ED expenditures must be deducted from the pool.[59] Grants, subsidies, forgivable loans and deductions from tax are among the items included in the definition of "government assistance".[60] Non-government assistance, such as reimbursements and inducements, are also subtracted from the pool.[61] To the extent that a taxpayer repays any government or non-governmental assistance, however, the taxpayer can add the amount back to the pool.[62] As noted earlier, the pool is also decreased by any ITCs claimed in respect of SR & ED.[63]

The proposed legislation also requires that ITCs claimed on the so-called "prescribed proxy amount" (described in detail below) must be subtracted from the pool.[64]

3. Claiming the SR & ED deduction for domestic research

If the taxpayer's pool is negative after all of the above items are subtracted, the taxpayer must include in income the negative amount.[65] Requiring the taxpayer to include such amounts in income is similar to the recapture of excess depreciation claims under the capital cost allowance system.

To the extent that a taxpayer's domestic SR & ED pool is positive, the pool amount can be carried forward and applied against future years' income. SR & ED expenditures cannot be carried back, *per se*. A taxpayer that is in a loss position, however, may want to claim the SR & ED expenditure to trigger a non-capital loss, which can be carried back three years.[66]

The carryforward of the SR & ED pool by a corporate taxpayer is restricted if the control of the corporation is acquired. Similar to the restrictions on loss carryforwards after a change in control, a taxpayer's SR & ED pool can be carried forward and set-off against income from a taxation year after the change in control only if the business to which the expenditures relate is carried on by the corporation for profit after the change in control, and only to the extent of its income for the year from that or a similar business.[67]

C. *Expenditures on SR & ED carried on outside Canada*

Expenditures of a current nature for SR & ED carried on outside Canada can be deducted in the year incurred.[68] Such expenditures are deductible regardless of whether the SR & ED is carried on directly by the taxpayer or by another party on the taxpayer's behalf, so long as the taxpayer is entitled to exploit the results of the research. Like expenditures on domestic SR & ED, the deduction for current expenses on SR & ED carried on outside Canada can be used to offset a taxpayer's income from any business.[69] Expenditures of a capital nature for SR & ED carried on outside Canada cannot be deducted.

Under the Act, payments made to non-residents can be subject to withholding tax of 25 percent. Payments made to non-residents for SR & ED are exempt from the withholding tax if the person making the payment and the non-resident have entered a bona fide cost-sharing arrangement where the parties share the R & D expenses in exchange for an interest in any or all property that results from the research.[70]

III. INVESTMENT TAX CREDITS FOR SR & ED

The second type of tax incentive for SR & ED is under the Act's system of investment tax credits.[71] Basically, a taxpayer can claim an ITC for "qualified expenditures", which is currently defined as expenditures on SR & ED that qualify for inclusion in the taxpayer's SR & ED pool.[72] The rate of the tax credit depends on the type of taxpayer and the location in which the SR & ED is carried out. No ITCs can be claimed with regard to expenditures on foreign SR & ED. (The ITC rates as well as rules regarding how to claim ITCs are set forth below under the heading: II. "Claiming ITCs with respect to SR & ED".)

A. *Qualified expenditures*

One of the most significant changes announced in the draft legislation is the broadening of the definition of "qualified expenditures" for ITC purposes. In addition to being able to claim ITCs with regard to expenditures that currently qualify for inclusion in a taxpayer's SR & ED pool, under the proposed legislation two additional amounts will also be considered qualified expenditures for ITC purposes:[73]

- amounts representing a portion of the capital cost of certain "shared-use-equipment"; and
- an amount representing the so-called "prescribed proxy amount".

58. Draft Legislation Sec. 37(9).
59. Sec. 37(1)(d).
60. Sec. 127(9) definition of government assistance.
61. Secs. 37(1)(d), 127(9) definition of "non-government assistance" and Sec. 12(1)(x).
62. Sec. 37(1)(c).
63. Sec. 37(1)(e).
64. Draft Legislation Sec. 37(1)(e).
65. Sec. 12(1)(v).
66. Sec. 111(1)(a).
67. Sec. 37(1)(h) and (6.1).
68. Sec. 37(2).
69. Prior to the 1987 tax reform, current expenditures on SR & ED carried on outside Canada could only be deducted from the taxpayer's income from the particular R & D business.
70. Sec. 212(1)(d)(viii).
71. The discussion regarding ITCs in this paper is limited to those ITCs that relate to scientific research and experimental development. ITCs available for other activities, such as those applicable for investment in manufacturing and processing activities, are not considered herein.
72. Sec. 127(9) definition of "qualified expenditure".
73. Draft Legislation Sec. 127(9) definition of "qualified expenditure".

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1. Shared-use equipment

One of the main complaints raised regarding Canada's ITCs for SR & ED is that little allowance is made under the current system for equipment that is purchased for use in both SR & ED and non-SR & ED production. Currently, expenditures on equipment that is used for non-SR & ED qualify for ITCs only if the non-SR & ED use is less than ten percent.

Under the proposals, a portion of the cost of depreciable equipment that is used in part for SR & ED and in part for other production will be considered "qualified expenditures" for the first two taxation years that such equipment is used, so long as the equipment is used "primarily" (i.e. greater than 50 percent) for the prosecution of SR & ED in Canada. The test for determining whether shared-use equipment is used primarily for SR & ED in Canada is to be based on the actual use of the property in the year the ITC claim is made, not the intended use at the time the equipment is purchased (as is the case for determining the inclusion of capital expenditures in the SR & ED pool).[74]

The proposed provisions speak in terms of claiming ITCs with regard to a portion of expenditures on "first term shared-use-equipment" and "second term shared-use-equipment". Basically, "first term shared-use-equipment" is shared-use equipment that was used primarily (i.e. greater than 50 percent) for SR & ED in Canada during the period from the time the property was acquired (and available-for-use) and ending at the end of the first taxation year that is at least 12 months from the time it was acquired. "Second term shared-use-equipment" is first term shared-use-equipment that is used during the second taxation year after its acquisition. Property that was not used within its first 12 months primarily for SR & ED, but which is used greater than 50 percent for SR & ED in the second year cannot be considered second term shared-used-equipment, since it was not "first term shared-use-equipment".

Under the proposals, buildings and leasehold interests in buildings, and property that is used for SR & ED during the assembly, construction or commissioning of a commercial facility that will be used (or consumed) during its useful life primarily (greater than 50 percent) for non-SR & ED activities, are specifically precluded from qualifying as "first term shared-use-equipment".[75]

If a taxpayer has first or second term shared-use-equipment, one-fourth of the capital cost of the equipment will be treated as a qualified expenditure, and therefore will be eligible for an investment tax credit, in the first or second taxation year, as the case may be.[76] The provisions regarding shared-use property are to be applicable with respect to purchases made after 2 December 1992.

The capital cost of shared-use property will have to be reduced by any government or non-government assistance that the taxpayer receives (or expects to receive) if the assistance is in respect of, or for the acquisition of, such property.[77] Furthermore, to the extent that ITCs are claimed in respect of such shared-use property, the undepreciated capital cost of that property's CCA class must also be reduced.[78]

2. The prescribed proxy amount

Under the current system, taxpayers can claim ITCs with regard to overhead expenses related to SR & ED to the extent that the overhead expenses are included in the SR & ED pool. As explained under the description of how to calculate the SR & ED pool, overhead expenses that are "directly attributable" to domestic SR & ED can be added to the pool, but taxpayers must track the actual overhead expense and be able to provide supporting documentation to justify their claims. This has proven to be one of the most difficult areas with which taxpayers have had to comply.

To alleviate compliance problems associated with tracking overhead expenses, the concept of the "prescribed proxy amount" is being introduced. Basically, taxpayers who calculate their SR & ED pool using the new elective method can claim ITCs with regard to overhead expenses using a simple formula based on wages and salaries of employees.[79] Therefore, for taxpayers choosing the elective method, the prescribed proxy amount is basically in lieu of adding overhead expenses to the SR & ED pool, and no supporting documentation for the actual overhead expenses will be required.

The prescribed proxy amount is 65 percent of the total portion of salaries and wages of employees that are directly engaged in SR & ED in Canada.[80] The portion of an employee's salary that is included in the formula is based on the time spent by the employee in the execution of SR & ED activities. Employment benefits and remuneration based on profits or bonuses are not included in the calculation of salary for purposes of the prescribed proxy amount.[81] The amount of salary of a "specified employee" (defined as a person who either does not deal at arm's length with the taxpayer or who owns ten percent or more of any class of shares of the corporation)[82] that can be included in the prescribed proxy amount is limited.[83]

The prescribed proxy amount must be reduced by the amount of governmental or non-governmental assistance the taxpayer receives (or can expect to receive) that can reasonably be considered in respect of expenditures that the prescribed proxy amount is considered in lieu of.[84]

And finally, if the taxpayer claims an ITC in respect of the prescribed proxy amount, in the year following that in which the credit is claimed, the SR & ED pool must be reduced by

74. Draft Legislation Sec. 127(9) definitions of "first term shared-use-equipment" and "second term shared-use-equipment".
75. Draft Reg. Sec. 2900(9).
76. Draft Legislation Sec. 127(11.1)(e).
77. Draft Legislation Sec. 127(11.1)(e).
78. Sec. 13(7.1).
79. Draft Legislation Sec. 127(11.1)(f) and Draft Reg. Sec. 2900(4).
80. Draft Reg. Sec. 2900(4).
81. Draft Reg. Sec. 2900(7).
82. Draft Legislation Sec. 248(1) definition of "specified employee".
83. Under Draft Reg. Sec. 2900(5), the limitation is the lesser of two amounts: (i) 75% of the salary and wages of the specified employee, and (ii) 2.5 times the Year's Maximum Pensionable Earnings (YMPE), which is set under the Canada Pension Plan legislation. The YMPE amount is indexed, and for 1993 it is $ 33,400. So, if a specified employee's income is less than $ 111,333, the maximum amount that can be included in the proxy amount will be 75% of the salary and wages. If the specified employee's wages are greater than $ 111,333 for 1993, a maximum of 2.5 times the YMPE, i.e. $ 83,500, will be included.
84. Draft Legislation Sec. 127(11.1)(f).

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the amount of the ITC claimed with regard to the prescribed proxy amount.[85]

B. *Claiming ITCs with respect to SR & ED*

As noted, the rate of the tax credit depends on the type of taxpayer and the location in which the SR & ED activities are carried out. For Canadian-controlled private corporations whose taxable income in the year before the ITC is claimed is $ 200,000 or less (including the income of associated corporations), the rate of the tax credit is 35 percent of the SR & ED[86] up to the corporation's expenditure limit, which is $ 2 million (and which must be shared by associated corporations).[87] For all other taxpayers (including corporations whose taxable income in the year before the ITC is claimed exceeds $ 200,000), the rate of the credit is 30 percent for SR & ED carried out in the Atlantic Provinces[88] and the Gaspé Peninsula[89] and 20 percent for SR & ED carried out anywhere else in Canada.[90]

In determining the amount of ITC available, government and non-government assistance that the taxpayer receives (or can expect to receive) that is related to the property or the qualified expenditures must be deducted.[91] (Of course, to the extent that such assistance was deducted in computing the prescribed proxy amount or the capital cost of shared-use-equipment, the amount need not be deducted again.)[92] To the extent that the taxpayer subsequently repays such assistance, the re-paid amounts are added back to the ITCs available.[93]

Since 1988, the amount of the ITCs that can be claimed in a taxation year has been limited by the taxpayer's "annual investment tax credit limit". The amount of the annual investment tax credit limit depends on whether the taxpayer is a corporation (with different amounts available for Canadian-controlled private corporations) or another type of taxpayer. Basically, a corporation can claim ITCs of up to three-fourths of the amount of income tax that is payable for the year (exclusive of the federal surtax) on its tax otherwise payable.[94] Canadian-controlled private corporations (CCPCs) can claim an additional amount equal to three percent of the amount of income eligible for the small business deduction, which is generally the first $ 200,000 of the corporation's active business income (including that of associated corporations).[95]

The annual investment tax credit limit for other taxpayers is $ 24,000 plus three-fourths of income tax payable in excess of $ 24,000.[96] Individuals can also use ITCs to offset up to three-fourths of the federal surtax.[97]

Unused ITCs can be carried back three years and carried forward ten years.[98]

IV. REFUND OF ITCs

Under Canada's refundable investment tax credit provisions, certain taxpayers who earn ITCs have the choice of receiving a cash refund equal to a portion of the ITC they could claim, instead of using the ITC to offset their tax liability. This mechanism provides a cash flow benefit to qualifying taxpayers and is an attractive alternative for taxpayers who cannot currently use a tax credit.

Under Section 127.1 of the Act, individuals, "qualifying corporations", and certain trusts[99] are eligible for refunds of ITCs related to SR & ED. Corporations that were Canadian-controlled private corporations throughout the year are considered qualifying corporations, so long as their taxable income in the year prior to claiming the refundable ITCs did not exceed $ 200,000 (including income of associated corporations).[100]

The amount of the ITC refund that can be claimed depends on the type of taxpayer and the nature of ITC claimed. For individuals, certain trusts and qualifying corporations, the refund rate for ITCs relating to SR & ED is 40 percent.[101] Qualifying corporations can also claim refunds of 100 percent of ITCs earned for SR & ED expenditures that are not of a capital nature.[102]

To claim a refundable ITC the taxpayer must file a prescribed form with its annual income tax return.[103] On filing the form the taxpayer is deemed to have paid tax in an amount equal to the amount of the refundable ITC claimed. Therefore, to the extent that a taxpayer is considered to have overpaid its tax liability, a cash refund is made. Of course, the amount of ITCs otherwise available for deduction will be reduced to the extent that a refundable ITC is claimed.[104]

V. CONCLUSION

The proposed changes to the incentive provisions concerning SR & ED do not reflect a change in government policy. Instead, they merely clarify existing assessing practice, with a view to simplifying compliance requirements placed on taxpayers.

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85. Draft Legislation Sec. 37(1)(e).
86. Sec. 127(10.1).
87. Sec. 127(10.2).
88. The Atlantic provinces are: Newfoundland, New Brunswick, Nova Scotia, and Prince Edward Island.
89. Sec. 127(9)(e)(iv)(A) under the definition of "specified percentage".
90. Sec. 127(9)(e)(iv)(B) under the definition of "specified percentage".
91. Draft Legislation Sec. 127(11.1)(b) and (c) clarify that the assistance need only be reasonably considered to relate to the property or qualified expenditures to require deduction.
92. Draft Legislation Sec. 127(11.1)(c).
93. Sec. 127(9) definition of "investment tax credit", specifically para. (e.1) thereunder, and Draft Legislation Sec. 127(9) definition of "investment tax credit", para. (e.2).
94. Sec. 127(9) definition of "annual investment tax credit limit", specifically subpara. (a)(i) thereunder.
95. Id. at subpara. (a)(ii).
96. Id. at para. (b).
97. Sec. 180.1(1.2).
98. See Sec. 127(9) definition of "investment tax credit", specifically subpara. (h)(iii) thereunder.
99. Trusts qualify so long as the beneficiaries of the trust are either individuals or a qualifying corporation. Sec. 127.1(2) definition of "refundable investment tax credit", specifically subpara. (a)(iii) thereunder.
100. Sec. 127.1(2) definition of "qualifying corporation".
101. Sec. 127.1(2) definition of "refundable investment tax credit", specifically subparas. (a)(i) through (a)(v) thereunder.
102. Sec. 127.1(2) the definition of "refundable investment tax credit", specifically subparas. (a)(vi) and (vii).
103. Sec. 127.1(1).
104. Sec. 127.1(3).

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As of 30 January 1993, the proposals remain in draft legislation form. Though there has been no indication as to the timeframe in which a bill will be presented to Parliament, based on the government's stated commitment to fostering scientific research and experimental development, it is likely that a bill will be submitted in the near future. Of course, further refinements and changes are always possible, so readers are cautioned to seek professional advice before implementing any changes based on the draft legislation discussed herein.

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PEOPLE'S REPUBLIC OF CHINA:

THE NEW LAW ON TAX ADMINISTRATION

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Contents

I. Features of the ATC Law
- A. Uniform application to all taxpayers
- B. Powers of the tax authorities
  1. Organization of the STB
  2. Discretionary powers
  3. Tax collection powers
- C. Restricting the powers of the local government
- D. Declaration of taxpayers' rights and obligations and duties of the tax authorities
  1. Taxpayers' rights and obligations
  2. Duties of tax officials

II. Tax Administration
- A. Tax registration
- B. Books and records
- C. Returns
- D. Assessment
- E. Payment of tax
  1. Tax payment in respect of payments to residents of China
  2. Withholding tax in respect of payments to non-residents
  3. Instalment payments
  4. Payment notwithstanding appeal
  5. Demand for payment
  6. Refund of overpaid tax
- F. Collection of taxes
  1. Seizure of assets
  2. Bank-stops
  3. Taxpayers leaving China
- G. Tax audit and demand for information

III. Fines and Penalties
- A. Fines
- B. Penalties
- C. Tax avoidance
- D. Tax evasion
- E. Criminal prosecution

IV. Tax Disputes
- A. Objections and appeals
- B. Administrative review
- C. Judicial appeal

V. Conclusion

The Law of the People's Republic of China Concerning the Administration of Tax Collection (the ATC Law) was promulgated on 4 September 1992 and became effective as of 1 January 1993.[1] The ATC Law applies to individuals, Chinese enterprises, foreign-invested enterprises and foreign enterprises doing business in China. It sets forth provisions with respect to general tax administration (including tax registration, administration of accounting books and vouchers, and tax statements), tax collection, tax auditing and penalties for non-compliance with tax formalities.

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I. FEATURES OF THE ATC LAW

Before the commencement of the economic reforms in the late 1970s, China had a very simple tax system that levied mainly turnover taxes.[2] The government relied on profits delivery from state-owned enterprises. As the economy undergoes a gradual change to a more market-oriented economy, a tax system has been developed, and tax revenue has become an important source of revenue to the government. In 1991, for example, more than 300 billion yuan of tax revenue was collected, accounting for about 90 percent of the total budget revenue to the government.[3]

As the tax system becomes more complex as a result of the reforms, tax administration must adapt to new challenges. The introduction of the ATC Law is an important step in China's tax reform.

A. *Uniform application to all taxpayers*

Unlike most countries where there are two or three major taxes, China has about 30 taxes,[4] including seven income taxes, five taxes on goods and services and numerous property and resource taxes. Taxes were introduced on a piecemeal and ad hoc basis to meet the requirements of the reforms. The tax system distinguishes between

1. The ATC Law was adopted at the 27th Session of the Standing Committee of the 7th National People's Congress on 4 September 1992. For the author's English translation of the ATC Law, see Appendix A. The ATC Law supersedes the "Provisional Regulations of the People's Republic of China Concerning the Administration of Tax Collection", issued by the State Council on 21 April 1986.
2. For further discussion, see Jinyan Li, *Taxation in the People's Republic of China* (New York: Praeger, 1991).
3. *Zhongguo Shuiwu* (*Chinese Tax Affairs*), No. 1 (1991), at 3.
4. China's tax system is highly centralized. Local governments derive their taxing powers from the Central Government; accordingly, the taxes that they are empowered to levy, and the maximum rates of such taxes, are commonly prescribed by the Central Government. Local governments have the authority to introduce implementing rules with respect to the local tax laws promulgated by the Central Government; they also have powers to grant reductions or exemptions from local taxes.
Taxes are designated to be local taxes if revenues derived from them accrue exclusively to local governments. Local taxes include the Real Estate Tax, Urban Land Use Tax, Farmland Use Tax, Vehicle and Vessel Use Tax, Slaughter Tax, Stamp Tax, Banquet Tax, Market Transaction Tax and Livestock Transaction Tax.

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Chinese citizens and foreigners,[5] Chinese enterprises and foreign corporations, state-owned firms and non-state-owned firms. For example, business profits are taxed under five laws applying separately to foreign-invested enterprises, state enterprises, collective enterprises, private enterprises and individual households.[6] Similarly, goods and services are subject to five taxes: Chinese enterprises are taxed under the Value-Added Tax,[7] Product Tax,[8] Business Tax[9] and Salt Tax,[10] and foreign-invested enterprises (joint ventures and foreign subsidiaries in China) and foreign enterprises doing business in China are subject to the Consolidated Industrial and Commercial Tax (CICT).[11] Most of the tax revenue is collected from four major taxes: Product Tax, Value-Added Tax, Business Tax (together accounting for more than 50 percent of the total tax revenue), and the State Enterprise Income Tax, accounting for 19 percent of the tax revenue.

Along with the movement toward a more developed tax system and the creation of checks and balances has come an increase in the number of rules, procedures and tax forms for all participants in the system, both taxpayers and tax administrators. Different taxes required different procedures for administration and compliance.

One major reason for the amount of tax administrative work and huge number of forms filed is the large number of tax rates and the application of many different taxes. Efforts have been made to simplify the tax system.[12] The provisional regulations introduced in 1986 adopted uniform administrative rules with respect to Chinese enterprises and individuals while taxes imposed on foreigners and foreign enterprises were left to be administered separately under the CICT, Individual Income Tax Law and the Foreign Income Tax Law. The ATC Law now applies the same rules to all taxpayers. Tax administration will thus be simplified.

B. *Powers of the tax authorities*

1. Organization of the STB

The State Tax Bureau (STB) is the government department in charge of general tax administration in China.[13] The STB is responsible for collecting all sales and income taxes.[14] It is a quasi-independent bureau of the State Council. The Commissioner of the STB reports directly to the Minister of Finance. It has a professional staff of around 500 and is responsible for setting national goals or quotas on the amount of revenue to be collected in each province.[15]

5. Non-Chinese citizens are subject to the Individual Income Tax. This tax was created in 1980 to apply to both foreigners and Chinese citizens, although it was intended to apply primarily to the growing community of foreigners working in China. The tax is levied on the worldwide income of residents of China and on Chinese-source income of non-residents. Income from employment is now taxed at progressive rates ranging from 2.5 to 22.5%, and income from investment and property is taxed at a flat rate of 20%.
Chinese citizens are taxed under the Individual Income Regulatory Tax. This tax was introduced in 1986, and from the beginning of 1987 has applied to Chinese citizens domiciled in China. It is charged at progressive rates of 20 to 60% on income from employment, personal services and rental income. Income from investment is taxed at a flat rate of 20%.
A consolidation of these two taxes is being considered in China.

6. The five taxes imposed on business income are the following:

(i) The State Enterprise Income Tax is levied on state enterprises. Large and medium-sized firms pay a flat rate tax of 55% on profits. In addition, state enterprises are liable for a State Enterprise Income Regulatory Tax if their profit level is higher than average. Small enterprises pay an eight-grade progressive tax, which rises from 7% to 55%.

(ii) The Collective Enterprise Income Tax is applied to urban and rural collective enterprises. The business profits of these enterprises are taxed at an eight-grade progressive scale, as is the case with small state enterprises.

(iii) The Household Income Tax is applied to individually owned industrial and commercial firms that employ fewer than seven employees. Net profits are taxed on a ten-grade progressive scale, which rises from 7 to 60%. In addition, a surtax of from 10 to 40% (determined by the local authorities) is imposed on taxable income in excess of 50,000 yuan a year.

(iv) The Private Enterprise Income Tax is charged on privately-owned firms that employ more than seven people. Unlike other taxes, a flat tax rate of 35% is adopted. No surtax is charged. Profits distributed by a private enterprise are taxed again, in the hands of the owner, at a rate of 40% under the Private Investors' Individual Income Regulatory Tax.

(v) The Foreign Income Tax applies to foreign enterprises doing business in China and Chinese-foreign joint ventures. This tax is charged on the worldwide income of resident enterprises at a flat rate of 30%. A local tax of 3% is also payable, bringing the effective rate to 33%. Various incentives are offered to taxpayers engaged in productive ventures and/or established in special open areas. In reality, about 80% of foreign investment is in costal regions and the standard tax rate thus is 15% or 24%. Such foreign investment is also eligible for tax holidays and reductions. Non-residents are taxed in China only on income derived from sources in China. Investment income is subject to a withholding tax of 20%. The tax is normally reduced by tax treaties.
For more discussion of this tax, see Jinyan Li, "The New Income Tax on Foreign Investment", 45 *Bulletin for International Fiscal Documentation* (October 1991), at 482; and "The Implementing Regulations for the New Consolidated Income Tax on Foreign Investment," 46 *Bulletin for International Fiscal Documentation* (April 1992), at 170.

7. The value added tax applies to some selected manufactured products which had been subject to cumulative taxation under the previous tax system. Originally there were two taxable categories, but there are now 24; rates of tax vary from 8 to 45%.

8. In terms of raising revenue and regulating prices through taxation, the Product Tax is China's most important tax. It applies to about 270 items of products taxable at 26 different rates. It is collected at the manufacture and import stage for industrial goods and at the purchase stage for agricultural products.

9. The Business Tax is charged on businesses engaged in construction, transportation, services and trades; rates range from 3 to 15%.

10. The Salt Tax is an excise tax imposed on salt producers and distributors. Tax rates vary from one area to another and depend upon the kind of salt and type of producer.

11. The Consolidated Industrial and Commercial Tax was a general tax on goods and services in force before the reforms of 1983-84, and was retained to apply to enterprises with foreign investment. It was anticipated at the beginning of the economic reforms that tax laws would be constantly amended to reflect the transition from a strict state-planned economy to a market-oriented economy. In order to avoid frequent changes in legislation and to create a stable investment environment for foreign investors, it was decided that foreign investment would continue to be taxed under this tax.
Since 1988, the CICT was no longer levied on foreign-invested enterprises and foreign enterprises in Shenzhen. These enterprises are subject to the Product Tax, Value-Added Tax and the Business Tax. See Guo, Hongde, "Opinions on Consolidating the Two Systems of Turnover Taxes", *Shewai Shuiwu* (*International Taxation*), No. 2 (1992), at 9-12.

12. For example, the income taxes imposed on foreign-invested enterprises and foreign enterprises were consolidated in 1991. The Chinese government is in the process of consolidating the two individual income taxes and the taxes on domestic enterprises. In Shenzhen Special Economic Zone, such consolidation has already been experimented.

13. The STB was formerly known as the "State General Tax Bureau".

14. The Ministry of Finance is responsible for administering the Agriculture Tax, Animal Husbandry Tax, Farmland Use Tax and Contracts Tax.

15. The STB has the following departments: turnover tax department, income tax department, local tax department, foreign tax department, tax collection department, tax reform and administrative review department, planning and accounting department, personnel and education department, general office, supervision department, offshore petroleum tax bureau, research institute of tax science, tax newspaper and periodicals publishing house, administrative service centre and Yangzhou tax staff training centre.

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Tax offices are also set up at the provincial and local levels. Provincial level tax bureaus have parallel structures. These tax offices are under dual leadership: tax officials are employees of the local government, but under the leadership of the STB with respect to tax administration. Taxes are collected by 500,000 provincial and local tax officials. The STB and its local offices hire a staff of half million, roughly one tax official for every 35 to 40 enterprise taxpayers.

Most of the staff are recently recruited with high school or post-secondary school education, which has created enormous training problems. Only about 20 percent of the tax staff have a college education, but not necessarily in law or accounting. Since taxes are collected by provincial and local offices, provincial tax bureaus seem to have their own local collection measures. There is little information exchange or coordination between tax offices in different provinces. Data processing equipment is not much used in China and a national computer network is yet to be developed.

2. Discretionary powers

The Chinese tax authorities may have more discretionary powers than those possessed by their counterparts in the developed countries. Chinese tax legislation tends to be broadly worded allowing the tax administrators to exercise their discretionary powers. In some cases, the tax authorities are empowered to make discretionary decisions. For example, Article 2(6) of the Individual Income Tax Law provides that taxable income includes "other kinds of income specified as taxable by the Ministry of Finance";[16] Article 19(4) of Foreign Income Tax Law provides that the tax authorities have the power to reduce or waive the 20 percent withholding tax on certain royalty payments to non-residents.

Chinese tax legislation includes laws enacted by the legislature,[17] regulations introduced by the State Council[18] where the NPC has delegated the legislative power to the State Council and implementing regulations issued by the State Council or the Ministry of Finance.[19] At the top of the legislative hierarchy are tax laws enacted by the legislature. Tax laws usually concern the broad principles of fundamental tax matters and tax regulations typically deal with legislative issues which may be subject to further development. Both tax laws and tax regulations tend to leave the detailed provisions to be dealt with by implementing regulations issued by the State Council or the STB.[20] The STB is normally responsible for drafting the implementing regulations.

The STB's power of statutory interpretation also goes beyond mere administrative interpretation. Under the Chinese Constitution, the power of statutory interpretation is shared among the legislature, courts and the government agency implementing the legislation. The body introducing the legislation is empowered to interpret the legislation. The legislature has the sole power to interpret tax laws, although this is typically delegated to the State Council. The State Council has the power to interpret tax regulations. Again, the State Council usually delegates this power to the Ministry of Finance or the STB.[21] The STB has the power to interpret the implementing regulations. Article 113 of the Foreign Income Tax Regulations provides, for example, that "the Ministry of Finance and the STB shall be responsible for interpreting these implementing regulations". The STB frequently issues interpretation bulletins, circulars or implementing measures to provide clarification with respect to specific tax matters, whether raised by the local tax authorities or by individual taxpayers. These rulings do not have the force of law, but they are binding on the tax authorities and provide some interpretative guidance to taxpayers and the courts.

Unlike courts in most other countries, Chinese courts are ~~not~~ empowered under the Constitution to make general statutory interpretations. In fact, Chinese courts are not independent of the legislature, but directly under its leadership.[22] Courts may only make judicial interpretation of the legislation, such as issues on application of the law or regulations, jurisdiction of the government department under the legislation and determination of penalties. In respect of the general interpretation of the tax legislation, courts normally follow the interpretation given by the STB.

3. Tax collection powers

While the STB and its local offices have a great degree of discretionary powers, their collection powers are limited to the power of seizure of property in some cases. More powers are now provided under Part III of the ATC Law, under which the tax authorities have the power to demand from any person any information or additional information including a return of income, books, invoices, statements or other documents;

16. The STB was previously under the Ministry of Finance.
17. The National People's Congress (NPC), or its Standing Committee. At present, such laws include the CICT Law, the Individual Income Tax Law, the Foreign Income Tax Law and the newly introduced ATC Law.
18. The State Council is the executive body of the Chinese government and consists of the premier, vice-premier, state councillors, ministers of the ministries and state commissions, the auditor general and the secretary general of the State Council. Under the Constitution, the State Council is empowered to adopt administrative measures, rules and regulations to carry out laws enacted by the NPC and to conclude treaties and agreements with foreign states. The NPC may also delegate some of its legislative power to the State Council. The State Council has used this delegated power to introduce all of the taxes except the Individual Income Tax, the Foreign Income Tax and the CICT.
The ministries under the State Council formulate administrative rules, measures, decisions and orders within their respective jurisdiction in accordance with the laws and administrative regulations of the State Council.
19. The Ministry of Finance has primary responsibility for the development and administration of tax legislation. Most of the tax laws and regulations are initially drafted by officials of the STB. The draft is then submitted to the Ministry of Finance. Upon approval of the Minister of Finance, the draft is submitted to the State Council. Where the State Council has the power to introduce the law or regulations, the Premier promulgates the law or regulations. Where the law is to be enacted by the NPC or its Standing Committee, the draft will be submitted to the NPC for promulgation. At each stage, opinions and comments on the draft are solicited from both legal and accounting experts and on occasion by taxpayers.
20. For example, the Individual Income Tax Law contains 15 articles, whereas the implementing regulations have 27 articles.
21. For example, Art. 29 of the Foreign Income Tax Law authorizes the State Council to introduce implementing regulations for the law. Under Art. 113 of the Foreign Income Tax Regulations, the State Council authorizes the Ministry of Finance and STB to interpret the implementing regulations.
22. The Chinese Constitution provides that courts are the judicial organs of the state (Art. 123), that the Supreme People's Court is responsible to the National People's Congress and its Standing Committee (Art. 128) and that the President of the Supreme People's Court is appointed by the National People's Congress (Art. 62).

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to investigate and examine a taxpayer's records and books of account for purposes of administering the tax laws; to obtain information from other departments of government; to search and seize taxpayers' property without pre-authorization by a court; to enforce tax collection by suspending the taxpayers' bank in making payments out of the taxpayer's account, and to charge penalties.[23]

C. *Restricting the powers of the local government*

Another feature of the Chinese tax system is the competing interests within the tax area. Not only is the Central Government's interest at odds with that of taxpayers, but the Central Government's interest is also at odds with provincial and local governments.[24] China differs from many other countries in that the Central Government collects very few taxes.[25] It is the tax offices under the local governments, especially county-level governments, that are responsible for the collection of taxes. This heavy reliance on local governments for collection of the bulk of taxes gives local governments substantial leverage with respect to the revenues they collect, and makes it critical for the Central Government to distinguish and secure its share of the revenue.[26] In order to protect local interest, local governments frequently grant unauthorized tax reductions and exemptions to local enterprises and compete with each other in offering tax incentives to attract investors and businesses to their regions.

The ATC Law provides clearly that the STB is responsible for the national tax administration and no other government agencies, institutions or individuals may interfere with STB's work. Local governments must support the tax authorities in collecting the target amount of tax. According to Article 55 of the ATC Law, any unauthorized tax reductions and exemptions are null and void and individuals making the decisions are held personally liable.

D. *Declaration of taxpayers' rights and obligations and duties of the tax authorities*

1. Taxpayers' rights and obligations

Chinese legal and cultural traditions emphasize more on obligations and duties than on individual rights. Taxpayers' rights are not clearly specified under the existing tax legislation. The Constitution provides that citizens have the right to be treated equally before the law,[27] the right to personal dignity and the right not be insulted, falsely charged or framed-up in any means,[28] and the right not be unlawfully searched at home.[29] The ATC Law provides that taxpayers have the right to a refund of the overpaid tax,[30] the right to compensation if the damages are caused by the misconduct of tax officials,[31] the right to an extension of time limitation for tax payment in the event of unforeseeable diasters,[32] the right to both administrative and judicial appeal over a dispute with the tax authorities[33] and the right to confidentiality in respect of the information provided to the tax authorities.[34]

Taxpayer's duties and obligations are provided in both the Constitution and the ATC Law. Article 56 of the Constitution provides, for example, that every citizen has the duty to pay tax in accordance with law. Extensive obligations are also prescribed in the ATC Law, such as the obligation to cooperate with the tax officials, to provide all relevant information in the course of tax audit or inspection,[35] to inform the tax authorities where there is a non-compliance with tax laws by other taxpayers,[36] and to comply with the requirements on tax registration, tax payment and record-keeping.[37]

2. Duties of tax officials

In view of the broad discretionary powers of the tax officials, Article 6 of the ATC Law provides that tax officials must administer tax laws and regulations impartially and devote themselves to their duties. Tax officials are prohibited from extorting or taking bribes, practising favouritism, committing malpractice, neglecting their duties.[38] They are required not to abuse their powers to overcollect tax or deliberately create difficulties for taxpayers and withholding agents.[39] In a case where a tax official colludes with a taxpayer or assists a taxpayer to commit non-compliance or tax evasion, the official

23. See Note of the Editor of China's Tax Affairs, "An Important Milestone in Tax History in China", *Zhongguo Shuiwu* (*China Tax Affairs*), No. 10 (1992), at 10-11.
24. "Local" government refers here to all governments below the national level. Thus, provincial, municipal, county and township are included unless otherwise specified.
25. Upon the establishment of the People's Republic in 1949, China adopted a centralized political and economic structure. All major economic plans are formulated under the direction of the State Council. The fiscal system has been centralized, under which all revenue and expenditure must be handled by the Central Government. However, in a vast country like China, where economic developments and cultural background vary greatly from region to region, centrally issued policies and regulations tend to be interpreted in diverging ways by local authorities to best suit their local interests. Underneath the surface of a highly centralized hierarchy, "regionalism" or "localism" has always existed and has become more obvious since the adoption of the new economic policies. Enterprises are mostly under the administrative control of local governments. They often bypass the instructions issued by the central planning commissions in order to avoid the rigidity which the planning process involves. In attempting to maximize their objective functions, local governments often intervene in the management of enterprises situated in the region, sometimes without a sufficient legal base; and in other cases they form an alliance with local businesses against the Central Government to protect local interests.
26. Revenues to the Central Government include income taxes collected from state enterprises owned by the Central Government; Business Tax collected from the railway companies, banks, insurance companies and other enterprises controlled by the Ministry of Finance; customs duties, CICT, and income tax collected from foreign-invested enterprises or foreign enterprises engaged in offshore oil exploration.
Local tax revenues include revenues from income taxes on other domestic enterprise and local taxes.
Revenues from the Product Tax, Value-Added Tax, Business Tax, Salt Tax, Individual Income Tax and Foreign Income Tax are shared between the central and local government.
27. Art. 33 of the Constitution.
28. Art. 38 of the Constitution.
29. Art. 39 of the Constitution.
30. Art. 30 of the ATC Law.
31. Art. 31 of the ATC Law.
32. Art. 20 of the ATC Law.
33. Art. 56 of the ATC Law.
34. Art. 7 of the ATC Law.
35. Arts. 33 and 34 of the ATC Law.
36. Art. 7 of the ATC Law.
37. Arts. 9-17 of the ATC Law.
38. Art. 53 of the ATC Law.
39. Art. 54 of the ATC Law.

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will face administrative sanctions imposed, and/or be jointly liable as an accomplice in any criminal charge brought against the taxpayer.[40]

II. TAX ADMINISTRATION

A. *Tax registration*

Enterprises and individuals engaged in business activities are required to register with the local tax office within 30 days after a business licence is issued. The tax authorities will issue a tax registration certificate to the taxpayer. If the business of a taxpayer is changed as in the case of mergers, divisions, liquidations or change in locations, the taxpayer must file another registration with the tax authorities in respect of the change.[41]

B. *Books and records*

Books and records must be kept by taxpayers and withholding agents.[42] Withholding agents are required to deliver itemized records with respect to the underlying tax upon the remittance of the tax withheld. Taxpayers engaged in business or production operations must keep inside China their accounting books, accounting records and other supporting documents. Vouchers, account books and accounting statements of the taxpayer must be completed in the Chinese language, or in both Chinese and foreign languages. Taxpayers using computers for bookkeeping must treat the accounting records in computer storage or output as account books. Magnetic tapes and diskettes must be kept properly before hard copies are printed. These records must be kept for at least 15 years.

Sales invoices and business receipts of the taxpayers must be submitted to the local tax authorities for approval before they are printed and put into use.[43] Such invoices and business receipts can only be printed by firms designated by the tax authorities. Taxpayers are prohibited from printing their own invoices without the permission of the tax authorities.

C. *Returns*

Taxpayers are required to file annual tax returns.[44] With respect to individual income taxes, most items of income are subject to withholding tax and withholding agents are required to file returns on a monthly basis. Where no withholding tax is imposed a taxpayer must pay the tax and file a monthly return within the first week of the following month.[45] Taxpayers who earn income outside China are obliged to file a tax return within 30 days after the end of each year.

Enterprises are required to file their income tax returns and final accounting statements with the local tax authorities within a specified time period after the end of the taxation year, irrespective of making profits or sustaining losses in the taxation year.[46] The final tax return must be filed together with the final accounting statements. The audit reports signed by a certified public accountant registered in China must also be submitted. Audits carried out by non-Chinese firms, even if such firms have offices in China, are generally not acceptable on their own for tax purposes.[47] In the event that a taxpayer cannot submit the income tax returns and the final accounting statements within the time limit due to special reasons, an application can be made to the local tax authorities within the filing time limit for approval of an appropriate extension. If the final due date for filing tax returns falls upon Sunday or an official public holiday, the day following the public holiday is treated as the final due date.

Branches or business establishments of foreign enterprises are required to submit a copy of their final accounting statements to the local tax authorities, at the same time as they submit them to their respective head office, or to the business establishment in charge of consolidated tax filing.[48] Foreign enterprises that have two or more business establishments in China may select to file a consolidated return, and appoint one establishment for consolidated tax filing and payment. However, that establishment must assume the supervisory and management responsibility over the business of the other establishment, and keep complete accounting records and vouchers that correctly reflect the income, costs, expenses, profits and losses of other business establishments. An application to file a consolidated return must be made to the local tax authority.[49] Once the consolidated tax return of a foreign enterprise is approved, any establishment of new business organizations, merger, change of address, termination or close-down of the enterprise must be reported to the tax authorities.

When a taxpayer's business is liquidated, a return must be filed with the local tax authorities prior to its dissolution.

D. *Assessment*

According to Chinese law, income tax is levied on an annual basis. The taxation year is the calendar year unless a taxpayer obtains special approval for a taxation year other than the calendar year. There is no statutory requirement for the issue of a formal assessment by the tax authorities. However, the tax authorities are obliged to release a certificate for tax payment upon receipt of the tax payment.[50]

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40. Art. 52 of the ATC Law.
41. Arts. 9-11 of the ATC Law.
42. Arts. 12-15 of the ATC Law.
43. Art. 14 of the ATC Law. See also "Interim Rules Concerning the Administration of Invoices Used by Foreign-Invested Enterprises and Foreign Enterprises", issued by the STB, 27 December 1991.
44. Arts. 16 and 17 of the ATC Law.
45. Art. 7 of the Individual Income Tax Law, and Art. 13 of the Individual Income Regulatory Tax Regulations.
46. For example, the time limit is four months after the year-end for foreign-invested enterprises and foreign enterprises under Art. 16 of the Foreign Income Tax Law, and 35 days after the year-end for state enterprises under Art. 14 of the State Enterprise Income Tax Regulations.
47. Art. 17 of the Foreign Income Tax Law.
48. Arts. 89-93 of the Foreign Income Tax Law.
49. Where all the business establishments involved in the consolidated tax return are located in the same locality, the application is subject to approval by the tax authority of provincial tax bureau of that locality. Where the establishments are located in two or more different provinces, the application is subject to approval by the STB.
50. Art. 22 of the ATC Law.

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In assessing taxable income of a taxpayer, the tax authorities have the right to inspect the financial, accounting and tax affairs of the taxpayer. To this end, the taxpayer is obliged to produce factual reports, provide all relevant information and it must not refuse to cooperate nor conceal any important evidence.

The tax authorities are normally bound by a return or information supplied by or on behalf of a taxpayer. If no return has been filed, or no proper records of accounting or books are kept by the taxpayer, the tax authorities may make an arbitrary assessment of the amount of tax payable.[51] The ATC Law does not specify any basis or time limitation for such assessment. Presumably, the assessment must be made within the time limitations specified under the ATC Law. The methods of assessment may include a "net worth" method or a profit comparison with other taxpayers in similar situations. The onus of proof to show that the assessment made by the tax authorities is in error will be on the taxpayer.

E. *Payment of tax*

Taxes are normally paid by way of withholding at source, instalment payment or payment at the end of a taxation year.

1. Tax payment in respect of payments to residents of China

Every person paying salaries, wages, remuneration for independent personal services, rental income or royalties to individuals must deduct or withhold therefrom the amount determined in accordance with prescribed rules under the Individual Income Tax or Individual Income Regulatory Tax and must, at such time and as may be prescribed, remit that amount to the State Treasury on account of the payee's tax. The withholding agents must keep the amount deducted or withheld separate and apart from their own money, and must file withholding returns to the local tax authorities with respect to the tax deducted and remitted. Failure to comply with this requirement may result in penalties and in criminal prosecution. The withholding agent is entitled to a service fee of one percent (three percent in the case of tax payable by citizens) of the tax withheld.[52]

Once tax is deducted by the withholding agent, the payee is under no obligation to file tax returns unless the income is subject to progressive tax rates under the Individual Income Regulatory Tax. Under the Individual Income Regulatory Tax, a taxpayer must also file a monthly return with the local tax authorities if the taxpayer's monthly aggregated income from employment, contractual fees, independent personal services and rentals exceeds the monthly basic exemption of about 400-450 yuan.[53]

2. Withholding tax in respect of payments to non-residents

Residents of China must deduct and remit 20 percent (15 or 10 percent if the recipient is a resident of a country with which China has a tax treaty) of an amount paid to a non-resident subject to withholding tax under Article 19 of the Foreign Income Tax Law.[54] This includes fees paid in respect of construction, installation, assembly and exploration, fees for services (such as consultation, management, training and other labour services), dividends, interest, taxable capital gains, royalties, rental or leasing income. Withholding tax on dividends is currently exempt.[55]

Where a person has failed to deduct or withhold any amount as required by law from an amount paid to individuals or non-residents, that person is liable to pay as tax on behalf of the non-resident the whole amount what should have been deducted or withheld. The only defence to the withholding agent is that the tax authorities have been advised of the fact that the payee of the amount has refused to have the tax deducted.[56]

3. Instalment payments

Under the individual income tax laws, individuals are required to pay tax on a monthly basis. No instalment payment is thus required. Payments of tax can be made in Chinese currency in cash or by way of remittance or transfer of accounts. Where payments are made in marketable securities or in kind, the value of the payment must be determined in terms of money. Where there is income in foreign currency, the amount is calculated according to the exchange rate fixed by the Chinese government as of the date the tax payment is due. Foreigners are generally required to pay tax in Bank of China foreign exchange certificates.

All enterprises and corporations must remit income tax in monthly or quarterly instalments in accordance with the provisions in the tax laws. Under the Foreign Income Tax Law, for example, income tax must be paid in advance in quarterly instalments. The amount of tax is computed as one quarter of the planned annual profit or the actual income in the preceding year. Such payments must be made within 15 days from the end of each quarter and the final settlement must be made within five months from the end of each taxation year. Any excess payment is refunded and any deficiency is repaid. Taxpayers must also file quarterly provisional tax returns in respect of advance payments with the local tax authorities.[57]

4. Payment notwithstanding appeal

The taxpayer must, within the specified time limitations, pay to the State Treasury any part of the tax payable, fines or penalties. A taxpayer who does not agree with an assessment or the penalties imposed may file an application for administrative review or judicial appeal. Taxes and penalties that are determined to be owing must first be paid, however, before the commencement of the appeal process.[58]

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51. Art. 23 of the ATC Law.
52. Art. 19 of the ATC Law.
53. For further discussion, see Jinyan Li, "The New Regulatory Tax on Individual Income", 41 *Bulletin for International Fiscal Documentation* (April 1987), at 167.
54. Persons making payments to individuals who are not resident in China are liable to withhold tax under Art. 6 of the Individual Income Tax Law.
55. Art. 19 of the Foreign Income Tax Law.
56. Art. 47 of the ATC Law.
57. Arts. 15-16 of the Foreign Income Tax Law.
58. Art. 56 of the ATC Law.

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5. Demand for payment

Where, in the opinion of the tax authorities, a taxpayer is attempting to avoid payment of tax by transferring or concealing assets or income, the tax authorities may direct that all taxes and penalties be paid before the deadline for tax payment. Legal proceedings including bank-stops and seizure of assets may be taken if payment is not made.[59]

6. Refund of overpaid tax

If there is an overpayment of tax, the excess must be refunded to taxpayers without delay.[60] Within three years of payment, a taxpayer has the right to demand such refund. If there is a deficient payment due to the mistake of the taxpayer in computing the tax payable, the tax authorities may enforce the payment within three years. In certain special cases, the limitation period can be extended to ten years.[61]

F. *Collection of taxes*

All taxes and penalties payable under the tax legislation are debts to the government recoverable as such in court or in other manners. The necessary procedures for paying or providing security for the payment of taxes and penalties owing to the tax authorities are provided in the ATC Law.

The tax authorities must inform the taxpayer that an amount payable under the tax laws has not been paid on the expiration date and allow the taxpayer to pay the tax within a newly determined time limit. If the taxpayer fails to pay the tax within the time limit, the tax authorities may impose penalties. Enforcement measures, such as seizure of assets and bank stops, can only be taken in certain situations.

1. Seizure of assets

Where taxpayers who carry on business without a business licence have failed to make a payment of the tax assessed by the tax authorities, the tax authorities are empowered to direct that the goods and chattels of the person in default be seized.[62] Once seized, the property may be sold by public auction if the taxpayer does not pay the amount of tax due within a reasonable period of time. Any surplus resulting from the sale after the deduction of the outstanding tax payment must be paid to the owner of the property seized. The tax authorities must issue a receipt to the taxpayer for the assets seized. Upon payment of the tax in default, the seized assets must be returned to the taxpayer.[63]

Similar procedures can be taken in two other cases:

(i) where the tax authorities have discovered that a taxpayer has transferred or concealed business assets or other property to avoid tax payment and the taxpayer has failed to make a tax payment or provide a satisfactory security for the tax payment when the tax authorities demanded for such payment or security; and

(ii) where a taxpayer carrying on business in China has failed to pay the tax within the time limitations, or a withholding agent has failed to withhold and remit the tax within the time limitations, or a guarantor for tax payment has failed to pay the tax on behalf of the taxpayer.[64]

2. Bank-stops

As an alternative to seizing the taxpayer's assets, the tax authorities may also enforce tax payment by directing the taxpayer's bank to suspend payments out of the taxpayer's bank account.[65] Where such bank-stop was imposed because the tax authorities have reasonable grounds to believe that a taxpayer has attempted to evade a tax payment by concealing assets, if the amount of tax has been paid as demanded by the tax authorities, the tax authorities must immediately authorize the bank to resume payment from the taxpayer's account. Otherwise, the bank must pay the amount of tax outstanding out of the taxpayer's account. If the bank-stop is imposed because the taxpayer (or withholding agent or guarantor for the tax payment) has not paid the tax within the time limitations, the tax authorities may direct the taxpayer's bank to pay the amount of tax from the taxpayer's account to the tax authorities on account of the tax liability.

3. Taxpayers leaving China

Taxpayers leaving China are required to settle their tax payments first. If such persons fail to pay the tax and fail to provide security to the tax authorities, the tax authorities may notify the customs to deny their exit.[66]

G. *Tax audit and demand for information*

The ATC Law authorizes any investigation and examination of a taxpayer's records and books of account by the tax authorities for any purpose related to the administration and enforcement of the tax laws.[67] A tax official may, at all reasonable times, enter any premise or place where any business is carried on, where property is kept, where anything is done in connection with any business or where any records are or should be kept.[68] The tax official may audit or examine the books, records and any account or document relevant to the information in the books or records or the tax payable.

Tax officials may demand that a taxpayer or withholding agent provide information or additional documents in connection with the administration and enforcement of the tax laws. The tax authorities may also examine mails and shipments of the taxpayer at railway stations, ports, airports and postal offices. With the approval of a local bureau commissioner, the bank accounts of taxpayers can be examined.[69]

In the course of investigation of non-compliance with the tax law, tax officials may take notes, make video and audio recording or photocopy of the relevant documents. Tax offi-

59. Art. 26 of the ATC Law.
60. Art. 30 of the ATC Law.
61. Art. 31 of the ATC Law.
62. Art. 25 of the ATC Law.
63. Art. 29 of the ATC Law.
64. Art. 27 of the ATC Law.
65. The same rules apply to withholding agents and guarantors for the payment of tax.
66. Art. 28 of the ATC Law.
67. Arts. 32-36 of the ATC Law.
68. Art. 32 of the ATC Law.
69. Art. 32 of the ATC Law.

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cials must present proof of identification before the investigation.[70]

III. FINES AND PENALTIES

In case of non-compliance with the provisions of the ATC Law or other tax laws and regulations, fines and penalties may be imposed by the tax authorities to enforce the payment of the tax. The ATC Law does not, however, provide for charging of interest on late payment. The amount of the fines or penalties is not computed by any reference to interest rate.

A. *Fines*

A fine can be imposed by the tax authorities where a taxpayer has failed to pay the tax within the time limitations, or a withholding agent has failed to withhold tax and remit the tax to the State Treasury within the time limitations. The fine is normally computed on a daily basis from the day on which the payment was required to be made at the rate of 0.2 of the amount of tax in default.[71]

There is no provision in the ATC Law requiring that interest or its equivalence is paid by the tax authorities to taxpayers in respect of overpayment of taxes.

B. *Penalties*

Where a taxpayer or withholding agent has failed to comply with the law, the taxpayer is normally given an opportunity for compliance. If the taxpayer or withholding agent has failed again, penalties are imposed.In general, penalties are levied in the following cases: delay in making returns, failure to complete tax registration, failure to keep proper records and books of account, failure to withhold an appropriate amount of tax or failure to provide the tax authorities with proper documents and information.[72] The amount of penalties varies from 2,000 yuan to 10,000 yuan depending on the seriousness of the offence.

Penalties may also be imposed in the following cases:

(i) where a taxpayer has failed to pay the tax within the time limitations;[73]
(ii) where a withholding agent has failed to withhold and remit the tax or withheld tax at an amount less than that required by law;[74]
(iii) where a taxpayer has transferred assets or other property to defeat the collection of the tax by the tax authorities;[75]
(iv) where a taxpayer has bribed tax officials for the purpose of paying no or less tax;[76]
(v) where a taxpayer has fraudulently claimed a tax refund for export;[77]
(vi) where a taxpayer has used violent means to resist tax payment;[78] or
(vii) where a taxpayer has illegally printed and used invoices and business vouchers.[79]

C. *Tax avoidance*

Tax planning is not as common in China as in many other countries. The principle that one can arrange his or her affairs in such a way as to avoid or minimize the tax liability has not been enshrined in China. There seems to exist a presumption in Chinese legal thinking that whatever is not prohibited by law is not necessarily permitted. "Tax avoidance" is often not distinguished from "tax evasion".

Chinese tax laws do not contain any general anti-avoidance provisions which are commonly found in the tax laws of Western countries. The tax laws require that in order for an expenditure to be deductible the amount must be reasonable.

Transfer pricing rules are found in Article 13 of the Foreign Income Tax Law. According to this provision, foreign investment enterprises and Chinese establishments and sites of foreign companies are required to conduct business transactions with their affiliated companies on an arm's length basis. The tax authorities are empowered to make reasonable adjustments if such transactions are not conducted on an arm's length basis and the amount of tax payable to China consequently is reduced. Article 24 of the ATC Law requires that enterprises or establishments of foreign enterprises in China deal with their affiliates at an arm's length basis. This provision may have the effect of extending the transfer pricing rule to domestic enterprises. It is questionable, however, whether such a construction is appropriate considering that none of the income tax laws governing domestic enterprises contains a transfer pricing provision. This ambiguity may be cleared by the implementing regulations to be issued by the State Council.

D. *Tax evasion*

The term "tax evasion" is defined to mean the non-payment or underpayment of tax by a taxpayer by the deliberate omission of revenue, fraudulent claiming of expenses or allowances, or a misrepresentation, concealment or withholding of material facts, or by destroying or fraudulently altering business records.[80]

Although most taxpayers are state-owned and collective enterprises in China, tax evasion is nevertheless a serious problem.[81] According to investigations by the tax authorities,

70. Art. 35 of the ATC Law.
71. Art. 20 of the ATC Law.
72. Arts. 37-39 of ATC Law.
73. Art. 40 of the ATC Law.
74. Arts. 39, 40 and 46 of the ATC Law.
75. Art. 41 of the ATC Law.
76. Art. 43 of the ATC Law.
77. Art. 44 of the ATC Law.
78. Art. 45 of the ATC Law. In the past few years, several thousands of tax collectors have been violently attacked and some tax officials have been killed or seriously injured by taxpayers. See, for example, *Renmin Ribao (Haiwai Ban) (People's Daily) (Overseas Edition)*, 8 March 1989 and 20 November 1989, at 1; *Zhongguo Shuiwu* (*Chinese Tax Affairs*), No. 6 (1992), at 6-7.
79. Art. 48 of the ATC Law.
80. Art. 40 of the ATC Law.
81. There may be several explanations for this: (a) there is a lack of rule of law in China where traditions and cultural values place more emphasis on the rule of man; (b) taxation is new in China and taxpayers have not fostered a sense of observing the tax laws on their own initiative, nor do they have the habit of paying taxes; (c) the lack of efficiency in tax administration and, in some cases, the acceptance of bribes by tax collectors make it possible for taxpayers to abuse the tax system; (d) the discriminatory taxation of different types of enterprises and different categories of goods and services create incentives for evasion, particularly in an environment where evasion and avoidance were practices of long standing.

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tax evasion cases are found in about 50 of state and collective enterprises and about 80 of households and private businesses.[82] Each year, about 4-6 billion yuan of tax revenue is recovered through tax inspection conducted by 1,000 tax officials, which may indicate the scale of tax avoidance and tax evasion in China.[83]

The techniques of evasion reported are not new or unusual, such as double invoicing to minimize the amount of total sales subject to tax, misrepresenting the quality and hence the taxable value of goods, failure to record some purchases and sales and underpricing commodities for accounting records only. Some taxpayers, private businesses in particular, simply destroy or keep no accounting records, or set up multiple bank accounts to conceal actual taxable income.

Severe penalties are imposed under the ATC Law and the Criminal Law. For example, where any person has committed an offence of tax evasion, the tax authorities may, in addition to recovering the tax overdue, impose a penalty not exceeding five times the amount of tax overdue.[84] The amount of penalty depends on the amount of tax evaded. If the amount of tax evaded exceeds 100,000 yuan, the term of imprisonment can be as long as seven years, and the amount of penalty is up to five times the amount of tax evaded. Tax evasion is also a criminal offence punishable under the criminal law.

E. *Criminal prosecution*

The Criminal Law was amended at the same time when the ATC Law was enacted.[85] Every person who has committed an act of tax evasion or tax resistance is guilty of an offence and, in addition to any penalty otherwise provided, may be punishable by imprisonment. The term of imprisonment depends on the amount of tax evaded and whether the offence is repeated by the taxpayer.

A maximum term of three-year imprisonment is provided in the following situations:

(1) where a taxpayer has evaded a tax payment by not filing tax returns, by making false entries in records or books of account, by destroying, altering or otherwise disposing of records or books of account, or by hiding assets to defeat tax collection, and the amount of tax evaded exceeds 10,000 yuan, accounting for more than ten percent of the tax payable by the taxpayer;[86]

(2) where a lesser amount of tax is evaded, but the taxpayer has committed a crime of tax evasion after paying a penalty for an earlier offence of tax evasion and the cumulative amount of tax evaded exceeds 10,000 yuan;[87] or

(3) where the amount of refund fraudulently claimed for export products exceeds 10,000 yuan.[88]

A maximum term of seven years of imprisonment is provided where the amount of tax evaded is more than 100,000 yuan and accounts for more than 30 percent of the tax payable, or where the taxpayer uses force to resist tax payment or tax collection, irrespective of the amount of tax concerned. A more severe punishment applies if the violent tax resistance has caused personal injuries or death; the offender may face criminal charges for assault or manslaughter.[89]

A corporation officer, agent or director who directed, authorized or assented to the commission of the offence is party to and guilty of the offence and is liable to punishment provided for the offence, but the maximum imprisonment period is three years.

IV. TAX DISPUTES

A. *Objections and appeals*

There are no formal procedures for taxpayers to file objections to the assessment by the tax authorities. Article 56 of the ATC Law allows both administrative and judicial appeals, although the former is much preferred by both taxpayers and tax administrators.

B. *Administrative review*

Under Article 56 of the ATC Law, a taxpayer may request an administrative review if the taxpayer disagrees with the assessment made or penalties imposed by the tax authorities. An administrative review is conducted in accordance with the "Rules for Administrative Review in Taxation Matters" (the "Administrative Review Rules").[90] These rules allow citizens, legal persons, stateless persons, foreign persons, foreign organizations and other organizations to apply for administrative review if such persons consider that their lawful rights and interests have been infringed by any conduct or decisions of the tax authorities.

The Administrative Review Rules provide for specified time limitations for submitting an application for administrative review. In general, applications in respect of the payment or withholding of income tax must be submitted within 60 days of receiving a certificate for tax payment.[91] Applications for

82. See Xinhua Domestic Service in Chinese 1515 GMT 18, (August 1988): FBIS-CH1-88-161; Ke, Zaishu, Yang, Zhiping and Deng, Zhizhong, "The Merits and Demerits of Enterprises Avoiding Taxes", *Zhongguo Shuiwu (Chinese Tax Affairs)*, No. 10 (1986), at 27; Han, Shaochu, "The Material Requirement of Taxation is to Administer the Law with Law", *Zhongguo Shuiwu (Chinese Tax Affairs)*, No. 12 (1985), at 20; and Yu, Biao and Xie, Chunpu, "Analyzing the Illegal Activities of Avoiding and Evading Taxes", *Fazhi Ribao (Jurisprudence Newspaper)* (1 September 1987), at 3.

83. See *Zhongguo Shuiwu* (*Chinese Tax Affairs*), No. 6 (1992), at 6-7.

84. Art. 40 of the ATC Law.

85. The Criminal Law has been amended by "The Supplementary Provisions of the Standing Committee of the National People's Congress on Severely Fighting the Crimes of Tax Evasion and Tax Resistance" (the "Supplementary Provisions") issued by the 27th session of the 7th Standing Committee of the National People's Congress.

86. The same rules apply where a withholding agent has committed tax evasion in similar fraudulent manner.

87. Art. 1 of the Supplementary Provisions.

88. Art. 44 of the ATC Law.

89. Art. 6 of the Supplementary Provisions.

90. These Rules were issued by the STB on 29 September 1991 and became effective from 15 October 1991.

91. Art. 56 of the ATC Law. Under the Administrative Review Rules, in cases where the payment of Consolidated Industrial and Commercial Tax or individual income taxes is involved, applications must be made within 15 days of receipt of proof of tax payment. This provision, however, has been overridden by Art. 56 of the ATC Law.

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the review of a penalty must be submitted within 15 days of receipt of the notice of the penalty. In other cases, applications should be made within 15 days of becoming aware of the specific administrative act.[92]

Applications for administrative review must be filed in writing containing the name and address of the taxpayer and the respondent tax office(s), a statement of facts, arguments and claim for remedies. A decision must be made by the administrative review agency within 60 days after the receipt of the taxpayer's application.[93] The tax review agency may order the tax authorities to perform a specific act within a time limit. Failure to perform such act, the review agency may apply to a court for enforcement. The review agency may also award monetary compensation to taxpayers where the tax authorities have caused damages to the taxpayer.

C. *Judicial appeal*

If a taxpayer is not satisfied with the review decision, the taxpayer may institute legal proceedings in court within 15 days from the date of receipt of the review decision.If a taxpayer does not accept a penalty imposed by the tax authorities, the taxpayer may, within 15 days from the date of receipt of the notice of the penalty, directly file a law suit in court. If the taxpayer has failed to apply for administrative review to the higher tax authorities or institute legal proceedings in court within the time limit and has failed to comply with the penalties imposed, the tax authorities may apply to a court for mandatory enforcement of their decisions.[94]

Tax litigation is rare in China. Most tax disputes are resolved by negotiations or administrative appeal. There is a traditional preference for informal settlement of disputes. There is no specialized tax court in China and there are no sophisticated legal and accounting professionals to assist taxpayers. More importantly, Chinese courts do not have a general power of statutory interpretation; the tax authorities are often authorized to both administer and interpret the implementing tax regulations, which constitute the bulk of the tax legislation.

V. CONCLUSION

The tax administration system in China has developed rapidly during the past decade. The STB and its local offices have been expanded from a staff of 178,000 in 1979 to the present of 500,000. Although there are still problems, such as the shortage of highly trained tax collectors and resources, the lack of coordination between the STB and local tax offices, and the complexity in the tax system, the promulgation of the ATC Law is an important step forward in China's tax reform. Because the ATC Law is enacted by the legislature, tax administrators will find that their tax collection and enforcement powers have been strengthened while taxpayers will find that their rights and interests will be protected under the law.

92. Art. 28 of the Administrative Review Rules.
93. Art. 56 of the ATC Law.
94. Art. 56 of the ATC Law.

Appendix A

LAW OF THE PEOPLE'S REPUBLIC OF CHINA CONCERNING THE ADMINISTRATION OF TAX COLLECTION

(Promulgated by the 27th Session of the Standing Committee of the 7th National People's Congress on 4 September 1992)

PART I. GENERAL PRINCIPLES

Article 1:

This Law has been promulgated for the purposes of strengthening the administration of tax collection, securing tax revenue to the state and protecting the legal rights and interests of taxpayers.

Article 2:

This Law shall apply to the administration of taxes collected by the tax authorities.

Article 3:

Matters with respect to the commencement or cessation of tax collection, tax reduction, tax exemption, tax refund and the payment of any underpaid tax shall be dealt with in accordance with law; where the State Council is authorized to introduce regulations on such matters, these regulations shall apply.

No government departments, entities or individuals may be allowed to make decisions in violation of law or regulations with respect to the commencement or cessation of a tax collection, tax reduction, tax exemption, tax refund, and payment of any underpaid tax.

Article 4:

The term "taxpayers" refers to entities or individuals that are liable to pay tax in accordance with law or regulations.

The term "withholding agents" refers to entities or individuals that are liable to withhold tax as required by law or regulations.

Taxpayers or withholding agents must pay tax, withhold (or collect) and remit tax in accordance with law or regulations.

Article 5:

The competent tax department under the State Council (the State Tax Bureau, "STB") shall be responsible for the national tax administration.

Local people's governments at various levels shall strengthen their leadership in tax administration within their jurisdictions and support the local tax authorities in carrying out their duties and complete their tasks of tax collection.

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Other government departments or entities shall support and assist the tax authorities in carrying out their duties.

No entities or individuals shall impede the tax authorities from carrying out their legal duties.

Article 6:

Tax officials shall administer the tax legislation impartially and devote themselves to their duties. They shall not extort or accept bribes, practise favouritism, commit malpractice, neglect their duties, or fail to collect or undercollect the amount of tax payable. They shall not abuse their powers to overcollect tax or deliberately create difficulties for taxpayers or withholding agents.

Article 7:

Any entity or individual has the right to report any act of non-compliance with the requirements of law or regulations. The tax authorities shall keep the identity of the informant confidential and reward the informant according to the relevant regulations.

Article 8:

For the purpose of this Law, "tax authorities" refers to tax bureaus at various levels and their sub-bureaus or tax stations.

PART II. TAX ADMINISTRATION

Chapter 1: Tax Registration

Article 9:

All enterprises, branches of enterprises in other jurisdictions, sites engaged in production and business operations, individual households engaged in industrial or commercial activities, and institutions engaged in production or business operations ("Business Taxpayers") shall, within 30 days after the obtaining of a business licence, register with the local tax authorities on presentation of the relevant supporting documents. Upon examination and verification of the supporting documents, the tax authorities shall issue a certificate of tax registration to the taxpayer.

The State Council shall issue detailed measures concerning the scope and formalities of tax registration for taxpayers other than Business Taxpayers.

Article 10:

Where a change occurs in the production or business of a Business Taxpayer, the taxpayer shall, within 30 days after the date of completing the business registration with the Administration for Industry and Commerce ("AIC") or prior to the submission of an application for cancellation of a business registration to the AIC, change or cancel the tax registration with the tax authorities on presentation of the relevant supporting documents in respect of the change.

Article 11:

Certificates of tax registration shall be used by taxpayers according to the regulations of the STB. Such certificates shall not be lent, altered, damaged, traded or forged.

Chapter 2: Administration of Accounting Books and Supporting Vouchers

Article 12:

Business Taxpayers or withholding agents shall, in accordance with the regulations issued by the relevant finance department under the State Council or the STB, establish accounting books, and keep records based on legitimate and valid vouchers. Industrial and commercial households that are unable to keep accounting books may be permitted by the local tax authorities not to keep accounting books.

Article 13:

The financial and accounting systems or accounting methods of a Business Taxpayer shall be submitted to the tax authorities for records.

Where the financial and accounting systems or methods of a Business Taxpayer do not conform with the regulations of the finance department under the State Council or the STB, the amount of tax payable shall be computed in accordance with such regulations.

Article 14:

Invoices or vouchers must be printed by enterprises authorized by the tax authorities at the level of the government of provinces, autonomous regions and municipalities directly under the Central Government. No enterprises are permitted to print invoices without such authorization.

The measures regarding the administration of invoices shall be issued by the State Council.

Article 15:

Business Taxpayers or withholding agents shall maintain their accounting books, supporting vouchers for the accounts, receipts for tax payments and other relevant information for the period prescribed by the competent fiscal or tax department under the State Council.

Accounting books, supporting vouchers for the accounts, tax payment receipts and other relevant information shall not, without approval of the tax authorities, be forged, revised or destroyed.

Chapter 3: Tax Returns

Article 16:

Taxpayers shall file tax returns and submit tax returns, financial, accounting statements and other relevant information required by the tax authorities based on the practical needs within the time limit prescribed in law or regulations, or the time limit determined by the tax authorities in accordance with law or regulations.

A withholding agent shall submit a return on the tax withheld and remitted and other relevant information demanded by the tax authorities based on practical needs within the time limit provided in law or regulations, or within the time limit determined by the tax authorities in accordance with law or regulations.

Article 17:

Where a taxpayer or withholding agent is unable to file a tax return or to submit a withholding return within the prescribed time limits, the time can be extended upon approval of the tax authorities.

PART III. TAX COLLECTION

Article 18:

The tax authorities shall collect tax payments according to law or regulations, and shall not collect, cease to collect, overcollect or undercollect tax in violation of law or regulations.

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Article 19:

A withholding agent shall withhold tax according to law or regulations. The tax authorities shall not require any enterprise or individual to withhold tax where the enterprise or individual has no legal obligation to withhold.

The tax authorities shall, according to the relevant regulations, pay a service fee to withholding agents for withholding or collecting the tax.

Article 20:

Taxpayers or withholding agents shall pay or remit tax within the time limit prescribed in law or regulations, or within the time limit determined by the tax authorities according to law or regulations. Where a taxpayer is unable to pay the tax within the prescribed time limits as a result of special difficulties, the time can, upon approval of a tax bureau (or a sub-bureau) above the county level, be extended for a period of three months or less.

Where a taxpayer has failed to pay the tax within the time limit provided in the preceding paragraph or a withholding agent has failed to remit the tax within the time limit provided in the preceding paragraph, the tax authorities shall, in addition to demanding the taxpayer or withholding agent to pay or remit the tax within the time limits, impose a fine on a daily basis at the rate of 0.2% of the amount of tax in arrears, commencing on the day due for payment.

Article 21:

A taxpayer may, in accordance with law or regulations, apply to the tax authorities in writing for a tax reduction or exemption.

Applications for tax reductions or exemptions shall be examined and approved by the agency authorized under law or regulations. Any decision on tax reductions or exemptions shall be null and void if it is made by unauthorized local governments, government departments, entities or individuals.

Article 22:

A certificate for tax payment must be issued by the tax authorities to a taxpayer when a tax payment is made or when tax is withheld and remitted by a withholding agent.

Article 23:

The tax authorities may make an arbitrary assessment of the tax liability of a taxpayer in any of the following situations:

a) the taxpayer is permitted under this Law not to keep any accounting books;
b) this Law requires the taxpayer to keep accounting books and the taxpayer has failed to do so;
c) the taxpayer has kept accounting books, but the accounting entries have not been entered in an appropriate manner or the information on costs, vouchers for receipt and expense are incomplete so that the tax authorities are unable to audit the books; or
d) the taxpayer has failed to file tax returns within the prescribed time limit, and failed again within the prescribed time limit set by the tax authorities when the tax authorities demand the taxpayer to file tax returns.

Article 24:

An arm's length price shall be charged when fees are received from or expenses paid to an affiliated enterprise by an enterprise, or an establishment or site in China of a foreign enterprise engaged in production or business operations. Where an arm's length price is not used and the amount of tax payable in China is thus reduced, the tax authorities shall have the power to make reasonable adjustments.

Article 25:

Where an entity or individual is carrying on business without a business licence, the case shall be dealt with by the AIC. Additionally, the tax authorities shall assess the amount of tax payable by the entity or individual and demand for tax payment. Should the entity or individual refuse to pay the tax, the tax authorities may seize goods or commodities with a value of not more than the amount of tax payable. If the amount of tax payable is paid thereafter, the tax authorities must immediately release the seized goods or commodities. If tax is not paid after the seizure, the seized goods or commodities may, upon approval of the commissioner of a tax bureau above the country level, be sold by public auction and the proceeds from the auction may be used to pay the outstanding tax.

Article 26:

Where the tax authorities have reasonable grounds to believe that a Business Taxpayer has taken actions to evade a tax payment, the tax authorities may, prior to the deadline for tax payment, demand the taxpayer to pay the tax within a time limit. In the event that the tax authorities have discovered that there is evidence showing that a taxpayer has transferred or concealed taxable goods, commodities, other assets or taxable income, the tax authorities may demand the taxpayer to provide a security for tax payment. Where the taxpayer is unable to provide such security, the tax authorities may, upon approval of the commissioner of a tax bureau at county level or above, take the following measures to enforce tax payment:

a) to notify in writing the bank or other financial institutions with which the taxpayer has kept an account to suspend making payments out of the taxpayer's account for an amount equal to the amount of tax payable; or
b) to seize the taxpayer's commodities, goods or other assets with a value equal to the amount of tax payable.

If tax is paid within the time limit, the tax authorities shall immediately terminate the above measures. If tax is not paid within the time limit, the tax authorities may, upon approval of the commissioner of a tax bureau (or a sub-bureau) above the county level, notify in writing the above-mentioned bank or another financial institution to pay the tax authorities the amount of tax payable from the taxpayer's account, or may sell by public auction the seized commodities, goods or assets and use the sales proceeds to pay the amount of tax outstanding.

The tax authorities shall compensate a taxpayer for damages caused by inappropriate enforcement actions of the tax authorities or the failure of the tax authorities to end the enforcement actions immediately upon payment of the tax within the time limit.

Article 27:

Where a Business Taxpayer or a withholding agent has failed to pay or remit the tax within the time limit, or a guarantor for tax payment has failed to pay the guaranteed amount of tax within the time limit, the tax authorities shall demand for payment of the tax within a time limit. If tax is not paid within the time limit, the tax authorities may, upon approval of the commissioner of a tax bureau (or a sub-bureau) above the county level, take the following actions:

a) to notify in writing the bank(s) or other financial institutions with which the taxpayer, withholding agent or a guarantor for tax payment has opened an account to pay the amount of tax from such account to the tax authorities; or

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b) to seize and sell by public auction commodities, goods, or other assets of the taxpayer, withholding agent or guarantor for tax payment, with a value equal to the amount of tax payable, and to use the proceeds to pay the tax in default.

In taking the above enforcement measures, the tax authorities may also collect the amount of fines imposed on late payment of the tax from the taxpayer, withholding agent or guarantor for tax payment.

Article 28:

Taxpayers who are liable to pay tax in China and desire to leave the country are required to pay off the tax to the local tax authorities or provide the tax authorities with security for tax payment. If the taxpayer has failed to pay off the tax or provide a security, the tax authorities may notify the administration in charge of exit to stop the taxpayer from leaving the country.

Article 29:

When seizing commodities, goods or other assets of taxpayers, the tax authorities shall issue a receipt for the seized items. When sealing up commodities, goods or other assets, the tax authorities shall make a list of the sealed items.

Article 30:

Where the tax authorities have become aware of an overpayment of the tax by a taxpayer, the excess shall be refunded to the taxpayer without delay. Where a taxpayer has become aware of the overpayment himself, the taxpayer may apply for a refund within three years from the date of payment of the tax. Upon examination and verification of the application, the tax authorities shall immediately refund the taxpayer the excessive amount of tax.

Article 31:

Where a non-payment or underpayment of tax by a taxpayer or withholding agent is caused by the tax authorities, the tax authorities may, within three years from the due date, demand for payment of tax in arrears. No fines shall be imposed by the tax authorities.

Where a non-payment or underpayment of tax by a taxpayer or withholding agent is caused by the mistake of the taxpayer or the withholding agent, the tax authorities may enforce the collection of the taxes in arrears within three years. In certain cases, the statutory limitation can be extended to ten years.

PART IV. TAX INSPECTION

Article 32:

The tax authorities shall have the power to do the following:

a) to inspect the accounting books, supporting vouchers for the accounts, statements and any relevant information of a taxpayer or a withholding agent with respect to withholding and remittance of the tax;
b) to inspect a taxpayer's commodities, goods or other assets at the taxpayer's place of production or business and the place where these commodities, goods or assets are stored; to inspect a withholding agent's compliance with withholding (or collecting) and remittance of tax;
c) to demand a taxpayer or withholding agent to provide documents, evidential materials and information with respect to the payment or withholding (or collecting) and remittance of the tax;
d) to make inquires of the payment or withholding (or collecting) of tax by taxpayers or withholding agents;
e) to inspect invoices, certificates and other documents with respect to the transportation or mail of the taxpayer's taxable goods, commodities or other assets at railway stations, docks, airports and postal offices;
f) upon approval of the commissioner of a tax bureau (or a sub-bureau) above the county level, after presenting a permit (in a standard form printed for national use) for the inspection of deposit accounts, to examine and verify the deposit accounts of a Business Taxpayer or withholding agent at banks or other financial institutions; to examine and verify the savings account of a Business Taxpayer, provided that the savings account is verified by the regional office of a county or municipal branch of a bank which has designated some bank officers to provide information to the tax authorities.

Article 33:

A taxpayer or withholding agent shall accept the lawful inspection of the tax authorities, shall provide them with accurate and truthful information and documents, and shall not refuse the tax inspection or conceal any facts.

Article 34:

In conducting tax inspections, other government departments and entities shall support and coordinate with the tax authorities and provide information and evidence about taxpayers, withholding agents or other parties in connection with the payment or withholding (or collecting) and remittance of the tax.

Article 35:

In investigating a case of non-compliance with tax laws, the tax authorities may record (tape-record or video-record), photograph and reproduce the relevant evidence and documents.

Article 36:

Officials sent by the tax authorities to conduct a tax inspection shall produce identification cards and undertake to keep secret.

PART V. LIABILITIES

Article 37:

In case where a taxpayer has committed one of the following acts of non-compliance and failed to remedy it within the time limit set by the tax authorities, a penalty of not more than 2,000 yuan, or in case of serious non-compliance, a penalty of more than 2,000 but less than 10,000 yuan can be imposed:

a) failure to complete tax registration, to change or cancel tax registration within the time limits;
b) failure to establish or maintain a system of accounting, or to keep the supporting vouchers for accounts and other relevant information as required by regulations; or
c) failure to submit financial and accounting systems or the financial and accounting methods to the tax authorities for records.

Article 38:

Where a withholding agent has failed to keep and maintain accounting books, supporting vouchers for the accounts and other relevant information in respect of the tax withheld and remitted, the tax authorities may impose a penalty of not more than 2,000 yuan, or,

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in case of serious non-compliance, a penalty of not more than 5,000 yuan.

Article 39:

Where a taxpayer has failed to file tax returns on time, or a withholding agent has failed to file withholding returns on time, the tax authorities may demand for such returns within a time limit and impose a penalty of up to 2,000 yuan; if the taxpayer or withholding agent has failed to file the returns within the time limit, the amount of penalty can be more than 2,000 yuan but less than 10,000 yuan.

Article 40:

"Tax evasion" means the non-payment or underpayment of tax by a taxpayer through forging, revising, concealing or destroying without authorization accounting books or supporting vouchers for the accounts, or by overstating expenses or understating or non-reporting of income, or by filing false tax returns. Where the amount of tax evaded is more than 10,000 yuan accounting for more than 10 percent of the amount of tax payable, or where the taxpayer has evaded tax payment after having been subject to an administrative penalty for a previous offence of tax evasion, the tax authorities shall, in addition to pursuing the collection of the tax evaded, impose a penalty on the taxpayer in accordance with Article 1 of the "Supplementary Provisions on Punishing the Crimes of Tax Evasion and Tax Resistance" (the "Supplementary Provisions"). Where the amount of tax evaded is less than 10,000 yuan, accounting for less than 10 percent of the amount of tax payable, the tax authorities may, in addition to pursuing the collection of the tax evaded, impose a penalty of not more than five times the amount of tax evaded.

Where a withholding agent has failed to withhold or withheld an insufficient amount of tax by using the means mentioned in the preceding paragraph and the amount of tax evaded is more than 10,000 yuan, accounting for more than 10 percent of the tax to be withheld, Article 1 of the Supplementary Provisions shall apply. Where the amount of tax evaded is less than 10,000 yuan, the tax authorities may, in addition to pursuing the collection of the tax, impose a penalty of not more than five times the amount of tax evaded.

Article 41:

Where a taxpayer who has failed to pay tax on time has transferred or concealed his assets so that the tax authorities are unable to collect the tax payment, if the amount of tax in question is more than 10,000 yuan, the tax authorities may, in addition to collecting the tax, impose a penalty under Article 2 of the Supplementary Provisions. If the amount of tax is less than 10,000 yuan, the amount of penalty may not exceed five times the amount of tax evaded.

Article 42:

Any enterprise or institution that has committed a crime under Article 40 or 41 shall be dealt with under Article 3 of the Supplementary Provisions. Where no crime is committed, the tax authorities may, in addition to collecting the tax, impose a penalty of not more than five times the amount of tax evaded or underpaid.

Article 43:

Where a taxpayer has paid no tax or has underpaid tax as a result of offering a bribe to tax officials, a penalty shall be imposed under Article 4 of the Supplementary Provisions.

Article 44:

Where an enterprise or institution has obtained a tax refund for export by fraudulently claiming that its products are export products, if the amount of tax refund fraudulently obtained exceeds 10,000 yuan, the tax authorities shall, in addition to pursuing the repayment of such refund, impose a penalty in accordance with Article 5(a) of the Supplementary Provisions. If the amount of refund concerned is under 10,000 yuan, the amount of penalty shall not exceed five times the amount of the refund.

Where an entity or individual other than those mentioned in the preceding paragraph has fraudulently obtained a tax refund for export, the tax authorities shall, in addition to pursuing the repayment of the refund, impose a penalty on the entity or individual under Article 5(b) of the Supplementary Provisions. Where the amount of tax refund involved is small and no crime has been committed, the tax authorities shall pursue the repayment of the tax refund and impose a penalty of less than five times the amount of tax refund.

Article 45:

The term "tax resistance" refers to the refusal of taxpayers to pay tax by means of violence or threat. In case of tax resistance, the tax authorities may, in addition to collecting the tax, impose a penalty in accordance with Article 6(a) of the Supplementary Provisions or, if the case is not serious and no crime has been committed, impose a fine of not more than five times the amount of tax in default.

An act of tax resistance causing personal injury or death constitutes an offence of assault or manslaughter under criminal law. The offender shall be severely punished and a penalty shall be imposed in accordance with Article 6(b) of the Supplementary Regulations.

Article 46:

Where a Business Taxpayer has failed to pay the tax or paid an insufficient amount of tax or where a withholding agent has failed to withhold or withheld an insufficient amount of tax within the time limit, and failed again within the time period set by the tax authorities for the payment, the tax authorities may, in addition to collecting the tax payment, impose a penalty not exceeding five times the amount of tax in default under Article 27 of this Law.

Article 47:

Where a withholding agent has failed to withhold tax as required by law, the tax shall be paid by the withholding agent, except in a case where the withholding agent has promptly reported to the tax authorities about the fact that the taxpayer has refused to have the amount withheld by the withholding agent.

Article 48:

Where invoices are printed in violation of Article 14 of this Law, the tax authorities shall destroy the illegally printed invoices, confiscate the profit from printing such invoices, and impose a penalty.

Article 49:

Administrative penalties mentioned in this Law shall be imposed by a tax bureau (or sub-bureau) above the county level. Where a penalty is less than 1,000 yuan and is imposed on an industrial and commercial household or an entity or individual that carries on business without a business licence, the penalty shall be imposed by the local tax station.

Upon receipt of a payment of penalty, the tax authorities shall issue a receipt to the taxpayer.

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Article 50:

According to Article 157 of the Criminal Law, criminal charges shall be brought against individuals who, by using violent means or threat, obstruct tax officials from carrying out their lawful duties. Where the obstruction of duties does not involve violence or threat, a punishment shall be imposed by the public security authorities according to the Law Concerning the Administration of Public Security and Punishment.

Article 51:

All fines and confiscations received by the people's courts or the tax authorities shall be turned over to the State Treasury.

Article 52:

Where a tax official has colluded with, instigated or assisted a taxpayer or withholding agent in committing the offenses mentioned in Articles 40, 41, 42 and 44 of this Law, he shall be punished under the Criminal Law. If no crime has been committed, he shall be punished administratively.

Article 53:

Where a tax official has taken advantage of his position and powers to accept or take property from taxpayers or withholding agents and has committed a crime, he shall be charged for bribery under the Criminal Law. If no crime has been committed, administrative sanctions shall be imposed.

Article 54:

Where tax officials have neglected their duties and failed to collect tax or have collected tax at an amount less than that required by law thereby causing a substantial loss of revenue to the state, these officials shall be investigated for criminal offenses under Article 187 of the Criminal Law. If no crime has been committed, administrative sanctions shall be imposed.

Tax officials who have abused their powers and deliberately created difficulties for taxpayers and withholding agents shall be subject to administrative sanctions.

Article 55:

Where a decision is made in violation of law or regulations with respect to the commencement or cessation of tax collection, tax reduction, tax exemption, tax refund, or the payment of underpaid tax, the decision shall be revoked, the amount of tax underpaid shall be collected, and the amount of tax overcollected shall be refunded to the taxpayer. Persons directly responsible for making such decisions shall be investigated by the tax authorities at a higher level for administrative liabilities.

Article 56:

In the case of a dispute with the local tax authorities, a taxpayer, withholding agent or guarantor for tax payment shall first pay the amount of tax, fines and penalties in accordance with law or regulations. Within 60 days from the date of receipt of a certificate for tax payment from the tax authorities, such person may apply to the tax authorities at a higher level to the local tax authorities for review. A review decision must be made by the tax authorities at the higher level within 60 days after the receipt of the application. If the review decision is not acceptable to the applicant, he can bring the matter before the local people's court.

PART VI. SUPPLEMENTARY PROVISIONS

Article 57:

A taxpayer or withholding agent may appoint an agent to represent him in tax matters.

Article 58:

The collection of Agriculture Tax, Animal Husbandry Tax, Farmland Use Tax, and Contracts Tax shall be administered with reference to the provisions of this Law.

The collection of Customs Duties, Shipping Tonnage Tax and other taxes collected by the Customs shall be administered according to other laws and administrative regulations.

Article 59:

Where there is a conflict between the provisions of this Law and those of a tax treaty or agreement concluded between China and other countries, the provisions of the treaty or agreement shall govern.

Article 60:

Where there is a discrepancy between the provisions of existing laws and the provisions of this Law, the provisions of this Law shall govern.

Article 61:

The detailed rules and regulations for the implementation of this Law shall be introduced by the State Council in accordance with this Law.

Article 62:

This Law shall become effective as of January 1, 1993. The "Provisional Regulations of the People's Republic of China Concerning the Administration of Tax Collection" issued by the State Council on April 21, 1986 shall be repealed at the same time.

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SINGAPORE:

1993 BUDGET

REWARDS FOR GOING ABROAD AND REBATES FOR GST AT HOME

Lee Fook Hong MBA, FCIS, FAIA, ACIArb

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Contents

I. Introduction
II. Fiscal Year 1993 Changes
A. Tax changes for companies
B. Personal income tax changes
C. Other changes
III. Tax Changes to Accompany the GST
A. Corporate tax rate
B. Personal tax changes
C. Property tax rebate
D. Changes in other existing indirect taxes to offset GST
E. Other changes to offset GST
IV. Conclusion

I. INTRODUCTION

The 1993 Budget, released on 26 February 1993, comprised three sections:
Part I – Review of the economy
Part II – The Fiscal Year 93 Budget
Part III – Fiscal position, tax changes and offsets for the GST.

In Part I, the Minister reported that the Singapore economy grew by 5.8 percent in 1992. This was largely due to double-digit growth in the construction sector and strong growth in the transport and communications sector. Manufacturing and commerce sector growth was weak while performance in the financial and business services sectors was moderate. For 1993, the Ministry of Trade and Industry is forecasting economic growth of between 6 to 7 percent. In the next few years, economic performance is expected to average around 5 to 6 percent.

In the longer term, higher growth rates require new strategies, key among which is to build an external wing to the Singapore economy. The focus will be on the rapidly growing Asia-Pacific region where Singapore entrepreneurs, government-linked companies and statutory boards have increasing investments in Malaysia, Indonesia, China, Vietnam and Cambodia. To encourage enterprise both in and out of Singapore, on top of incentives for specific offshore activities, a comprehensive approach is being adopted to lower direct taxes, both corporate and personal income taxes. The long-term aim is for a corporate tax rate of 25 percent and a marginally higher top personal tax rate. Higher dependence will be placed on broad-based indirect taxes with the proposed introduction of the Goods and Services Tax (GST) from 1 April 1994.

In Part II of his speech, the Minister reiterated the Government's expenditure policies of investing to promote future growth, control of costs, and efficient allocation of financial and manpower resources. Key areas of expenditure will be economic infrastructure, education, health care, public housing and national security. Budgeted operating and development expenditure (S$ 15.5 billion) will be met from estimated operating revenue of S$ 17.2 billion. Spending is projected to be within 20 percent of GDP.

In Part III of the budget speech, the Minister announced tax changes. He dealt with the tax changes in two sections. In the first section, he dealt with tax changes specific to fiscal year 1993 and the incentives to develop an external economy and to attract new investments to Singapore. In the second section, he dealt with tax changes for fiscal year 1994 with the introduction of GST. This section covers corporate and personal tax cuts, property tax rebates, compensating adjustments to existing indirect taxes as well as additional rebates and expenditures to help lower income groups cope with the GST.

II. FISCAL YEAR 1993 CHANGES[1]

A. *Tax changes for companies*

1. Tax incentives to promote an external economy

Seven incentives to promote the development of an external economy are proposed:

1. Unless otherwise noted all changes are effective as from the 1994 year of assessment.

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(a) *Unilateral tax credit for dividend income*

Dividend income remitted from non-treaty countries will be granted a unilateral tax credit. Provided the company or individual owns at least 25 percent of the capital of the foreign company paying the dividend, a unilateral tax credit will be given for the underlying profits out of which the dividend is paid. A unilateral tax credit will also be given where a tax treaty does not provide for an underlying tax credit. The total tax credit claimable is restricted to the Singapore tax payable on the gross dividend.

(b) *Extension of unilateral tax credit scheme for services*

The existing unilateral tax credit scheme, intended to encourage professionals to export their services, is now extended to cover management consultancy services and qualifying services prescribed under the Finance and Treasury Centre tax incentive. The scope of countries is also extended to include Fiji, Kampuchea, Laos, Myanmar and Vietnam.

(c) *Double tax deduction for promotion of export of services*

A double tax deduction, currently given on certain approved expenses incurred in the promotion of the export of goods manufactured in Singapore, will be extended to approved expenses incurred in the promotion of the export of services. Qualifying services would include feasibility studies, product certification and packaging for export. Further details will be forthcoming from the Trade Development Board which will administer the scheme.

(d) *Double tax deduction for developing overseas investment opportunities*

A double tax deduction will also be given for expenses incurred in exploring and developing overseas investment opportunities. The Economic Development Board (EDB) will administer this scheme and details of eligible expenses, including consultation and legal fees for setting up development offices and conducting feasibility studies, are forthcoming.

(e) *Removal of requirement for intermediate holding company* [2]

The requirement for an intermediate holding company under the existing Overseas Investment Incentive will be removed. The incentive permits the investor to claim capital losses against his domestic income. With the proposal, the holding company need only maintain separate accounts for each approved investment.

(f) *Overseas Enterprise Incentive*

Currently, under the Income Tax Act, a company may apply for tax exemption on remitted foreign income on a case-by-case basis. In order to give companies greater certainty in planning their overseas ventures, it is proposed that approved companies be exempt from tax for up to ten years on their qualifying income under the Overseas Enterprise Incentive.

An approved Overseas Enterprise will be issued with a certificate from the EDB stating the approved overseas investments and projects, the related qualifying income, the exemption period and commencement date. A portion of any incremental domestic income which is connected to the approved investments and projects may also be included as qualifying income.

The Overseas Enterprise must be a Singapore incorporated resident company which is at least 50 percent owned by Singapore citizens, permanent residents, statutory boards or the Government. It will be able to declare exempt dividends to its ordinary shareholders out of its tax-exempt income. If the shareholder is the holding company, it may in turn declare exempt dividends to its ordinary shareholders.

(g) *Tax exemption scheme for venture capital and regional funds*

To encourage companies to invest in the Asia-Pacific region by pooling together venture capital and regional funds, there will be tax exemption on the gains from disposal of approved local and overseas investments, regardless of the holding period, and on interest income from convertible loan stocks and dividends derived from approved overseas investments. The exemption, to be granted by the EDB, shall be for a period of ten years.

2. Tax incentives to attract offshore activities to Singapore

Six incentives are proposed to attract offshore activities to Singapore:

(a) *International arts and antiques centre incentive*

To promote Singapore as an international centre for the trading of arts and antiques, income derived by approved art and antique dealers from transacting on behalf of non-residents with approved auction houses will be taxed at the concessionary rate of 10 percent. The concession will be granted for an initial period of five years with the possibility of further extension.

Additionally, well-established auction houses which conduct substantial auctioning activities and private museum operators in Singapore can qualify for the Pioneer Services tax incentive. The approved income of such a company will be tax exempt for a period of five years with possible extension for up to another five years. Donations to the National Museum will qualify for tax deduction of up to twice the value of the donation.

The Ministry of Information and the Arts and the EDB will jointly administer these incentives.

(b) *Extension of Approved Trustee Company Incentive*

To further develop the trustee business in Singapore, the range of exempt income under the Approved Trustee Company incentive will be extended to include specified income of non-resident beneficiaries of trusts.

2. The effective date of this change was not stated.

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(c) *Extension of tax holiday for SIMEX*[3]

To strengthen the capital base of the Singapore International Monetary Exchange Limited (SIMEX), the tax holiday which SIMEX has enjoyed since 1984 will be extended for another five years. This is intended to sustain its rapid growth and maintain the confidence of international investors.

(d) *Extension of Warehousing and Servicing Incentives*

Introduced in 1978, the Warehousing and Servicing Incentives provided for one half of the income of the approved warehousing or servicing company to be tax exempt for five years. To encourage companies to make initial investments in excess of the minimum requirement of S$ 2 million and expand further after the exempt period, it is now proposed that the tax relief period be extended by periods not exceeding five years at a time.

(e) *Extension of tax exemption scheme for syndicated loan facilities*[4]

Due to expire on 31 December 1993, the Syndicated Credit and Underwriting Facilities Scheme was introduced in 1983 to promote the development of loan syndication activities in Singapore. Income derived under the scheme is exempt from tax. To secure Singapore's position as a leading syndication centre in Asia, the scheme will be extended by another five years.

(f) *Tax exemption for interest paid by members of RAS Commodity Exchange*[5]

To make it more attractive for non-residents to trade on the RAS Commodity Exchange, tax exemption will be given on interest paid by members of the Exchange on the margin deposits for futures transactions of non-residents. Interest paid by the Exchange to its non-resident members on their margin deposits, security deposits and adjusted net capital will similarly be exempt from tax.

3. Other tax changes for companies

(a) *Property tax rebate*[6]

A one-off 25 percent rebate will be granted for commercial and industrial properties for the year commencing 1 July 1993. Property-owning statutory boards and Government agencies will pass on this rebate to their tenants. Private sector landlords are encouraged to pass on at least half of the rebate to their tenants.

(b) *Adjustment factor for capital allowances and tax losses of companies with tax incentives*

Companies granted tax incentives will usually have income taxed at a concessionary rate and income taxed at the normal corporate rate. To date, a dollar-for-dollar set off has been given where a company has a loss and a profit in the two different categories. This resulted in a tax reduction which is different from that based on the tax rate at which the income is taxed. To correct this position, an adjustment factor of the ratio which the tax rate of the loss or capital allowance to be set off bears to the tax rate of the income against which the loss or capital allowance is to be set off will be made.

The adjustment does not apply where incentives provide for complete exemption of income.

(c) *Deduction cap on medical expenses*

To instil greater cost consciousness by employers and employees in the consumption of medical services, the tax deductibility of expenses on medical benefits incurred by employers will be capped at 2 percent of total employees' remuneration.

For companies which exceeded the 2 percent cap in year of assessment 1992, a transitional cap starting at 4 percent will be given. In year of assessment 1994, the cap will be 4 percent of payroll costs or the percentage in year of assessment 1992, whichever is the lower. The transitional cap of 4 percent will be reduced by 0.5 percent per year until it reaches 2 percent after 5 years, i.e. in year of assessment 1998.

For companies enjoying concessionary tax treatment, the resulting increase in income from disallowing expenses in excess of the cap will not be treated as concessionary income but will be taxed at the normal corporate tax rate.

The cap for new companies will be 2 percent.

Medical benefits for public sector employees are currently under review.

B. *Personal income tax changes*

Several tax changes affecting individuals were announced:

1. Individual income tax rebate[7]

An across-the-board one-off 5 percent rebate is given on individual income tax for year of assessment 1993.

2. Election to be non-resident[8]

Singapore citizens who work abroad for more than six months in any calendar year can elect to be treated as non-residents for tax purposes. As non-residents, income remitted to Singapore is not subject to tax.

3. Separate claims for normal and enhanced child relief[9]

Normal child relief and enhanced child relief (ECR) may now be claimed separately. ECR will continue to be claimable only by the married woman.

3. This incentive is effective from 1994-1998.
4. This incentive is effective from 1 January 1994-31 December 1998.
5. The effective date of this incentive is not stated.
6. The rebate applies from 1 July 1993-30 June 1994.
7. Effective for the 1993 year of assessment.
8. Effective for the 1993 year of assessment.
9. Effective for the 1993 year of assessment.

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4. Unilateral tax credit for overseas employment income and director's fees

Singapore citizens who work abroad for less than six months in any calendar year are considered tax residents whose remitted foreign income is taxable. However, relief is available under Singapore's tax treaty network. Where there is no tax treaty, it is now proposed that unilateral tax credit will be given on remitted employment income and director's fees.

5. Taxation of retirement benefits

Other than contributions to the Central Provident Fund (CPF), all retirement benefits received from private employers, including gratuities and pensions, will be taxable upon receipt by the employee. The proposal affects only benefits paid out of funds contributed after 31 December 1993. For existing approved pension and provident funds, the tax-free benefits accrued up to 31 December 1993 will be computed for each intended recipient, and remain tax exempt when paid.

6. Waiver of residence requirement for certain dependants

Currently, on condition that they reside under the same roof, relief is given for taxpayers who support their aged parents or handicapped dependants. The only exception is when the dependant is confined to a hospital or nursing home for medical reasons. This residence requirement is now waived provided the taxpayer has expended at least S$ 1,500 per year in the maintenance of each aged parent or handicapped sibling.

7. Separate assessment for married women on all income

Married women are currently allowed separate assessment on their earned income and income derived from accumulated earned income. It is proposed that election for separate assessment be extended to all sources of a married woman's income.

8. Tax relief for CPF contributions by the self-employed

The current relief of 17.5 percent (maximum cap of S$ 12,600) against assessable self-employment income will be increased to 18 percent with the maximum cap at S$ 12,960.

C. *Other changes*

1. CPF contributions[10]

With effect from 1 July 1993, employer CPF contributions will go up by 0.5 percent to 18.5 percent while employee CPF contributions will go down by an equal percentage to 21.5 percent. If the economy sustains its projected growth, the two rates will be equalized at 20 percent from 1 July 1994.

2. CPF share ownership top-up scheme[11]

In September 1993, each CPF member who is a Singapore citizen and over 21 years of age will receive a grant of S$ 200. To be eligible, the member or his employer must have contributed at least S$ 500 during the six-month period from 1 March 1993 to 31 August 1993. Contributions below S$ 500 will receive a pro-rated top-up.

Citizens without CPF accounts, including housewives, retired people and the self-employed, will be allowed to start an account to benefit from the scheme.

3. Rebate for service and conservancy charges[12]

The Government will pay the December 1993 service and conservancy charge for Singapore citizens residing in one to three-room Housing and Development Board (HDB) flats. This one-off payment is the equivalent of the 5 percent tax rebate for year of assessment 1993.

4. Duties on cigarettes and tobacco[13]

With immediate effect, import duty on cigarettes is raised from S$ 100 to S$ 115 per kilogram. In addition, the import duty on tobacco and excise duty on cigarettes will be raised from S$ 50 to S$ 60 per kilogram.

III. TAX CHANGES TO ACCOMPANY THE GST

A. *Corporate tax rate*

The corporate tax rate will be reduced from 30 to 27 percent. This is in line with the long-term target corporate tax rate of 25 percent.

B. *Personal tax changes*

1. Top personal tax rate reduced to 30 percent

The top tax rate of 33 percent will be reduced to 30 percent with progressive reductions in the lower tax brackets as shown in Appendix I.

2. Personal relief

The current personal relief of S$ 2,000 will be increased to S$ 3,000.

3. Annual tax rebate[14]

From year of assessment 1994, resident individuals will be granted an annual rebate starting at S$ 700, decreasing by S$ 50 each year until it reaches S$ 500 in year of assessment 1998, after which it will remain at S$ 500 per annum.

10. Effective 31 July 1993.
11. Effective in September 1993 only.
12. Effective for December 1993 only.
13. Effective as from 26 February 1993.
14. Applicable from year of assessment 1994-1998 and thereafter.

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C. *Property tax rebate*[15]

Owner-occupied residential properties with annual values of less than S$ 10,000 will be given a property tax rebate. This will be on a sliding scale with the maximum rebate of S$ 150 per annum for annual values of S$ 5,000 or less. For annual values between S$ 5,000 to S$ 10,000, the rebate will be from S$ 150 to zero.

D. *Changes in other existing indirect taxes to offset GST*[16]

	Current rate	*New rate*
Tourism cess	4%	1%
Tax on domestic telephone bills	5%	Suspended
Tax on PUB bills in excess of $ 40	5%	2%
Entertainment duty	5%	Suspended
Cinematograph film hire duty	15%	Suspended
Petrol and diesel duties	Various rates	Rate adjustments to nullify GST effect
Import duties on cars, taxis, motorcycles and buses		

E. *Other changes to offset GST*

1. Rental rebates[17]

Rental rebates ranging from S$ 8 to S$ 16 per month will be given over five years for Singapore citizens who are tenants of one and two-room rental HDB flats.

2. Rebates for service and conservancy charges[18]

Rebates for service and conservancy charges ranging from S$ 4 to S$ 12 per month will be given over five years to Singapore citizens who are dwellers of one, two and three-room HDB flats.

3. Edusave grant

The Edusave grant to each pupil of S$ 50 per annum will be increased to S$ 100 per annum in order to offset the GST payable on school books and other miscellaneous school items.

4. Increase in public assistance[19]

Public assistance is given to aged destitutes, widows or deserted wives with young dependent children and those certified medically unfit to work. The monthly allowance currently given ranges from S$ 150 for a single-person household to S$ 430 for a four-person household. The proposed corresponding increases range from S$ 5 to S$ 15 per month.

5. Increase in Singapore allowance[20]

The Singapore allowance is given to pensioners whose monthly pensions are less than S$ 850. Subject to a monthly cap of S$ 100, the difference between S$ 850 and what the pensioner receives constitutes the Singapore allowance. The specified pension level will be increased to S$ 900 per month and the maximum allowance increased to S$ 130 per month.

6. Grants to Citizens' Consultative Committees (CCCs)[21]

The CCCs will receive an annual grant of S$ 3 million for the purpose of assisting those identified as not benefiting from the other proposed relief schemes to offset GST. The amount per household is not expected to exceed S$ 200 per annum.

IV. CONCLUSION

In concluding his most broad-based budget in recent years, the Minister cautioned that although the outlook for 1993 looked better than the last three years, there is a need to change the orientation of the people towards venturing abroad. This is to ensure that Singapore can continue enjoying high economic growth. The tax changes he announced are designed to promote overseas investments and encourage the repatriation of foreign earnings. Additionally, with the implementation of GST, Singapore will become more competitive.

There has been favourable post-budget reaction from businessmen and the community at large and all welcome the budget as one offering rewards to go abroad and rebates for GST at home.

APPENDIX I

REDUCTION IN PERSONAL INCOME TAX RATES (EFFECTIVE YEAR OF ASSESSMENT 1994)

Chargeable income $	YA 1993 Existing rates* %	YA 1994 Revised rates** %
1 – 5,000	3.5	2.5
5,001 – 7,500	6	5
7,501 – 10,000	8	6
10,001 – 15,000	8	7
15,001 – 20,000	9	8
20,001 – 25,000	12	11
25,001 – 35,000	14	13
35,001 – 50,000	17	15
50,001 – 75,000	21	19
75,001 – 100,000	24	22
100,001 – 150,000	26	24
150,001 – 200,000	28	25
200,001 – 400,000	31	28
> 400,000	33	30

* Rates do not include the 15% tax rebate on the first $ 10,000 of chargeable income which has been given since Y/A 1987

** Revised rates include the above 15% tax rebate

15. Effective date not stated.
16. Effective 1 April 1994.
17. Effective date not stated.
18. Effective date not stated.
19. Effective date not stated.
20. Effective from 1 April 1993.
21. Effective date not stated.

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HONG KONG:
BUDGET 1993/94
HONG KONG CONTINUES TO ACHIEVE REMARKABLE GROWTH

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In a period when many developed economies are facing increased taxes and substantial cutbacks in expenditure it was a very pleasant change to listen to the Budget Speech of Hong Kong's Financial Secretary Mr Hamish Macleod which he delivered to the Legislative Council on 3 March 1993. While many people see Hong Kong as an insignificant dot on the map facing severe political problems as the clock ticks by towards 1 July 1997 when Hong Kong becomes a Special Administrative Region of the People's Republic of China, the facts tell a somewhat different story.

Probably the most significant fact is that GDP grew 5 percent in real terms with GDP per head growing to US$ 16,000, and in this connection Hong Kong has already overtaken Spain and New Zealand and has almost caught up with Australia and the United Kingdom. With GDP expected to grow at 5.5 percent in 1993/94 this will put Hong Kong ahead of both Australia and the United Kingdom and will be fast approaching Italy and the Netherlands.

Exports grew in the period by 19 percent and are expected to grow by 18.5 percent in 1993/94 while re-exports are expected to grow by 25 percent and imports by 19 percent. This places Hong Kong as tenth in the world in terms of international trade. This growth has been achieved not in Hong Kong's traditional markets in North America and Western Europe but in South East Asia in general where trade expanded 23 percent, and in particular China where the rate was 25 percent.

One unsatisfactory part of Hong Kong's economy is that inflation remains stubbornly high and although it dropped during the year it is still running at about 9.5 percent. However, the Financial Secretary is of the firm view that with one of the lowest unemployment rates in the world and a significant growth in GDP inflation is not such a serious problem as it might otherwise be. He pointed to the many western economies where price stability (low inflation) has only been achieved at the cost of high unemployment and low economic growth. At the same time low unemployment has produced its own problems and labour has had to be imported from China and other countries in the region. However, emphasis is also being placed on increasing productivity and retraining of labour where HK$ 1.3 billion of Government funds has been committed to this end. A further problem is the shortage of land and its effect on domestic prices and industrial costs. The latter has been solved to a great extent by the relocation of many industries to Southern China where despite inflation export prices have only risen by 1 percent.

Much speculation took place in the weeks leading up to the Budget on the size of the surplus which had been forecast in 1992 as HK$ 7.5 billion but was expected to be considerably larger. This optimistic view was often fuelled by various statements made by Government spokesmen in the run up to the Budget who spoke of "buoyant revenue" and the like. And so it turned out that few were surprised when Mr Macleod announced that the estimated surplus for the year was expected to be HK$ 20.5 billion. However, what was surprising was that the difference was not accounted for solely through increased revenues but approximately one half resulted from underspending on capital works programmes. This the Government proposes to address in the future by allowing more private sector involvement in the control and management of projects. Despite the welcome surplus the Financial Secretary said that he remained committed to the main principles of Government budgeting policy:

- public spending must not grow faster than the economy; and
- the reserves must provide an adequate cushion to meet known commitments and future uncertainties.

EXPENDITURE

The forecast expenditure for 1993/94 calls for an increase of HK$ 17.4 billion over the original estimate for 1992/93 to HK$ 132.5 billion. The major beneficiaries of the increased spending arose out of the Governor's policy address to the Legislative Council in October 1992 and relate mainly to social services, the environment and the transport infrastructure. The principle areas of focus of the additional expenditure will include an increase in welfare payments for the Elderly and Comprehensive Social Security Assistance Scheme, a new hospital in the New Territories, a total of HK$ 17.2 billion for community health care, an additional HK$ 7.3 billion to upgrade the Hong Kong Sewage Scheme so as to improve the water quality of Hong Kong's harbour, HK$ 2 billion to the Housing Society to assist the sandwich class in obtaining housing, improvements to one of the major highways in Hong Kong and the construction of a new road to the border with China.

REVENUE PROPOSALS

In setting his proposals for Revenue for 1993/94 the Financial Secretary said that his main aim had been to maintain fiscal prudence while at the same time reducing the tax burden as far

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as possible for the largest number of tax-paying households. In so doing Mr Macleod faced three challenges:

(1) Because tax concessions are current in nature even a modest cut can have a multiplying effect in subsequent years.
(2) It is necessary to avoid measures which would add significantly to inflation.
(3) No measures should be taken which complicate the existing simple tax system.

The principle proposals that he recommended were therefore:

1. *Salaries Tax*

	1992/93	1993/94
	HK$	HK$
Personal Allowance	46,000	56,000
Married Persons Allowance	92,000	112,000
First Child	15,500	17,000
Second Child	11,500	17,000
Subsequent Children	No Change	
Dependent Children	13,500	17,000
Single parent	23,000	20,000

These concessions will mean that some 250,000 existing taxpayers will no longer have to pay any tax at all and a further 1.2 million taxpayers will pay less tax, thus benefiting a total of some 90 percent of salaries taxpayers at a cost of HK$ 2.6 billion in 1993/94 and HK$ 17 billion up to 1997. Other concessions were as follows:

2. *Profits Tax*

No change.

3. *Estate Duty*

The nil rate band has been extended from HK$ 4 million to HK$ 5 million and thereafter the rates will be 6 percent on estates between HK$ 5-6 million and 12 percent for estates between HK$ 6-7 million and 18 percent in respect of estates over HK$ 7 million.

4. *Entertainments Tax*

The remaining tax under this heading is the entrance fee to race meetings. This has been abolished at a cost of some $ 10 million which sum the Royal Hong Kong Jockey Club has undertaken to donate to the Community Chest.

5. *Stamp Duty*

In line with the reduction in Stamp Duty on stock transfers from 0.5 percent to 0.4 percent in the previous Budget a further reduction has been proposed to 0.3 percent.

6. *Cosmetics Duty*

This has now been abolished.

7. *Fuel, Alcohol and Tobacco*

The Financial Secretary has recommended an increase of 9.5 percent in the specific duty rates on these commodities.

8. *Rates*

The Financial Secretary did not recommend any change to the charge for rates; however, he did say in this connection that there would be the usual three-yearly revaluation which would become effective from 1 April 1994 which may see an increase in rates depending on the revaluation.

TAX POLICY

The Financial Secretary took the opportunity to announce two measures to improve the tax system. The first was to introduce a Composite Tax Return which would avoid the need for taxpayers to submit separate returns under Profits, Salaries and Property Taxes. The other measure was a perceived anti-avoidance proposal in respect of the taxation of royalties. At present tax is levied at the standard rate on 10 percent of royalties paid by a Hong Kong company. In order to counteract avoidance the tax in future will be levied on the full amount of the royalties payment or a ten-fold increase in the tax burden which perhaps means a mention in the record books as the largest increase in tax ever proposed. How this proposal will impact on Hong Kong's aim to improve technical know-how remains to be seen. The Financial Secretary also proposes to provide additional resources to the Inland Revenue Department to assist in the further development of the Field Audit programme.

CONCLUSION

While the good news of surpluses and growth is most encouraging it is perhaps surprising to find that the Financial Secretary is budgeting for a deficit in 1993/94 of HK$ 3.4 billion, particularly in view of the requirement in the Basic Law of the future Special Administrative Region for a regime of balanced budgets. While this is not expected to impact on the Government's reserves it does appear that the Financial Secretary has been unnecessarily generous. The substantial decrease in the number of salaries tax payers could, in the view of this author, seriously impact on future reserves as the measures have seriously narrowed the already narrow tax base. One might consider that the Financial Secretary has mortgaged the future for short-term popularist gains.

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JAPAN:

TAX HAVEN AND FOREIGN TAX CREDIT RULES: 1992 AMENDMENTS AND THEIR IMPACT ON DUTCH HOLDING COMPANIES

Ebel Magnin and Eero Rautalahti

I. INTRODUCTION

The amendments made in 1992 to the Japanese legislation on tax havens and foreign tax credits have a significant impact on Japanese multinationals having holding companies in the Netherlands. Under the new legislation such Dutch holding companies are likely to be considered tax haven companies, thus causing the Japanese parent company to lose the tax advantages offered by the Dutch participation exemption.

These amendments to the Japanese Income Tax Act (ITA) were enacted in connection with the Japanese State Budget for 1992, and they became effective as of 1 April 1992. In this article, these amendments will be referred to as the "1992 Amendments".

From the Dutch point of view, the essential effect of the 1992 Amendments is to make the hitherto tax-exempt capital gains accrued through Dutch holding companies fully taxable in Japan in the hands of the Japanese parent company, regardless of whether such gains are distributed or not. Similarly, dividends from operations in low-tax countries routed through the Netherlands will also be fully taxable in Japan, unless such dividends are redistributed to Japan within two years.

On the other hand, the 1992 Amendments also expanded the indirect foreign tax credits available to Japanese parents. Under the new rules, the parent may claim tax credit for the income tax paid by secondtier subsidiaries, whereas the earlier legislation allowed a credit for the first tier only.

This article outlines the contents of the legislation in its current form, and proposes certain structural scenarios, which could (i) enable Japanese multinationals to escape the application of the tax haven rules to their Dutch holding companies and, at the same time, (ii) allow them to utilize the second-tier indirect foreign tax credits.[1]

II. OUTLINE OF THE TAX HAVEN RULES

The Japanese legislation against operations in tax havens was originally introduced in 1978. The rules were tightened extensively both in 1981 and 1985 in response to the various tax planning schemes created by Japanese businesses to circumvent their application. Despite the legislation, the number of tax haven corporations owned by Japanese companies have continuously increased.[2] The 1992 Amendments are a further attack against aggressive tax planning. As seen below, the new rules effectively prevent (or at least complicate) the use of many commonly accepted international tax planning techniques.

As background, it should be borne in mind that under the Japanese ITA:

- dividends received from foreign corporations are fully taxable (although a credit is available subject to certain limitations), whereas dividends received from other Japanese corporations are either wholly or 80 percent tax-exempt depending on the level of shareholding;
- capital gains are in principle fully taxable at normal income tax rates;
- the corporate tax rate in Japan amounts to approximately 52 percent, and the domestic tax system allows only limited flexibility for profit calculation.

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Contents

I. Introduction
II. Outline of Tax Haven Rules
  A. Definition of a tax haven corporation
    1. Application of the 25 percent effective tax rate test
    2. Practical complications
  B. Other applicable tests
    1. Japanese control test (50 percent test)
    2. Major ownership test (5 percent test)
    3. Moment of determination
  C. Exception: legitimate and proper business
  D. Calculation of income when tax haven rules apply
  E. Relief from multiple taxation
III. Outline of Indirect Foreign Tax Credit Rules
  A. Foreign taxes entitled to credit
  B. Calculation of allowable foreign indirect tax credit
  C. Overall limitations on tax credits
IV. Alternative Structures
  A. Alternative A: utilizing existing Dutch operations
  B. Alternative B: sourcing
  C. Alternative C: avoiding Japanese control
V. Conclusion

1. When preparing this article, we had limited access to the Japanese legislation, and even then only in the form of free translations. Accordingly, the structural scenarios presented below should be treated as general ideas only, and their implementation in practice would obviously require careful planning and consideration by Japanese tax practitioners.
2. Takaki Tokuoka and Simon Takagi, "Black and Grey Areas in Japanese CFC Legislation", *International Tax Review* (July/August 1991), at 11.

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The purpose of the tax haven rules is to prevent taxpayers from avoiding Japanese tax by structuring their operations through low-tax jurisdictions and retaining the after-tax income in such low-tax jurisdictions.

A. *Definition of a tax haven corporation*

Prior to the 1992 Amendments, a corporation could be regarded as operating in a tax haven only if it had its principal office or main business interests in a jurisdiction designated by the Japanese Minister of Finance as a tax haven. The list of tax havens (as it was in force until 30 March 1992) included 42 countries or territories. Most of these were typical tax havens (such as Cayman Islands, Panama, Netherlands Antilles). Luxembourg holding companies and Swiss holding and domiciled companies were also included in the list. However, high-tax countries offering limited tax advantages to certain types of businesses (such as the Netherlands, Belgium, Singapore or Ireland) were not considered tax havens.

The 1992 Amendments abolished the entire concept of designated tax haven and the lists of tax haven countries. The new rules define as a tax haven any country or jurisdiction where the effective income tax rate is substantially low. The further definition of "substantially low" is determined by Cabinet Orders promulgated under the ITA. According to the Cabinet Order in force[3] at the time of writing, an effective income tax rate is substantially low if it amounts to 25 percent or less.

1. Application of the 25 percent effective tax rate test

For the purposes of the 25 percent test, the effective income tax rate is calculated by comparing the actual tax burden suffered by a foreign affiliate to its total net income. If the actual tax burden is less than 25 percent of the total net income, then the affiliate is deemed to be a tax haven corporation (for the sake of brevity, the term "tax haven corporation" will be abbreviated here as "THCO").

In this determination, the net income of the affiliate is calculated according to the rules of the Japanese ITA.[4] Accordingly, the income which is tax-exempt in the affiliate's home country (for example, capital gains) is added to the income.

However, dividends that the affiliate has received from its domestic and foreign subsidiaries are excluded from calculation of the net income, if such dividends are tax-exempt for the receiving affiliate under an affiliation privilege. Consequently, a Dutch holding company is not caught by the 25 percent test, as long as it only channels dividends from foreign operations or investments to the Japanese parent. However, when the holding company realizes a capital gain in the Netherlands, such capital gain is likely to bring the holding company within the scope of the tax haven rules.[5]

For the purposes of the 25 percent test, all income taxes actually paid by the foreign affiliate are taken into account, including taxes paid in other countries. Consequenly, if the affiliate operates in another country through a permanent establishment (PE), income tax levied on the income of the PE is included in the calculation of the tax burden.[6]

The 25 percent test is applied individually to each foreign subsidiary or affiliate of a Japanese taxpayer. It is also applied separately in respect of each fiscal year.

Example 1:

A Japanese multinational ("Nippon Co") has a holding company in the Netherlands ("Nippon BV"). Nippon BV has three wholly-owned operating subsidiaries, one in the United Kingdom, one in Sweden and one in Germany.

In Year 1 Nippon BV receives dividends from all three subsidiaries, but does not declare a dividend to Nippon Co. None of the operating companies is caught by the tax haven rules, because they all operate in countries where the tax rate is above 25 percent (United Kingdom 33 percent, Germany approximately 50 percent, Sweden 30 percent). Nor is Nippon BV caught, because its sole income consists of inter-group dividends.

In the course of Year 2 Nippon BV sells its Swedish subsidiary for a profit of Dfl. 50 million. At the same time it acquires all shares in an Irish finance company operating under the special ten percent corporate income tax rate. The UK and German subsidiaries distribute dividends to Nippon BV, who again declares no dividend to Nippon Co. For the Year 2, Japan will impose income tax on Nippon Co on (i) the capital gain of Dfl. 50 million realized by Nippon BV; and (ii) on the after-tax profits of the Irish subsidiary (as the effective income tax rate in Ireland is only 10 percent).

2. Practical complications

In practice, the Japanese tax administration may confront difficulties in enforcing the new 25 percent tax haven rule. Under the earlier legislation, it was very clear to both the taxpayer and the authorities whether or not a foreign affiliate was within the scope of the tax haven rules.

In order to enforce the 1992 Amendments, the Japanese tax administration will continuously have to monitor all the foreign affiliates of Japanese businesses to determine whether any of them is a THCO for any given year. Similarly, Japanese multinationals need to carefully monitor the tax burden of their affiliates in order to avoid unpleasant surprises. The administrative burden imposed on Japanese multinationals is massive, as they will have to calculate the tax burden and net income (following the Japanese rules) for each foreign affiliate every year.

If a foreign affiliate is considered a THCO, then its Japanese shareholders (provided that they hold over 5 percent of shares) are required to include their share of the THCO's profits in their income, and to report that to the Japanese tax authorities. Presumably, the Japanese tax authorities may find it difficult to verify that this actually happens. In order to check the effective tax rate of a certain foreign affiliate, the authorities will have to obtain detailed information regarding its accounts. Such information could either be requested from the Japanese taxpayer or could be accessed through mutual assistance from tax authorities in the affiliate's home country.

3. Enforcement Order issued on 31 March 1992.
4. See D below, where a similar calculation is described in more detail.
5. This situation might arise where a Dutch company realizes a capital gain by selling shares in an affiliated company, which gain is tax-exempt under the Dutch participation exemption.
6. Hirotomi Kimuro, "The current tax situation affecting foreign enterprises doing business with or in Japan", *CCH Journal of Asian Pacific Taxation* (May 1992), at 26.

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However, Japanese groups' operating companies in the countries offering special tax advantages can presumably expect to be under closer scrutiny by Japanese authorities. The Dutch holding companies are a rather obvious target in this respect, due to the beneficial treatment of capital gains on disposal of shares under the participation exemption.

B. *Other applicable tests*

Although the 25 percent tax rate test is the key element in the application of the Japanese tax haven rules, it is not the only applicable criterion. The tax haven rules apply only if three further conditions are fulfilled:

- the affiliate is a foreign related company, i.e. under substantial Japanese control;
- the Japanese taxpayer has over 5 percent equity interest in the affiliate; and
- the affiliate does not qualify for the exception for "legitimate and proper business".

The last condition will be discussed under C below.

1. Japanese control test (50 percent test)

In order to be a foreign related company, over 50 percent of the foreign company must be directly or indirectly controlled by Japanese residents or entities. The concept of Japanese residents and entities is very broad, encompassing Japanese companies and individuals, as well as foreign companies affiliated with the Japanese.[7]

Prior to the 1992 Amendments, the 50 percent Japanese control test was fulfilled only if more than half of the total number of shares issued and outstanding in the capital of the THCO were held by Japanese residents or entities. No distinction was made between voting or non-voting shares.

The 1992 Amendments introduced a further test, which is applied in addition to the previous one. Under the new rules, a foreign company is also a foreign related company if more than 50 percent of the voting shares issued and outstanding are held by Japanese residents, regardless of the number of non-voting shares issued.

It should be noted that for the purposes of the 50 percent test, the Japanese shareholders need not have any affiliation or other relationship with each other. The mere fact that half of the foreign company is owned by Japanese suffices (regardless of the actual relations between the Japanese shareholders).

2. Major ownership test (5 percent test)

Under current legislation, an interest in a THCO has consequences for a Japanese taxpayer only if the taxpayer holds more than 5 percent of the shares in the THCO. Prior to the 1992 Amendments, a 10 percent interest was required.

For purposes of the 5 percent holding test, the term "holding" has the widest conceivable interpretation. Both direct and indirect holdings are included; holdings by any affiliated or related parties (including personnel, family member, etc.) are counted together as one ownership interest.[8]

The 5 percent test is based on the total number of shares issued and outstanding in the THCO, regardless of the voting or other rights attaching to such shares.[9]

Example 2:

A Bermudan corporation ("BerCo") has issued 1,000 voting shares and 1,000 nonvoting preference shares. In Year 1 a Japanese multinational ("Nippon Co.") owns 47 (4.7 percent) of the voting shares and 400 (40 percent) of the non-voting preference shares. The remaining shares are owned by a US corporation with no connection to Japan. Nippon Co. does not need to report its share of BerCo's profits in Japan, as the 50 percent test is not met (Nippon Co. has only 22.35 percent of all the shares).

In the end of Year 2, 60 percent of the US corporation is acquired by a Japanese-controlled entity, who has no ownership connection to Nippon Co. Nippon Co. will need to report its share of the BerCo's profits for Year 2, because its ownership interest of total shares is 22.35 percent and the majority of BerCo is now controlled by the Japanese residents.

3. Moment of determination

Both the 50 percent Japanese control test and the 5 percent ownership test are determined on the basis of the ownership situation at the end of the business year of the THCO.

C. *Exception: legitimate and proper business*

The Japanese tax haven legislation is not intended to prevent Japanese companies from doing business in countries offering low tax rates. A specific exception is provided in the law for such legitimate business activities. A foreign affiliate has to fulfil four tests in order to qualify as legitimate and proper business. If all four tests are met, the Japanese shareholders of such a company need not report the income under the tax haven rules. The tests are defined very narrowly to cover only real operational business activities.

The tests are the following:

(1) the main business of the foreign affiliate must be other than holding securities or debt instruments, licensing industrial property rights or leasing of vessels or aircraft;
(2) the foreign affiliate must have a fixed place of business (shop, office, factory) where it actually conducts its business and which is also necessary for its business;
(3) the foreign affiliate must have local staff and management who operate the business in an independent manner as a separate business entity independent from its owners; and
(4) over 50 percent of the business of the foreign affiliate is conducted in the country where it is located (e.g. over half of the manufacturing takes place there, or over half of the revenues in retail sales are from domestic sales).

If the foreign affiliate is in the business of wholesale, banking, trust, securities, insurance, shipping or air transport, the last test is replaced with a requirement that over 50 percent of

7. For more details see IBFD, *Taxation in Asia and the Pacific*, Chapter Japan (International Bureau of Fiscal Documentation: Amsterdam), at para. C.12.1.
8. Id.
9. The text of the relevant legislation is not entirely clear on this point; this interpretation represents our best understanding on the basis of available information.

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its business must be conducted with unrelated and non-affiliated persons. The term "non-affiliated person" is defined narrowly, excluding not only group companies but also any unrelated Japanese company or individual who is subject to Japanese anti-avoidance measures, majority shareholders of such companies and any intervening persons in a structure involving tax haven companies.

The last-mentioned test is aimed to ensure that the tax haven rules cannot be circumvented by operating captive insurance or financing companies or intra-group service entities in low-tax jurisdictions.

The application of the legitimate and proper business exception was tested in a court case 1990.[10] In this case a Japanese group operated a subsidiary in Hong Kong as a captive service company for the purposes of procuring raw materials to the parent from South Asian countries. The subsidiary had local staff of two persons, and the taxpayer claimed that it had compelling business reasons for operating this subsidiary in Hong Kong.

The court ruled that the legitimate business reasons do not suffice to exclude the application of the tax haven rules. Although the Hong Kong subsidiary met all other tests, the court found that it was not sufficiently independent in its management and business. The court stated that the independent character of business should be evaluated on the basis of the overall fact situation, considering factors such as:

- where board meetings and shareholder meetings take place;
- where the actual management decisions are taken;
- where the books and accounts are held;
- to what extent the subsidiary has discretion in deciding matters relating to its business.

It is quite clear on the basis of the legislation and the above court case that mere "window dressing" will not suffice to exclude the application of the tax haven rules. The exception applies only to fully-fledged business operations. However, this does not mean that the exception could not be used in tax planning, provided the taxpayer actually has real business operations (a manufacturing operation, sales office, etc.) in a low-tax country.

D. *Calculation of income when tax haven rules apply*

When the tax haven rules are applicable, the Japanese taxpayer must include in its income a proportionate portion of the undistributed profits of the THCO. Thus, Japan taxes the profits of the THCO directly in the hands of the shareholder, regardless of whether such profits are distributed or not.

The law provides two alternative methods for the calculation of the net profits of the THCO, both leading essentially to the same end result. Profits can be calculated (i) entirely in accordance with the Japanese ITA, or (ii) in accordance with the rules of the country of the THCO with adjustments prescribed in law.

If the latter method is applied, the taxable profits of THCO are subject to the following adjustments:

(i) the following items are added to the net income:
- any exempt income;
- dividends deducted as expense;
- losses on revaluation of assets;
- depreciation in excess of what is allowed under Japanese tax law;
- directors' remuneration in excess of what is deductible in Japan;
- donations and entertainment expenses in excess of what is deductible in Japan;
- tax losses applied as a deduction; and
- foreign corporate taxes applied as a deduction.

(ii) The following items are subtracted from the net income:
- gains on revaluation of assets; and
- refund of foreign corporate tax (if considered taxable income at the THCO's country).

These adjustments are designed to bring the taxable profits of the THCO in line with the rules applicable to Japanese businesses.

Once the taxable profits of THCO have been calculated in the manner described above ("constructive profits"), the Japanese shareholder includes in its taxable income in Japan a portion of the constructive profits that corresponds with its shareholding interest in the THCO. If the constructive profits are negative, the Japanese shareholder is entitled to carry forward such constructive losses and deduct them from constructive profits of the THCO in later years.

E. *Relief from multiple taxation*

The calculation of constructive profits as described above does not take into account that the THCO may indeed distribute its profits. Hence, the same income would be taxed in Japan twice, first as income of the shareholders and then as a dividend received. Also, as the profits of each THCO are taxed separately in Japan, income earned by one THCO would be subject to multiple tax when routed through other THCOs in the form of a dividend. To alleviate these effects Japanese tax haven legislation provides certain relief rules.

When calculating the constructive profits of the THCO, dividends that the THCO distributes directly or indirectly to the Japanese shareholder are deducted from the net income. This deduction is denied, however, if the distribution is routed through a company which is subject to less than 25 percent tax on its dividend income. The Japanese shareholders of the THCO can, however, exclude such dividends (at the time of actual receipt) from their taxable income in Japan, provided that the intermediary company did not retain such profits for more than two years (see example 2 above).

When calculating the constructive profits, dividends which a THCO has received from another THCO are excluded from the net income, provided that the undistributed profits of the other THCO are directly taxed in the hands of the ultimate Japanese shareholder.

10. Tokyo District Court, decision dated 19 September 1990 (1368 Hanrei Jiho 53); the appeal on the case was subsequently dismissed by the Tokyo High Court, which confirmed the decision taken by the District Court (27 May 1991); the case is described in more detail in Tokuoka-Takagi, *supra* note 2.

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Finally, if a foreign country has imposed tax on the undistributed profits of the THCO, Japan allows a credit for such tax paid by the THCO.

III. OUTLINE OF THE INDIRECT FOREIGN TAX CREDIT RULES

Japan has a highly complicated set of rules on foreign tax credits, and the allowable credits have been made subject to various limitations. The following discussion does not purport to describe the system in its entirety, but rather concentrates on issues relevant to the tax haven rules and the structural scenarios presented below.[11]

A. *Foreign taxes entitled to credit*

Japan generally allows a tax credit on foreign income taxes which the Japanese taxpayer has paid abroad. The tax credit is normally available for any foreign taxes levied on net income (including federal, state and local taxes). The revenues subject to foreign tax are grossed up for Japanese tax purposes and added to the income of the taxpayer. Accordingly, the taxpayer is entitled to deduct from his Japanese income tax the amount of foreign taxes paid. The excess credits can be carried forward for three years.

Normally the tax credit is allowed only to the extent the Japanese taxpayer has paid itself the foreign tax (for example, for profits of a foreign PE). There are two exceptions to this rule:

- a Japanese taxpayer can claim a tax credit for the foreign income tax imposed on the undistributed profits of a THCO to the extent such profits are included in the taxpayer's income in Japan; and
- a Japanese company can claim an indirect tax credit for the underlying income tax paid by a foreign subsidiary in respect of dividends received from such subsidiary (first-tier indirect foreign tax credit). If the subsidiary has paid the dividends out of dividends received from a further subsidiary, the Japanese parent can claim tax credit also in respect of the income tax paid by the second subsidiary (second-tier indirect foreign tax credit). The second-tier credit was introduced to the Japanese tax law in the 1992 Amendments.

The indirect foreign tax credits are available only if the Japanese taxpayer has owned at least a 25 percent interest in the foreign company for a minimum of six months prior to the date when the decision regarding the declaration of dividend is made.

It is our understanding that foreign flow-through entities (US partnerships, Dutch VOFs and CVs) are treated for the purposes of indirect tax credit as if they were branch operations of the parent. Consequently, an intermediary flow-through partnership between first and second-tier subsidiaries should not prevent utilizing the tax credit for the taxes paid by the second-tier subsidiary.

If the second-tier subsidiary files a consolidated tax return with lower-tier subsidiaries, the allowable credit is calculated as if the second-tier subsidiary had filed a separate return.[12]

Example 3:

A Japanese corporation ("Nippon Co") owns 100 percent of a Dutch BV, which in turn owns 100 percent of a US corporation (USCo1). USCo1 has a further wholly-owned subsidiary (USCo2), and files a consolidated tax return. USCo1 and USCo2 have a pre-tax, non-consolidated income of 1,000 and 2,000, respectively, and pay an income tax on the consolidated basis of 1,020. Following the above formula, the allowable credit amounts to:

$$\text{Credit} = 1{,}020 \times \frac{1{,}980}{3{,}000 - 1{,}020} \times \frac{1{,}000}{3{,}000} = 340$$

As shown in the above example, only the tax underlying the dividend received from USCo1 which is sourced from its own after-tax income is creditable.

B. *Calculation of allowable foreign indirect tax credit*

The available indirect foreign tax credit is calculated according to the following formula:

$$\text{Credit} = \text{Foreign Tax} \times \frac{\text{Dividend}}{\text{Net Income} - \text{Foreign Tax}}$$

where
Foreign Tax = income tax paid by the foreign subsidiary.
Dividend = amount of dividend received by the Japanese shareholder.
Net Income = net taxable income of the foreign subsidiary.

Example 4:

A Japanese multinational ("Nippon Co") holds 100 percent of the shares of a UK-based operating company ("UK Co"). The profits before tax of UK Co are equal to £ 1,200 million which are subject to a corporate income tax rate of 33 percent. The UK Co applies a pay out ratio of 60 percent of its after-tax income.

The dividend declared by UK Co equals 60 percent of the after-tax profits or 60 percent of £ 804 million or £ 482.4 million. The corporate income tax paid by UK Co equals 33 percent of £ 1,200 or £ 396. Hence, the underlying tax credit available to the Nippon Co on the dividend received from UK Co is equal to:

$$\text{Tax Credit} = 396 \times \frac{482.4}{1{,}200 - 396} = £\ 237.6$$

The purpose of this formula is to ascertain that the allowable tax credit is equal to the proportionate amount of underlying tax that the dividend carries.

The allowable credit calculated in accordance with the above formula may result in an amount higher than the actual tax paid by the foreign affiliate. In such case, the allowable tax credit is quite obviously restricted to the amount of taxes actually paid.

If the dividend payment has been subject to foreign withholding tax, the allowable tax credit is limited to an amount calculated according to the following formula:

Maximum Credit = Dividend Paid – 2 x Foreign Withholding Tax

11. For a comprehensive analysis of the indirect foreign tax credits, see Tom Anderson, "A Survey of the Foreign Tax Credit System", 45 *Bulletin for International Fiscal Documentation* (May 1991), at 203-213.
12. Id.

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C. *Overall limitations on tax credits*

The Japanese tax legislation imposes a number of overall limitations to the amount of foreign tax credits which a Japanese taxpayer can utilize to offset its Japanese taxes.

Each taxpayer is subject to an overall, annual limitation calculated according to the following formula:

$$\text{Limit} = \text{Japanese Tax} \times \frac{\text{Total Net Foreign Income}}{\text{Total Worldwide Income}}$$

where
Japanese Tax = taxpayer's Japanese tax burden before deduction of credits.
Total Net Foreign Income = aggregate amount of taxpayer's foreign-source income.
Total Worldwide Income = aggregate amount of taxpayer's income from both Japanese and foreign sources.

When calculating the overall limitation, 66.6 percent of the foreign income which has not been taxed abroad must be excluded from total net foreign income. Prior to the 1992 Amendments, only 50 percent was excluded.

A number of other limitations apply to the foreign tax credits, including
- no tax credit is available for foreign taxes in excess of 50 percent of the relevant income (the excess can be treated as a deduction from income);
- for financial institutions and other businesses where significant amounts of interest income are received, special limitations on allowable credit apply, depending on the level of profitability of the business.

The foreign tax credits are utilized in the first instance to offset state corporate income taxes. To a limited extent, credit is also allowed against prefecturate and local taxes.

Japanese corporate taxpayers may also opt for deducting the foreign taxes from their income rather than as a credit against tax. The choice is either credit or deduction, and once chosen, the same method must be applied to all foreign taxes entitled to credit during the fiscal year.

IV. ALTERNATIVE STRUCTURES

As seen above, the Japanese tax haven legislation in its current form encompasses the capital gains and undistributed dividend income of Dutch holding companies belonging to Japanese multinational groups of companies. The possibility for avoiding tax on capital gains and non-distributed dividends has been a leading incentive for multinationals in setting up holding companies in the Netherlands. Consequently, the 1992 Amendments are causing considerable anxiety to Japanese multinationals which have routed their international holdings through the Netherlands.

The following structural scenarios are attempts to create alternative ways for retaining the benefits of the Dutch holding companies even after the 1992 Amendments. At the same time, the scenarios purport to draw maximal benefit from the second-tier indirect foreign tax credit in Japan.

A. *Alternative A: utilizing existing Dutch operations*

This structural scenario is based on the "legitimate and proper business" exception from the tax haven rules. Its application requires that the Japanese multinational has real and substantial business operations in the Netherlands. Such operations could, for example, include operating a manufacturing plant, having substantial sales (and a sales office) or conducting financing business in the Netherlands. As seen above, captive operations do not qualify in most cases.

Provided that all other conditions for the exception exist (substance, independence), an operating subsidiary may also hold shares in other operations or investments, provided the holding activity accounts for less than 50 percent of its business. Accordingly, a Dutch operational company owned by a Japanese multinational can assume tax-exempt capital gains to an extent such gains do not exceed the amount of its operational revenues.

Example 5:

A Japanese parent company (Nippon Co) has a wholly-owned subsidiary in the Netherlands (NL-OPCo), which owns and operates a plant and sells the products within the Netherlands. NL-OPCo also owns 50 percent in a UK company (UK-OPCo). In Year 1 NL-OPCo has operational revenues of Dfl. 10 million and sells its participation in UK-OPCo for a profit of Dfl. 9.5 million. The Japanese tax haven rules should not be triggered because the Dutch NL-OPCO still qualifies as a legitimate and proper business, regardless of whether its actual tax burden in the Netherlands is less than 25 percent.

This scenario has some obvious limitations:
- it can be utilized only by multinationals having substantial domestic operations in the Netherlands;
- it requires an operational company to hold participations in other companies, which may be difficult from a business perspective; and
- it is based on balance between the operational revenues and capital gains. In practice it may be difficult to estimate in advance how much capital gains may accrue from a given transaction. If capital gains exceed the operational revenues, the whole Dutch operation is deemed to be conducted in a tax haven.

On the other hand, this scenario is relatively safe against further amendments to the tax haven rules. It would be difficult for the Japanese legislator to prevent the use of a structure of this type without causing undue detriment to the legitimate foreign business operations of the Japanese multinationals.

B. *Alternative B: sourcing*

This alternative structure is based on the requirement that the foreign operations must bear a tax burden of 25 percent, lest they are characterized as tax haven operations. The current Japanese corporate income tax rate amounts to approximately 52 percent.[13] If the foreign non-distributed profits suffer a tax of 25 percent, the remaining 32 percent tax saving (i.e. the difference between the Japanese tax rate and 25 percent) can be deferred until the profits are ultimately distributed to

13. See *supra* note 3.

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Japan. Moreover, if the structure enables the maximal use of indirect foreign tax credits, the effective tax burden is reduced even further.

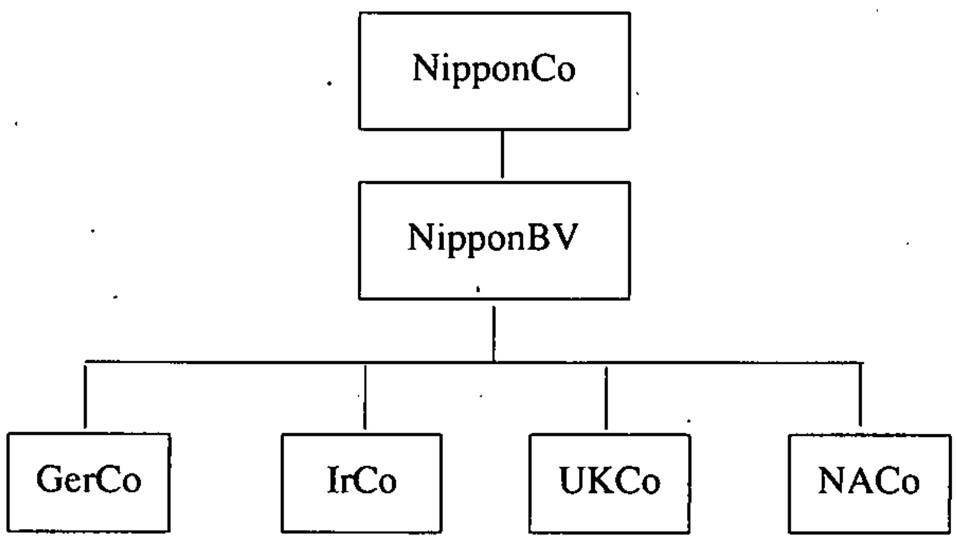
It is possible to create a structure where the taxes suffered in the high tax jurisdictions offset lower tax burdens in others, and the resulting overall tax burden at the level of first-tier subsidiary is only marginally over 25 percent.

Prior to the 1992 Amendments, Dutch holding company structures tended to be in line with the following scenario (countries used as examples only):

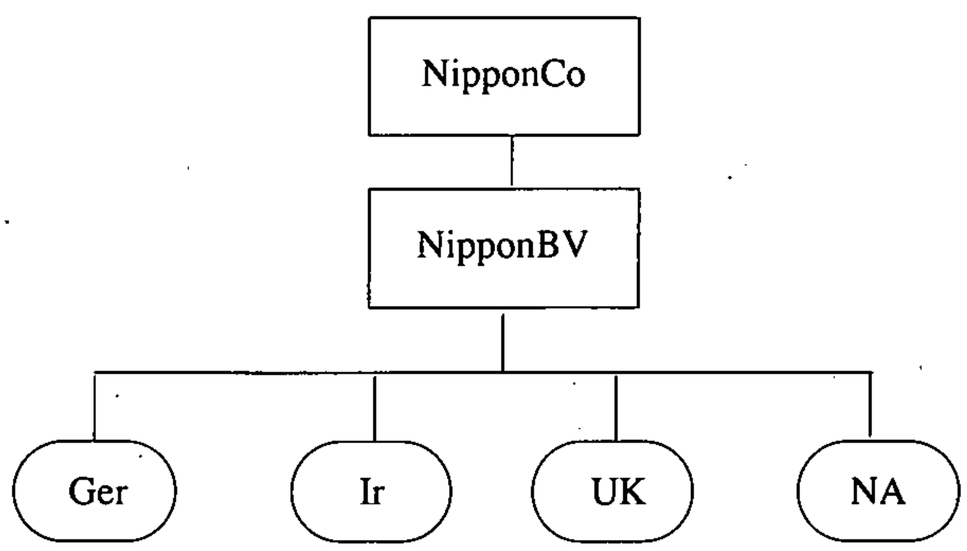
Example 6:

A Japanese parent company (NipponCo) owns manufacturing and sales operations in Germany (GerCo), Ireland (IrCo) and United Kingdom (UKCo). It also has a subsidiary in the Netherlands Antilles (NCo). Nippon Co has a wholly-owned Dutch holding company (NipponBV), which owns the foreign operational companies.

The corporate tax rates in the example countries are: United Kingdom 33 percent, Germany 60 percent, Ireland 10 percent and Netherlands Antilles 3 percent. Consequently, the Irish and Netherlands Antilles companies are both treated as THCOs (assuming that neither qualifies for an exception as legitimate and proper business). Moreover, the Dutch Nippon BV is also a THCO in respect of dividends and capital gains. The 1992 Amendments effectively prevent utilization of any tax advantages of this structure. Under the earlier legislation, only the Netherlands Antilles company would have been characterized as a tax haven company.

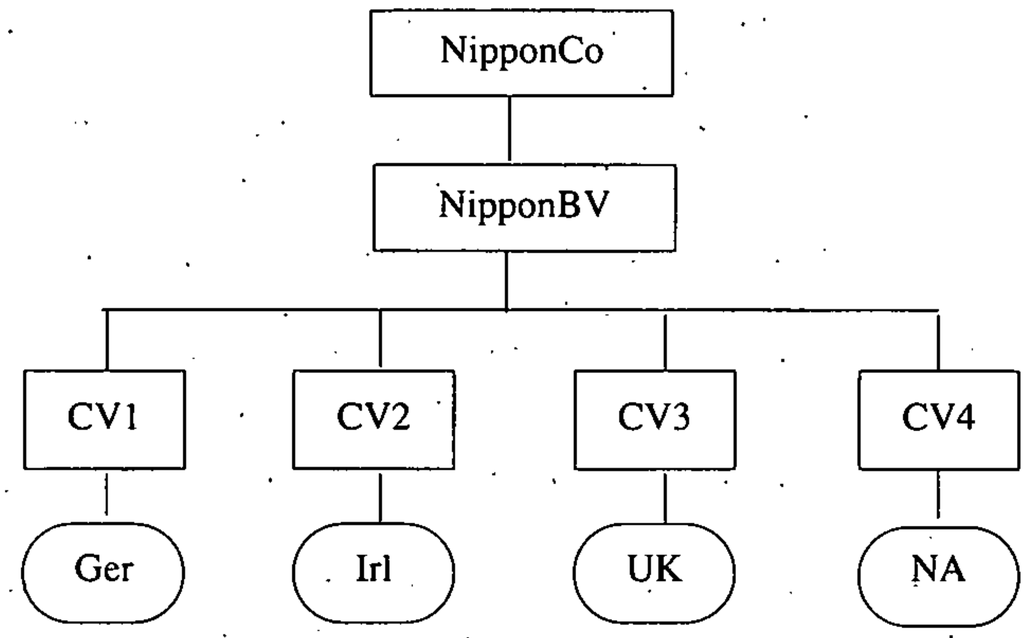


The mixing of tax rates can be achieved only by liquidating[14] the subsidiaries in the United Kingdom, Germany, Ireland and Netherlands Antilles, as then the Dutch BV would operate the business in those countries through PEs. In this case, the above structure would result in an effective income tax rate for the Dutch BV at the level of 25.75 percent. Thus the tax haven rules should not apply to the BV or to any of the operations of the PEs. However, the BV cannot realize capital gains without risking its effective tax rate to fall below 25 percent.



Operating PEs might not be a preferred alternative from a business perspective, as NipponBV would be directly liable for all debts of the PEs. Therefore, the model can be further enhanced by interposing Dutch CVs between NipponBV and the PEs. A Dutch CV (commanditaire vennootschap) is a partnership vehicle which imposes limited liability for certain partners (limited partners) and unlimited liability for others (general partners). A CV is not considered a tax subject under Dutch law, but its income is taxed directly as income of its partners.[15] However, for corporate and civil liability purposes, a CV is considered a legal person separate from its partners.

In order to limit the liability and to separate different operations from each other, one could interpose a separate CV between NipponBV and each of its foreign operations:[16]



This alternative would bring the structure as close as possible to the starting position. The Japanese tax haven provisions should not apply and, when NipponBV distributes its profits to NipponCo, the parent should be able to utilize the income taxes paid in Germany, Ireland, United Kingdom and Netherlands Antilles as indirect foreign tax credit. It is assumed that Japanese tax authorities will treat a CV for the purposes of tax haven legislation in the same manner as for purposes of indirect foreign tax credit, i.e. as equivalent to a branch.

Through this scenario, a Japanese multinational could continue deferring the Japanese tax on foreign dividends routed through the Netherlands. Moreover, if the dividends are redistributed to Japan, the Japanese parent can utilize the foreign income taxes paid as an indirect foreign tax credit.

The major disadvantage of this scenario is that the Dutch holding company will have to continuously monitor the effective tax burden in each country in order to maintain the desired mix of tax rates. Also, it allows only a limited possibility for realizing capital gains, as the tax-exempt capital gains of the Dutch holding company will have to be offset by a sufficient income tax in other countries.

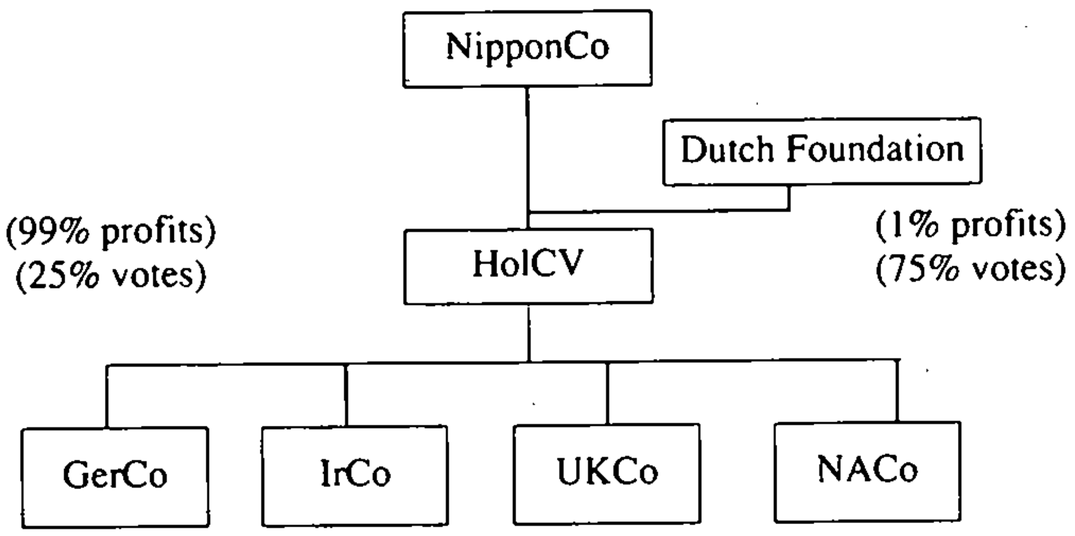
14. In this example liquidation would mean converting the local subsidiary into a branch. Obviously, such conversion might trigger a capital gains tax liability and/or other taxes which might seriously affect the economics of this scenario. We will not discuss possible scenarios to mitigate such adverse tax liabilities.
15. Under certain conditions a limited partnership in the form of a CV could be a separate tax paying entity subject to corporate income tax.
16. The CV obviously requires also a general partner, which can be a separate entity within the same group of companies. For the sake of clarity, general partners are not included in the chart.

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C. *Alternative C: avoiding Japanese control*

The third scenario is based on the Japanese control and major ownership tests, i.e. on reconstructing the holding company structure in a manner that the majority ownership of the Dutch holding company belongs to non-Japanese owners. This would exclude the application of the tax haven rules altogether, and enable unlimited operations in low-tax jurisdictions.

Using the same starting point as in the example in B above, the proposed structure could be as follows:



In this scenario the Dutch holding company (for which purpose now a BV is normally used) is replaced by a Dutch CV (HolCV). The rights and obligations of the partners of a CV can be determined rather freely by the terms of the partnership contract, making this form of business entity highly flexible.

Although a CV is normally treated as look-through partnership entity for the purposes of Dutch taxation, it is equally possible to create a CV which is a separate tax subject in the Netherlands. If the general partner is allowed to accept new partners into the partnership without the consent of all the limited partners, the CV is regarded as a separate taxpayer ("an open CV"). As a separate taxpayer, the CV should be able to enjoy protection of tax treaties as well as the benefits of the Dutch participation exemption.

Moreover, the partners of a CV can also freely agree on the distribution of profits (which does not necessarily follow the proportion of capital that the partners have contributed).

In the above example the Japanese parent company (NipponCo) is a limited partner in the HolCV, where it has contributed 75 percent of the capital. Under the terms of the partnership agreement, NipponCo is nevertheless entitled to receive 99 percent of the profits of the HolCV. The general partner (in this example a Dutch foundation) has 75 percent of stake of the capital but receives only 1 percent of the profits. Accordingly, over 50 percent of the HolCV is controlled by non-Japanese, and consequently the criteria for Japanese control are not met.

A Dutch foundation is a separate legal entity and in principle not subject to corporate income tax. In essence, it is not owned by anyone, although it does have a board to decide its investments and other relevant matters. Considering that Japan has no general anti-avoidance legislation, its seems possible that NipponCo could itself establish the foundation. In order to facilitate the defence of this structure, it may be advisable to have independent persons in the board of the foundation as well as provide for its dissolution in certain circumstances. The foundation may also issue a share certificate to NipponCo, under which any dissolution proceeds will be handed back to NipponCo.

Alternatively, the foundation could also be replaced by an independent trust company. However, the disadvantage then would be the fact that the effective control of the foreign operations is in the hands of an outsider, adding an element of uncertainty to NipponCo's position.

As the Japanese parent company controls 25 percent of the votes in the HolCV, it can utilize the indirect foreign tax credit for the income taxes paid by HolCV and its subsidiaries. As CV in this scenario is used as a separate taxpayer, it will most likely be regarded as such also for the purposes of indirect tax credit in Japan. Therefore, no intermediary holding companies can be interposed between HolCV and the operational companies, if JapCo desires to utilize the income taxes paid by operational subsidiaries in Germany, Ireland, United Kingdom and Netherlands Antilles.

The advantage of this scenario is that it excludes the application of the tax haven legislation altogether. Consequently, the subsidiaries of HolCV can engage in operations in tax havens, HolCV can realize capital gains as well as route and accumulate dividends without the intervention of the Japanese tax haven legislation. Moreover, when dividends are ultimately distributed to Japan, the parent company can utilize the indirect foreign tax credits.

On the other hand, when the profits are distributed to Japan, 1 percent would have to be channelled to the foundation. These funds could, however, be utilized to cover the running costs of the foundation.

This scenario is quite aggressive and vulnerable to further amendments to the Japanese tax haven legislation. It would be very easy for the Japanese legislator to prevent the use of such structures by specifying the provision regarding the major ownership (5 percent) test. Moreover, we realize that the split between the economic ownership and the legal ownership might be a concept which might not fit into the business philosophy of the Japanese parent company.

V. CONCLUSION

The 1992 Amendments in respect of the tax haven rules have put the use of Dutch holding companies in international structures in a less favourable light than before. The ideas presented above might form the basis for further thoughts to overcome the apparent tax disadvantages triggered by these amendments. How these new CFC rules will work out in practice remains to be seen. One thing is already clear now: these new rules have added more complexity to the already very complex Japanese tax system.

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INDIA:
1993/94 BUDGET

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The 1993/94 Indian Budget may be viewed as a growth-oriented people's budget. It is completely different and more refreshing than many of the previous budgets, and has left everyone wondering how the Finance Minister managed to reduce the budget deficit to around Rs. 43,140 million, while surprisingly sacrificing revenue to the extent of Rs. 45,220 million on account of rationalization and reduction of customs and excise duties, and at the same time increasing the central plan outlay by about 32 percent. Further, there is no new direct or indirect tax burden affecting individuals to any appreciable extent. The overall objective of the budget proposals has been to check the economic recession, speed up economic reform and internationalize Indian trade.

The Finance Minister announced a number of customs and excise duty reductions, not proposing any major amendment to the direct tax laws, leaving personal taxation intact, except for an increase in the standard deductions for salaries tax payers (from Rs. 12,000 to Rs. 15,000).

In framing the tax proposals, the Finance Minister stated that he was aware of the conflicting requirements of comprehensive reform of the tax structure and the need to protect revenue to finance the large increase in the plan. In principle, the Finance Minister accepted the Chelliah Committee proposals as set forth in its final report but decided to temporarily defer the reform of corporate taxation.

In respect of direct taxation the Finance Minister focused on encouraging foreign institutional investors to undertake a longer term involvement in India, accelerating industrialization of underdeveloped areas, increasing power generation and distribution, promoting a cleaner and healthier environment, and creating a strong base for science and technology, and the export of software.

This article summarizes the most important measures relating to direct taxes as they affect foreigners.

Contents

Corporation Tax Rates

100% Depreciation on Plant and Machinery relating to Environmental Protection and Pollution Control

Advance Rulings Introduced for Non-residents

Tax incentives

Conclusion

CORPORATION TAX RATES

Appreciating the worldwide trends in both corporate and personal taxation, the Chelliah Committee made several far-reaching recommendations in both of these areas. In its interim report the Committee recommended that in case of domestic companies, the tax rates inclusive of surcharge should in the course of the next three years (i.e. by assessment year 1995/96) be reduced to 40 percent. In the final report the Committee recommended lowering the corporate tax rate for all domestic companies to 45 percent in 1993/94 by abolishing the surcharge, and to 40 percent in 1994/95. Widely-held companies are currently subject to tax at 51.75 percent and closely-held companies at 57.5 percent, inclusive of surcharge. Although the Finance Minister accepted the broad thrust of the Chelliah Committee's recommendations its implementation has been postponed until next year.

100% DEPRECIATION ON PLANT AND MACHINERY RELATING TO ENVIRONMENTAL PROTECTION AND POLLUTION CONTROL

With a view to promoting a cleaner and healthier environment, a 100 percent depreciation allowance for pollution control equipment is proposed to replace the existing 40 percent on capital goods under the income tax rules.

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ADVANCE RULINGS INTRODUCED FOR NON-RESIDENTS

Pursuant to the announcement made in last year's Budget speech, the Finance Minister proposed a scheme for advance rulings in respect of transactions involving non-residents. Under the proposed scheme, advance rulings will be given on a question of law or fact in respect of a proposed transaction or a transaction undertaken by a non-resident. An application must be made to the authority in the form and manner to be prescribed by rules along with a fee of Rs. 2,500.[1] A request for a ruling may be withdrawn within 30 days. The authority has discretion to accept or reject an application, although no ruling will be issued where the request involves an issue already pending before the income tax authority, the Appellate Tribunal or any court; involves the determination of the fair market value of any property; or relates to a transaction which is designed prima facie for the avoidance of income tax.

The authority is required to issue an advance ruling within six months from the date of receipt of the application. The ruling will be binding on the applicant and in respect of the specific transaction to which the ruling was sought. The Commissioner will also be bound by the ruling. The proposed scheme does not provide for any right of appeal to the courts from the advance ruling.

An advance ruling may be revoked if it is subsequently discovered that it was obtained by fraud or misrepresentation of facts. The ruling will continue to remain in force unless there is a change in law or in fact on the basis of which it was granted.

TAX INCENTIVES

Tax Incentive for Foreign Institutional Investors Investing in Securities

While introducing a scheme for promoting foreign institutional investors in the Indian capital market the Government indicated that such investors will be liable to tax at 20 percent on investment income, and 10 percent on long-term capital gains. A new Section 115AD is proposed to be included in the Income Tax Act (ITA) relating to tax on income derived by foreign institutional investors from securities or capital gains arising from the transfer of securities.

Income received from securities (other than units referred to in Section 115AB) listed on a recognized stock exchange in India in accordance with the Securities Contracts (Regulations) Act, 1956 is proposed to be taxed at the rate of 20 percent. Long-term capital gains arising from the transfer of said securities are to be taxed at the rate of 10 percent, and short-term capital gains at the rate of 30 percent.

A new Section 196D is also proposed to be inserted in the ITA to provide for deduction of tax at source (20 percent) from income derived by foreign institutional investors in respect of securities. The deduction must be made either when the income is credited to the payee's account, when payment is made in cash, or when a cheque or draft is issued, whichever is earlier. No deduction of tax is to be made from any capital gains arising from the transfer of such securities.

Measures to Encourage Foreign Investment

Under the EC International Investment Partners Scheme the European Economic Community (EEC) will provide grants, interest-free loans and equity participation of dividend income accruing in India from investments made under the scheme, to be used for further investment in India. To facilitate investment by the EEC in India such income from investment has been proposed to be exempt from income tax. Accordingly, a new clause (23BBB) in Section 10 will provide a complete income tax exemption for Indian-source income in the form of dividends, interest or capital gains derived by EEC investors from investments made out of funds under the scheme.

Deduction of Head Office Expenditure for Non-Residents

ITA Section 44C currently contains a limit on the deduction for head office expenses in computing the taxable profits of non-resident taxpayers. The allowable amount is limited to either 5 percent of the taxpayer's "adjusted total income" for the relevant year or the annual average of the head office expenditure allowed during the base period of the previous three years, i.e. the previous year relevant to assessment year 1974/75 to 1976/77, or the actual amount of head office expenditure attributable to the business or profession of the assessee in India, whichever is less. Since the limit relating to average head office expenditure may operate to the disadvantage of persons who came to India before 1976, it is proposed to omit clause (b) of Section 44C and clause (iii) of the explanation to that section in order to remove the reference to "average head office expenditure". This amendment should place all non-resident assessees on equal footing with respect to allowability of the deduction.

Extension of the Tax Concession to Non-Resident Technicians Holding Indian Citizenship

ITA Section 10(6)(vii) exempts from tax perquisites paid by an employer on the salary of an employee who is not a citizen of India and who is engaged as a technician and renders services after 31 March 1988. This exemption is proposed to be extended to non-resident technicians who are Indian citizens.

Extension of Deduction for Profits from Export of Computer Software

ITA Section 80HHE provides for a 100 percent deduction in respect of income derived from software exports. The deduction is available for export profits derived during the previous year relevant to assessment years 1991/92, 1992/93 and 1993/94, and has now been extended for one more year, i.e. for assessment year 1994/95.

1. After receipt of the application, the authority will send a copy of the application to the relevant Commissioner and if necessary may request records.

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Tax Concession for Contributions to Universities and Institutions

Under ITA Section 80G, a 100 percent deduction is allowed in respect of donations made by a taxpayer to certain institutions. With a view to encouraging higher learning, it is proposed to increase the deduction for contributions to approved universities institutes of technology, institutes of management and equivalent institutions from 50 to 100 percent.

Tax Holiday for New Industrial Undertakings Set Up in Underdeveloped Areas

With a view to encouraging new investment in industrially underdeveloped States and Union Territories, a five-year tax holiday is proposed, to commence from the year of production for new industrial undertakings located in all the North-Eastern States, Jammu & Kashmir, Himachal Pradesh, Siukkim, Goa and Union Territories of the Andamann and Nicobar islands and Dadra and Nagar Haveli, Daman & Diu, Lakshdweep and Pondicherry.[2]

After completion of the fifth year the industrial undertaking will be entitled to the deduction under Section 80IA[3] for the remaining period, i.e. deduction from the profits from such undertakings will be allowed at the normal rate of 30 percent in the case of companies, and 25 percent in the case of non-corporate assessees. The deduction, at both the enhanced rate and normal rate, will be limited to 12 assessment years in the case of cooperative societies and ten assessment years in the case of other assessees as provided under ITA Section 80IA.

Tax Holiday for the Power-Generating Sector

A five-year tax holiday has been proposed in respect of profits and gains of new industrial undertakings set up anywhere in India for power-generating projects. The five-year tax holiday will be granted to undertakings which begin the generation of power on or after 1 April 1994. For subsequent assessment years the deduction from the profits of such undertakings will be allowed at the normal rate of 30 percent in the case of companies, and 25 percent in the case of non-corporate assessees. However, the deduction at the enhanced rate and the normal rate will be limited to 12 assessment years in the case of cooperative societies and ten years in the case of other assessees.

Expenditure on Scientific Research

Section 35 allows a deduction for contributions to approved scientific research associations, universities, colleges or other institutions to be used for scientific research. With a view to encourage industry to make use of facilities offered by the National Laboratories and Research Institutes, it is proposed to allow a weighted deduction of 125 percent of the contribution to approved National Laboratories and Institutions[4] carrying out research and development in natural and applied sciences.[5] This weighted deduction will be available only to users and producers of research which are approved by the prescribed authority.

Special Tax Concession for Contributions to the National Foundation for Communal Harmony

A deduction of 50 percent is allowed for donations made to certain trusts and institutions under Section 80G. However, a 100 percent deduction is allowed for donations made to specified funds. It is proposed to extend the benefit of the 100 percent deduction to donations made to the National Foundation for Communal Harmony. Further, it is also proposed to amend ITA Section 10(23C) to include the National Foundation for Communal Harmony as a fund whose income will be exempt from income tax.

CONCLUSION

The result of various relaxations proposed in the direct tax laws would be a net loss to the extent of Rs. 3,000 million according to the Finance Minister, but he hopes that improved tax collection will cover the estimated loss. It is quite refreshing to find that the Finance Minister has not attempted to unnecessarily meddle with the direct tax laws as in the past because invariably every amendment in some way or the other adds to the complexity of the already complicated tax laws. As the Finance Minister himself stated in the Budget speech, he has deferred the corporate tax reforms for the time being while in principle accepting the recommendations of the Chelliah Committee. The enlarged provision for education and health, tax incentives for scientific research, encouraging donations to educational institutions, and the emphasis on building infrastructure are all the positive socio-economic aspects of the Budget. The Budget proposals should speed up the process of economic recovery by accelerating industrial development, strengthening the capital market and attracting sufficient foreign exchange into India. This is all the more necessary in the area of foreign investment. Foreign investments can and must play a primary role in bolstering India's external reserves position.

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2. A new Eighth Schedule to the ITA is to be inserted which lists the States and Union Territories eligible for a new tax holiday.
3. Under ITA Sec. 80IA an assessee is entitled to a deduction at either 30% or 20% for a specified period of time (i.e. 10 or 12 years) in respect of profits of an industrial undertaking established anywhere in India. Under the new provision an industrial undertaking established in an underdeveloped area will benefit from the five year tax holiday and for the remaining five or seven years will be eligible for the deduction under Sec. 80IA.
4. A National Laboratory is defined as a scientific laboratory functioning at the national level under the aegis of the Indian Council of Agricultural Research, the Indian Council of Medical Research and the Council of Scientific and Industrial Research, and which is approved by the prescribed authority for this purpose.
5. A new sub-section 2(AA) in Sec. 35 is to be inserted for this weighted deduction.

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CUMULATIVE INDEX – 1993 Nos. 1-4

I. ARTICLES

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Denmark:
Bente Moll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

France:
Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Hong Kong:
Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

John Prebble:
100 Years of Income Tax 59

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Japan:
Alum Bati:
Taxation of Dividends and Interest 202

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

United States:
Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

Wim Wijnen:
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC: The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96, 219

IV. CONFERENCE DIARY 39, 149

V. BIBLIOGRAPHY

– Books 49, 100, 150, 226
– Loose-leaf services 51, 103, 154, 231
– List of addresses of the major publishing houses appearing in the Bibliography 53

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CONTENTS

VOL. 47 NO. 6 **JUNE 1993**

UNITED STATES: HOW TO ESCAPE THE WRATH OF THRASYBULUS' SWORD AND ESTABLISH REASONABLE ROYALTY RATES IN INTERCOMPANY LICENSING OF INTANGIBLES UNDER THE "BEST METHOD RULE" OF THE NEW SECTION 482 REGULATIONS — 307 — *Stephen A. Mihaly*

The new Section 482 regulations list four methods of determining an arm's length rate of royalty in a controlled transaction but they do not provide for any strict priority rules. Rather the regulations adopt a new approach referred to as the "best method rule", under which the arm's length rate of royalty must be determined by using the method which provides the most accurate arm's length result under the relevant facts and circumstances.

INTERNATIONAL: RECENT TAX REVENUE DEVELOPMENTS IN OECD COUNTRIES AND SOME POLICY IMPLICATIONS — 323 — *Ken Messere*

Mr Messere comments on recent trends in government tax revenue levels and structures, sub-central government tax revenues and general government financial balances. Also discussed are the fiscal policy implications of these revenue developments, primarily in the G7 countries, with special reference to what should be government reactions to the increase in fiscal deficits that are predicted to continue over the next few years in most of these countries.

THE US–NETHERLANDS INCOME TAX TREATY: TAX COLLECTION ASSISTANCE AND EVIDENCE-GATHERING — 342 — *Bruce Zagaris*

This article discusses the collective assistance provisions in the new US–Netherlands tax treaty. In particular, it examines how the provisions operate and the requirements to exhaust the treaty evidence-gathering prior to the right of the US government to invoke techniques under IRC Section 6038. Also examined are the procedural aspects of exchange of information, tax collection assistance (including such provisions in other treaties) and the OECD/COE convention on mutual administrative assistance in tax matters. To bring the new treaty into perspective the article discusses other means to gather evidence to collect taxes.

FINLAND: FUNDAMENTAL TAX REFORM: 25 PERCENT RATE ON CAPITAL INCOME AND CORPORATE INCOME — 348 — *Kari S. Tikka*

Finland launched a comprehensive income tax reform effective from 1 January 1993, covering the taxation of capital income of individuals and the taxation of business profits. Professor Tikka overviews the background to the reform, and then discusses the main features of the new system.

BIBLIOGRAPHY 354
– Books. 354
CONFERENCE DIARY 347
CUMULATIVE INDEX 359

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UNITED STATES:

How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the "Best Method Rule" of the New Section 482 Regulations

Stephen A. Mihaly

International licensing of valuable intangible properties, such as patents, know-how, manufacturing technology, trademarks or copyrights has been in existence for many years. When a useful new product or process is invented in one country, it is likely that it could be commercially exploited in other parts of the world also. Nowadays, most of the valuable intangibles, at least in the area of industrial property rights such as patents, know-how, technology or trademarks, are developed and acquired by companies. Therefore, for the sake of simplicity, we will refer to a "company" as the owner of the intangible.

The company developing a new product is not likely to be content with the commercial exploitation of the product in its own country. It is more likely that it will expect or hope to derive additional profits from the sale and marketing of the product in other markets. Sometimes, the manufacture of the products in the company's own country and the shipment of such products to destinations abroad might not be the most economical way of exploiting the opportunities in other markets of the world. In many cases, it may be more beneficial and preferable for the company to sell the invention (perhaps the foreign patent and related property rights) to a buyer located in a particular foreign country or to license the manufacture of such products to a local enterprise for royalty.

Quite often, the most efficient way of commercial exploitation of the product or invention is for the company to establish a manufacturing facility in one or several foreign countries. In most cases this will mean that the company will establish a subsidiary incorporated in the foreign country in which the manufacturing facility will be located. Numerous business considerations may dictate the use of such an offshore manufacturing subsidiary. For example, a US company desiring to sell its products in the European Economic Community (EEC), may find that the only way it can do so on a competitive basis is by establishing a local subsidiary to manufacture the products within the EEC. It is likely to find that the direct shipment of its products from the United States to the EEC would not be profitable because of the additional freight costs and EEC customs duties imposed on finished products imported from the United States. A lack of "presence" within the EEC might also be harmful. A Japanese manufacturing company may find that it is desirable to establish a manufacturing subsidiary in Thailand, Malaysia or Indonesia where the labour costs would be a fraction of the comparable labour costs in Japan. A German car manufacturer may find that it is preferable to establish a subsidiary company in the United States to produce its cars in this country in order to make its products more acceptable in the US market.

Normally, the foreign manufacturing subsidiary will need the manufacturing technology, know-how and perhaps patent protection of its parent corporation. When such industrial property rights are furnished to the offshore subsidiary as part of the licensing arrangement, the subsidiary will pay a royalty to its parent corporation for the license which permits it to use such manufacturing intangibles in its business. This will then raise the question what should be the rate of royalty payable by the

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Contents

I. Traditional Rule of Determining Arm's Length Rate of Return
II. Adoption of Super Royalty Concept by Tax Reform Act of 1986
III. Historical Development of 1993 Regulations
IV. New Methods of Determining Arm's Length Rate of Royalty
  A. Comparable uncontrolled transaction method
  B. Comparable profits method
  C. Profit split method
V. US Parent Corporation Licensing its Foreign Subsidiary
VI. How to Prevail with the CUT Method
VII. Factors to be Considered in Ascertaining Whether the CUT Method Could be Used to Determine the Arm's Length Rate of Royalty
VIII. Foreign Parent Corporation Licensing its US Subsidiary

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manufacturing subsidiary to its parent corporation for the license of such intangibles.

I. TRADITIONAL RULE OF DETERMINING ARM'S LENGTH RATE OF ROYALTY

In most cases, the rate of royalty paid by the manufacturing subsidiary to its parent corporation for the use of its intangibles could have significant tax ramifications. This is so partly because most countries do not tax on a current basis the profits realized by the company's offshore manufacturing subsidiary. Thus, if the corporate tax in the particular foreign country is significantly lower than the rate of the corporate tax in the parent corporation's home country, the parent corporation could derive a substantial tax benefit by receiving a relatively modest royalty from its manufacturing subsidiary.

Therefore, fiscal authorities of industrially developed countries have been giving attention to the matter of the rate of royalty payable by the offshore manufacturing subsidiary to its parent corporation and the rate of royalty in international licensing arrangements in general for some time.

The general principle has developed that the rate of royalty payable under such circumstances should be "arm's length". This general principle was adopted by the Council of the Organization for Economic Cooperation and Development (OECD) in 1979. Section 91 of the Report of the OECD Committee on Fiscal Affairs (entitled "Transfer Pricing and Multinational Enterprises"), approved by the OECD Council, stated this general rule as follows:

> The general principle to be taken as the basis for the evaluation for tax purposes of transfer prices between associated enterprises under contracts for licensing patents or know-how is that the prices should be those which would be paid between independent enterprises acting at arm's length. It follows from this that such transactions should not be treated differently for tax purposes from similar transactions between independent parties solely by virtue of the fact that the enterprises are associated.

The OECD Report also describes other methods of determining the arm's length rate of royalty "where a sufficiently similar transaction involving an unrelated party cannot be found, or does not provide satisfactory evidence" (Section 98).

This general approach, with emphasis on comparables involving unrelated parties, has been adopted by the tax laws of most industrially developed countries.

Substantially the same approach was in existence in the United States, at least since 1968. In that year, the IRS promulgated regulations under Section 482 of the IRC. Reg. §1.482-2(d)(2)(ii)(1968) contained the following general principle:

> In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

The 1968 Regulations stated that, in the event comparable transactions between unrelated parties for the same or similar intangibles could not be found, various other factors had to be considered in determining the arm's length rate of royalty. The following 12 factors were listed:[1]

(1) prevailing rate in the same industry or for similar property;
(2) competing offers or bids;
(3) terms of the licensing, such as limitation on the geographic area covered and the exclusive or non-exclusive character of the license;
(4) uniqueness of the property and the period of time for which it is likely to remain unique;
(5) duration and extent of legal protection of the property;
(6) value of services rendered by the licensor to licensee in connection with the license;
(7) licensee's prospective profits or cost savings;
(8) licensee's capital investment and start-up costs;
(9) availability of substitutes;
(10) arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to unrelated parties;
(11) cost of developing the intangible property;
(12) other relevant facts or circumstances.

In applying these regulations, the IRS had the added advantage that the taxpayer had the burden of proof to show that the determination made by the IRS that the income or deductions should be re-allocated between related parties was arbitrary, unreasonable or capricious. In the event the taxpayer was not able to satisfy this burden of proof, the determination of the IRS would be upheld. Thus, in practice, the taxpayer would have to prove that the determination made by the IRS was not correct and that the method used by the taxpayer in determining the arm's length royalty or some other alternative licensing arrangement satisfied the arm's length standard.[2]

It would have been reasonable to expect that the IRS should be able to prevent abuses of Section 482 by taxpayers based on the rules contained in its 1968 Regulations and enjoying the substantial tactical advantage that the burden of proof to prove the incorrectness of the determination of the IRS was on the taxpayer.

II. ADOPTION OF SUPER ROYALTY CONCEPT BY TAX REFORM ACT OF 1986

During the years 1984 and 1985, the US Treasury Department was becoming increasingly unhappy about the 1968 Regulations, claiming that the "arm's length" approach of such regulations was not sufficiently effective to protect the Treasury's interests. Apparently, the IRS auditing agents were not able to cope with the arguments and evidence advanced by the taxpayers' representatives.

Often, the taxpayers prevailed by relying on prevailing rates of royalties in the particular industry, even though the intangible property licensed to its controlled party was unique and highly profitable. The Treasury Department asked Congress to remedy the situation. By the summer of 1985, a rather

1. Reg. §1.482-2(d)(2)(iii)(1968).
2. *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), aff'd in part, rev'd in part, and rem'd, 856 F.2d 855 860 (7th Cir. 1988).

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highly charged atmosphere had developed on this issue in Congress.

As a result, in the Tax Reform Act of 1986 Congress added a sentence to Section 482 reading as follows:

> In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

This, of course, is a rather cryptic statement. It does not tell how the rate of royalty should be determined in such a manner as to satisfy the "commensurate-with-income" requirement. Congress instructed the Treasury Department and the IRS to deal with the details of the new rule and to determine how the provisions of the 1968 Regulations should be amended in order to comply with the new commensurate-with-income rule. The new rule has subsequently become known as the "super royalty rule".

The legislative history makes it clear, however, that the new rule does allow, or even provides for, a periodical review or adjustment of the rate of the royalty in order to bring the royalty rate in conformity with the income stream of the licensee. For example, if a royalty equal to 10 percent of sales was arm's length when the controlled licensee's after-royalty pre-tax income was equal to 20 percent of its sales, the 10 percent royalty would no longer be arm's length in a subsequent year when the controlled licensee's after-royalty pre-tax income was equal to 50 percent of sales. The rate of royalty would have to be increased to make it commensurate with the income realized by the controlled licensee from the use of the intangibles.

In its Report, the House Ways and Means Committee stated that "in requiring that payments be commensurate with the income stream, the bill does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income...".[3] This statement in the Congressional Report made the "contract manufacturer" approach a sort of taboo to the officials of the Treasury Department and the IRS charged with the duty to develop the regulations applying the new super royalty rule. The drafters faced the dilemma that in most cases the new super royalty rule could not be given meaningful application unless the controlled licensee would be treated, in effect, as a contract manufacturer, so that the task then became to accomplish approximately such treatment and result without ever using the words "contract manufacturer" or "contract manufacturer method".

III. HISTORICAL DEVELOPMENT OF 1993 REGULATIONS

When the super royalty rule was enacted by Congress in 1986, the new provision became effective in the taxable year beginning after 31 December 1986. The super royalty rule was heralded as one of the most revolutionary and significant changes in our tax laws. Thus, it would have been reasonable to expect that the IRS would promulgate regulations explaining the exact meaning of the new rule within a short period of time. Nevertheless, the IRS did not succeed in promulgating such regulations until 13 January 1993. Thus, amazingly, six full years went by without giving any guidelines to taxpayers about the meaning of the new provision. This is also likely to mean that six full years were wasted in actual application and enforcement of the new super royalty rule, thus presumably allowing the perceived abuses of the arm's length standard of the 1968 Regulations and the resulting perceived huge revenue losses to the US Treasury to continue.

The first effort of the IRS, in explaining the meaning of the super royalty rule, was the issuance of "A Study of Intercompany Pricing", also known as the "White Paper", on 18 October 1988.[4] The White Paper stated that when so-called "exact comparables" were available, the arm's length rate of royalty would be determined on the basis of such exact comparable transactions. However, the exact comparable transactions were defined rather narrowly so that it was not likely that this method could in fact be used. In the absence of exact comparables, the taxpayer was supposed to use inexact comparables or the so-called basic arm's length return method ("BALRM" method) which was based on the application of arm's length rate of return on the assets and functions of the relevant line of business of the controlled party. In practice, the principal rule of the White Paper would have been the BALRM method. In addition, the White Paper provided for periodic review and adjustments in the rates of intercompany royalties.

The "basic arm's length return method" was quickly discredited as nothing but a glorified version of the contract manufacturer method.

After four long years, in January of 1992, the IRS promulgated Proposed Regulations (1992 Proposed Regulations). Even though much of the analysis contained in the White Paper was discredited, the 1992 Proposed Regulations generally followed the approach of the White Paper. The 1992 Proposed Regulations provided for three methods of determining the arm's length rate of royalties:

1. *The matching transaction method.* The application of this method was enormously restricted since it could be applied only if there was evidence of comparables involving the *same* intangibles and the same or substantially similar economic conditions and contractual terms as the licensing involving a controlled company.

2. The *comparable adjustable transaction method* which could be applied when there was evidence regarding the same or similar intangibles under adjustable economic conditions and contractual terms.

3. The *comparable profits method* which was based on the use of the so-called "comparable profit interval", or "CPI".[5]

These three methods were supposed to be applied in the above indicated order of priority. However, the CPI would have been also used as a check on the application of method 2 (the comparable adjustable transaction method) so that, in final analysis, because of this and because of the fact that method 1 (the matching transaction method) could in fact almost never be applied, in practically all cases the arm's

3. Report of the Committee on Ways and Means of the House of Representatives on H.R. 3838, dated 7 December 1985, at 426.
4. Notice 88-123, 1988-2 C.B. 458.
5. Prop. Reg. §§1.482-2(d)(1)-(5)(1992).

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length rate of royalty would have been determined under the CPI method.

The 1992 Proposed Regulations would have pushed the super royalty concept to its ultimate extreme application. In practice, all controlled licensees would have been limited to a modest return normally realized by contract manufacturers and the rest of the profit would have been allocated to the parent corporation owning the intangibles in the form of very high royalties. One example in the 1992 Proposed Regulations[6] indicated a reallocation from the controlled party of royalty equal to 66 percent of its sales of licensed products.

There was a tremendous outpouring of objections against the 1992 Proposed Regulations. Representatives of many foreign governments indicated that the basic approach of such regulations was in conflict with the general principle of the arm's length rule adopted by practically all economically developed countries, that they would not accept the determinations made by the IRS on the basis of the CPI method and that the regulations were in conflict with provisions of existing income tax treaties. US Treasury officials then indicated that the proposed regulations would have to be substantially revised.

The next development was the issuance by the IRS, on 13 January 1993, of new Temporary and Proposed Regulations under Sections 482 and 6662 (dealing with penalties).

The new Temporary Regulations replace the provisions of the 1968 Regulations governing intercompany licensing completely and they also completely replace the 1992 Proposed Regulations (except for the chapter on research and development cost sharing). Since the Temporary Regulations are quite different from the 1992 Proposed Regulations, it would have been more appropriate to issue them in form of proposed regulations. The fact that they have been issued in form of temporary regulations means that they have the force of law from their effective date. They will continue to have the force of law until final regulations will be issued or for a period of three years from their effective date, whichever occurs first.

The 1993 Proposed Regulations contain rules on the profit split method (with the expectation that such provisions will be subsequently inserted in the Temporary Regulations), rules regarding the application of the accuracy-related penalties imposed by Section 6662 in the event of Section 482 adjustments (such as adjustments to the royalty rates) and rules relating to the so-called blocked income issue.

The Temporary Regulations[7] and the Proposed Regulations under Section 6662 are effective for taxable years beginning after 21 April 1993. Thus, in the case of taxpayers using a calendar year, they will become effective as of 1 January 1994.

The 1993 Proposed Regulations dealing with the profit split method[8] do not have a determined effective date, the expectation being that the effective date of such provisions will be determined when the regulations will be finalized.

The 1968 Regulations have been renumbered as Reg. §§1.482-1A and 1.482-2A. They are now effective for taxable years beginning on or before 21 April 1993. Thus, for example, again in case of a taxpayer using a calendar year, such regulations will remain in effect through 31 December 1993.

Even though the super royalty rule of the Tax Reform Act of 1986 applies to taxable years beginning after 31 December 1986, technically, there are now no new Section 482 regulations applicable to past taxable years (with respect to calendar year taxpayers through 31 December 1993), other than the 1968 Regulations. However, the Temporary Regulations state that "any reasonable method not inconsistent with the statute" could be used during the interim period of time (1987-1993) and further that the rules set forth in the Temporary Regulations will constitute a "reasonable method" for this purpose.[9]

IV. NEW METHODS OF DETERMINING ARM'S LENGTH RATE OF ROYALTY

The new regulations provide for four methods of determining the arm's length rate of royalty in a controlled transaction. These four methods are as follows:[10]

(a) comparable uncontrolled transaction method,
(b) comparable profits method,
(c) profit split method, and
(d) "other methods".

Although the regulations list these several methods of determining the arm's length rate of royalty, they do not provide for any strict priority rules. Instead of providing for any priority rules, the regulations adopt a new approach referred to as the "best method rule". Under this rule, the arm's length rate of royalty must be determined by using the method which provides the *most accurate* arm's length result under the relevant facts and circumstances.[11]

A. *Comparable uncontrolled transaction method*

The comparable uncontrolled transaction method ("CUT method") is similar to the basic principle of determining an arm's length rate of royalty contained in §1.482-2(d)(2)(ii) of the 1968 Regulations and Section 91 of the OECD Report. The regulations state that, for purposes of applying the best method rule, "the comparable uncontrolled transaction method, when it can reasonably be applied on the basis of available information, ordinarily will provide the most accurate measure of an arm's length charge for the transfer of intangible property".

Thus, even though the regulations do not provide for an order of priorities in which the various methods should be applied, this provision, coupled with the fact that the CUT method is mentioned in the first place, gives some edge to the CUT method over the other methods. It is relevant in this respect that the regulations state that the CUT method will ordinarily provide the "*most*" accurate measure of an arm's length charge for purposes of the best method rule. This should be contrasted with the language used in the regulations describing the comparable profits method which states only that, for

6. Prop. Reg. §1.1482-2(f)(11), Example 6.
7. Temp. Reg. §§1.482-1T – 1.482-5T.
8. Prop. Reg. §1.482-6T.
9. Temp. Reg. §1.482-1T(h).
10. Temp. Reg. §1.482-4T(a) and Prop. Reg. §1.482-6T.
11. Temp. Reg. §1.482-1T(b)(2)(iii)(A).

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purposes of the best method rule, the comparable profit method ordinarily will provide an "accurate" measure of an arm's length result.

B. *Comparable profits method*

The regulations list the comparable profits method as the next method for determining the arm's length of royalty payable by the controlled licensee. The comparable profits method is described in Temp. Reg. §1.482-5T. It is a simplified version of the comparable profits method which was contained in the 1992 Proposed Regulations (based upon the CPI). However, unlike the comparable profits method of the 1992 Proposed Regulations, the comparable profits method of the Temporary Regulations does not serve as a check on the validity of the other methods such as the CUT method. Thus, the comparable profits method is now simply another method of determining the arm's length rate of royalty.

Under the comparable profits method, the arm's length rate of royalty is determined by calculating profit level indicators from the financial information of comparable uncontrolled parties and applying the profit level indicators to one of the parties involved in the controlled transaction so as to determine the arm's length operating profit of such party. As already mentioned, the regulations[12] state that for purposes of applying the best method rule, the comparable profits method will ordinarily provide an accurate measure of an arm's length result.

The first step in applying the comparable profits method is to determine the "tested party". This would normally be the licensee unless the licensee also uses valuable, non-routine intangibles that it either acquired from uncontrolled taxpayers and with respect to which it bears significant risks and possesses the right to significant economic benefits or it has developed itself, in which case probably the profit split method of the 1993 Proposed Regulations would be a more appropriate method of determining the arm's length rate of royalty.[13]

Ordinarily, the comparable profits method should be applied separately to each "industry segment" of the tested party. This means a product or product line.[14] When it comes to the standard of comparability required under the comparable profits method, it is rather lax. The regulations[15] state that in applying the comparable profits method "the controlled and uncontrolled taxpayers need be only broadly similar, and significant product diversity and some functional diversity between the controlled and uncontrolled transactions is acceptable". In other words, even though the products are quite different and the functions performed by the uncontrolled licensee might be different from the functions performed by the controlled licensee, the information may still be used under the comparable profits method. However, the greater the similarity between the tested party and the comparable party, the more reliable would be the evidence under this method. If reliable data relating to comparable parties that operate within the same industry segment as the tested party are available, such data are required to be employed for purposes of the application of the comparable profits method.

The regulations describe a number of adjustments that should be (but are not required to be) made with respect to the comparable parties. Such adjustments are made only to the extent that they have a definite and reasonably ascertainable effect on operating profits. Accounting reclassification also may be made to ensure that various items are measured consistently.

The regulations state, in effect, that the rate of the royalty paid by the licensee will be considered arm's length under the comparable profits method if the licensee's reported operating profits are within the arm's length range consisting of a range of constructive operating profits derived from comparable parties.[16] Constructive operating profits are calculated by applying profit level indicators derived from the comparable parties to the tested licensee's financial data.

The regulations indicate several types of profit level indicators.[17] Among the various possible profit level indicators, one single profit level indicator must be selected. Such selection should be based on the nature of the activities of the licensee, the reliability of data available with respect to uncontrolled parties and the extent to which a particular profit level indicator is likely to produce a reasonable determination of the income that the licensee would have earned had it paid royalty at an arm's length rate.

The regulations mention three particular profit level indicators by name, namely the rate of return on assets, ratio of operating profit to sales and ratio of gross profit to operating expenses. The regulations seem to favor the return on assets profit level indicator provided the licensee does have substantial fixed assets or working capital which play a significant role in generating operating profit. When financial ratios, such as the above mentioned ratios of operating profit to sales or ratios of gross profit to operating expenses are used, more stringent comparability will be required than when the rate of return on assets is used as a profit level indicator.

In making the computations under the comparable profits method, interest, dividends or extraordinary gains and losses are excluded from the computation of "operating income" and interest expense and income taxes are excluded from "operating expenses". The term "operating assets" which is relevant when the return on assets profit level indicator is used does not include excess cash, portfolio investments or investments in subsidiaries.

Under the comparable profits method, the results of the controlled licensing arrangement will be considered arm's length if the licensee's operating profits will be within the range of the constructive operating profits derived from comparable parties. Normally, all such calculations should be made on the basis of several years, consisting of the taxable year and the preceding two taxable years.[18]

12. Temp. Reg. §1.482-5T(a).
13. Temp. Reg. §1.482-5T(a),(b)(1).
14. Temp. Reg. §1.482-5T(b)(2) and Reg. §1.6038A-3(c)(7).
15. Temp. Reg. §1.482-5T(c).
16. Temp. Reg. §1.482-5T(d)(1).
17. Temp. Reg. §1.482-5T(d).
18. Temp. Reg. §1.482-5T(d)(1).

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If the comparability standards of the comparable profits method are met and adjustments to reflect the differences between the controlled licensee and the uncontrolled parties are made, the arm's length range will include all of the constructive operating profits derived from the comparable parties. By way of illustration, in the event the return on assets profit level indicator is properly used and it shows that comparable unrelated licensees derived an operating profit equal to 4, 6 and 8 percent of their respective assets, and the controlled licensee's operating profits are equal to 7 percent of its assets, then the royalty actually paid by the controlled licensee will be considered arm's length.

If, on the other hand, the comparability standards are not met, or the adjustment for the mentioned differences are not made, then the arm's length range will consist of the interquartile range from the 25th to the 75th percentile of the constructive operating profits derived from the profit level indicators of the comparable parties (assuming the existence of at least four comparable parties).

In practice, it is likely that the use of the comparable profits method will result in reducing the profit of the controlled licensee to modest amounts. The preference of the profit level indicator based on return on assets is likely to further reduce the controlled licensee's profits. The fact that it may be almost impossible for the taxpayer to obtain reliable business segment or product line financial data relating to uncontrolled parties which would be somewhat comparable to the controlled licensee will not make the matter any easier for the taxpayer. Normally, financial data for business segment of product lines are not separately shown in publicly available financial documents. Therefore, usually, broad industry averages will have to be used in applying the comparable profits method, which could produce highly distorted results. Of course, there is the danger that the IRS would be using such data, based on broad industry averages, and sometimes even involving operations in other countries than in the country in which the controlled licensee operates.

The regulations do not contain any illustration of how the comparable profits method would be applied in connection with licensing of intangibles, except for the example contained in Temp. Reg. §1.482-5T(g), Example 3, which, for some reason, uses an extreme case of a "round-trip" transaction. In this example, a US parent corporation grants a manufacturing license to its foreign subsidiary to produce some high-tech products. The foreign subsidiary manufactures such products and sells them to a US subsidiary of the parent corporation for distribution in the United States. The price charged by the foreign subsidiary to its US sister company is arm's length. The foreign subsidiary also pays a royalty to its parent corporation at the rate of 5 percent of sales. In the example, the IRS increases the 5 percent royalty to 56 percent so that the operating profit of the foreign subsidiary becomes $ 3,750 which is 15 percent of its operating assets and 12.5 percent of its sales.

No explanation is given how the results would differ if the foreign subsidiary would not sell its products to the United States, but to sister companies abroad, or if it would sell them directly to unrelated customers, although the greater functions and risks assumed by the foreign subsidiary would then hopefully require the finding of profit level indicators of other companies dealing with unrelated parties and performing such more substantial functions and assuming such additional risks and such profit level indicators would show higher profits.

Many foreign manufacturing subsidiaries do not require large capital in form of fixed assets or working capital. Thus, for example, if the operating assets of the foreign licensee are $ 1 million and the arm's length rate of return on assets is 15 percent, this would mean that the operating profit of the licensee could be only $ 150,000.

In most cases, the application of the comparable profits method will cut back the profit of the controlled licensee very substantially. In this manner, the practical operation of the comparable profits method can be compared with the approach which Thrasybulus, Prince of Miletus, suggested some 2,500 years ago. Herodotus, *The History*,[19] describes this as follows:

> "At the beginning Periander [King of Corinth] was gentler than his father had been. But afterwards, when he had dealt, by messengers, with Thrasybulus, prince of Miletus, he became yet bloodier than Cypselus. For he sent a herald to Thrasybulus inquiring about the safest political establishment for administering the city best. Thrasybulus led out Periander's messenger, outside the city, and with him entered a sown field; then he walked through the corn, questioning, and again questioning, the herald about his coming from Corinth. And ever and again as he saw one of the ears of corn growing above the rest he would strike it down, and what he struck down he threw away, until by this means he had destroyed all the fairest and strongest of the corn. So he passed through the whole place and, having added no suggestion, sent the herald away.
>
> When the herald came back to Corinth, Periander was anxious to know what suggestion Thrasybulus had made. But the man said that Thrasybulus had made no suggestion at all, and indeed he wondered what sort of a man this was he had been sent to, a madman and a destroyer of his own property; for he recounted all that he had seen Thrasybulus do. But Periander understood the act of Thrasybulus and grasped in his mind that what he was telling him was that he should murder the most eminent of the citizens."

Thrasybulus' advice to Periander was to cut back on all outstanding people so that all folks would be simple and modest people. The message of the comparable profits method is to cut back the profit of the foreign manufacturing licensee, preferably to a modest rate of return on assets. Such matters as business efficiencies or talent and competence of the management of a controlled foreign licensee are not likely to get consideration when such approach is used.

One additional danger inherent in the comparable profits method for the taxpayer is the enormous relaxation, and perhaps the complete waiver, of the comparable uncontrolled transaction requirement. The absence of comparables would only reduce the reliability of the comparable profits method under the best method rule, but the comparable profits method could still be applied even though the relevant data would fail to meet the comparability standards of the comparable profits method and this result could be prevented only by showing

19. Chicago: University of Chicago Press, 1987. Herodotus was a 5th century BC Greek historian; he is generally referred to as the "father of history".

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that some other method, such as particularly the CUT method, would be more reliable under the best method rule.

It should be noted that the profit level indicators offered by the new regulations could have been considered also under the "other facts and circumstances" factor of the 1968 Regulations.

C. *Profit split method*

Another method of determining the arm's length rate of royalty in controlled licensing arrangements is the profit split method. This method is described in the Proposed Regulations issued by the IRS in conjunction with the Temporary Regulations.[20]

In order to be entitled to use the profit split method, several conditions must be satisfied. The application of the profit split method must, first of all, satisfy the best method rule. Furthermore, each party to the controlled licensing arrangement must own valuable, "non-routine" intangibles acquired from a third party or developed by itself. In other words, it is necessary to show that the controlled licensee owns some valuable, non-routine intangibles which it acquired from a third party (the controlled licensee possessing the burdens and benefits associated with the intangible) or that the licensee has developed such valuable, non-routine intangibles itself. Intangibles developed pursuant to a qualified cost sharing agreement to which the controlled licensee is a party, will qualify for this purpose.[21]

The ownership of such valuable, non-routine intangibles by the controlled licensee is thus a very basic condition to using the profit split method. Unfortunately, the regulations do not explain what is meant by "valuable, non-routine intangible". The Preamble to the regulations requests comments on the possible precise definition of such term. Thus, the regulations make the ownership of "valuable, non-routine intangibles" by the controlled licensee a prerequisite for the use of the profit split method, but they do not explain what such term means and, in effect, tell the taxpayers: "Should you know a person who knows what this means, please let us know."

For the time being, the only indication what intangibles could qualify as "valuable, non-routine intangibles" is in two examples contained in the Proposed Regulations. The first example is in Prop. Reg. §1.482-6T(c)(2)(iii). This example involves a US intangible which is a formula for a detergent that causes less water pollution. This US intangible contributes 30 percent of the combined profit of the controlled group. In addition, there are four European intangibles that, in total, contribute 60 percent of the total combined profit. These European intangibles consist of European marketing network, European brand name, alteration of the detergent formula for the European market and development of a fragrance for the European market. These are useful illustrations of intangibles which may be acquired by the licensee from a third party or developed by the controlled licensee and which would constitute "valuable, non-routine" intangibles.

The second example is set forth in Prop. Reg. §1.482-6T(c)(3)(iii). In this example, the US parent and its European subsidiary both conduct product development, process development and sales promotion. The product development includes adaptation of the other company's products to its own market. The evidence shows that the European subsidiary's marketing intangibles represent 1.7 percent of the estimated total asset value (including tangible and intangible properties), its product R&D represents 3 percent of such asset value and its manufacturing R&D represents another 2 percent of such asset value, so that the total intangible asset value of the European subsidiary represents 6.7 percent of the total asset value (while the US parent's intangibles represent 18.3 percent of the total asset value). The example indicates that if the controlled licensee's intangibles represent at least 6.7 percent of the total assets, then this will satisfy the "valuable, non-routine intangible" ownership requirement of the regulations so that the taxpayer could then use the profit split method provided it has complied with the other requirements described for the application of such method.

Of course, the uncertainty regarding the meaning of this term will make it difficult for the taxpayer to try to use this method or risk making an election to use the method since they could not be sure that they will be able to prove that the controlled licensee does own valuable, non-routine intangibles.

The "valuable, non-routine intangible" of the controlled licensee must contribute significantly to earning the combined profit from the business activity to which the controlled transactions are attributable, and there must be significant transactions between the controlled taxpayers (the parent corporation and its controlled subsidiary licensee), and the activities of each controlled party related to the controlled transactions must contribute significantly to the combined profit or loss derived from the relevant business activity.

A further, and most devastating, requirement is that the taxpayer must make a binding election to use the profit split method. This election is made by attaching a statement to the US income tax return electing to use the profit split method. The statement must define the relevant business activity to which the profit split method will apply, identify all of the participants in such activity and define the allocation method to be used in determining each participant's proportionate share of the profits or losses from such activity. The election to use the profit split method would be effective for the taxable year with respect to which the return containing such election is filed and all subsequent taxable years. It cannot be revoked without the consent of the IRS.

It seems that if the taxpayer makes the election to use the profit split method, it could preclude itself from using other methods such as particularly the CUT method. There does not seem to be any reason why there should be such a harsh restriction. To the contrary, the administration of justice and the objective of proving what is truly the arm's length rate of royalty in intercompany licensing would require that all relevant evidence, information and arguments could be put on the table. In the past, the taxpayers and the IRS did often have pertinent information under both what is now called the CUT method and the profit split method. All of such information

20. Prop. Reg. §1.482-6T.
21. Prop. Reg. §1.482-6T(b)(1).

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was relevant and useful in the final determination of the arm's length rate of royalty.

It seems unreasonable to put the taxpayer in the predicament that the only way it could rely on evidence qualifying under the profit split method would be for it to give up on evidence and arguments it would have under some other method, such as particularly the CUT method. For example, the taxpayer could very well have information that would seem to qualify under the CUT method and it could also have evidence that could qualify under the profit split method. In view of the uncertainties of all of these rules, the taxpayer could not be sure which of the methods will be given greater weight and it would be in an impossible situation if the only way it could preserve its rights to claim the evidence qualifying under the profit split method would be by electing the profit split method as the exclusive method determining the arm's length royalty it could rely on. The harshness of this requirement is likely to discourage taxpayers from daring to make an election under the profit split method and this is likely to result in reducing the extent to which this method would in fact be used under the new regulations.

In addition to filing the above mentioned written statement with its US corporate tax return, the taxpayer must document the combined profit or loss attributable to the relevant business activity and that the profit split method provides the most accurate measure of an "arm's length result".[22]

The Proposed Regulations provide for three specific profit split methods. All of such methods divide the profit between related parties on the basis of the relative value of their contribution to that profit.[23] In applying these methods, the role of comparables is substantially diminished or sometimes even completely eliminated.

The three specific methods described in the regulations are as follows:

1. Residual allocation method

This method is similar to the basic arm's length return method that was described in the White Paper. In applying this method, two separate steps must be taken. In the first step, it is necessary to allocate operating income to each related party (i.e. licensor and licensee) to provide a "market return" for its contributions to the relevant business activity other than valuable non-routine intangibles. These "market returns" must then be subtracted from the combined profit of the licensing activity. What remains is called "residual profit". The residual profit must be allocated between the licensor and licensee on the basis of (a) market value of intangible assets; (b) capitalized value of the intangible development expenditures; or (c) where the intangible development expenditures of the related parties are relatively constant over time, the relevant value of actual expenditures in recent years may be used to estimate the relative value of intangible contributions (rather than capitalizing such expenditures). Where the relevant intangible development expenditures are difficult to identify or where the facts and circumstances indicate that a comparison of such expenditures does not satisfactorily approximate the relative values of the related party's contributions, other methods may be considered. It should be noted that the residual allocation method does not require reference to the profitability of any comparable intangibles.

2. Capital employed allocation method

Under this method, the parties' combined income is divided between them by allocating an equal return to each party's capital employed. Capital employed is defined as the sum of operating assets and intangible assets. This method does not require reference to any comparable at all.

3. Comparable profit split rule

Under this method, the combined profit of the parties to the licensing arrangement may be apportioned based on the same percentages of the operating profit earned by unrelated parties participating in a similar licensing arrangement. A controlled licensee must be functionally comparable to the licensee involved in the unrelated transaction.[24] An illustration of this method would be if the evidence would show that a comparable licensor had made arrangements with an unrelated licensee dividing the combined profit from such business by allocating 75 percent of the profit to licensee and 25 percent to licensor. If such evidence is available, the rate of the royalty in the intercompany licensing contract could be fixed at a percentage that would produce allocating 75 percent of the combined profit income to controlled licensee and 25 percent of the combined profit to licensor. Reliable financial data must be available regarding the parties involved in the uncontrolled transaction. Finally, the combined profit split method may not be used if the combined return on capital earned by the uncontrolled parties varies significantly from the combined return on capital earned by the parties to the controlled licensing arrangement.

V. US PARENT CORPORATION LICENSING ITS FOREIGN SUBSIDIARY

Which particular method of determining the arm's length rate of royalty should the licensor US parent corporation prefer may depend on many circumstances, including the rate of foreign corporate tax imposed on the profits of its licensee subsidiary. Normally, it can be expected that the parties to the intercompany licensing arrangement would prefer to use the CUT method. This is so partly because, of course, the CUT method is more like the traditional method, similar to the traditional basic principle of determining the arm's length rate of royalty as described in the OECD Report and the 1968 Regulations. Thus, the US parent corporation will generally be more familiar with the meaning of the CUT method. In addition, no matter how difficult it is to find reliable comparables, it may still be easier to find reasonable comparables under the CUT method rather than under the novel approach of the comparable profits method.

If the manufacturing operations of the controlled licensee are located in a country with relatively low corporate tax rates such as Ireland, Singapore, Hong Kong, Thailand or Puerto

22. Prop. Reg. §1.482-6T(d).
23. Prop. Reg. §1.482-6T(a)(1).
24. Prop. Reg. §1.482-6T(c)(4).

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Rico, then the US parent corporation can even hope to achieve some tax savings by keeping the rate of royalty payable by its foreign subsidiary at some reasonable level. Many foreign countries grant complete or partial exemptions or reduced tax rates for local manufacturing operations, particularly when the products are shipped for export.

Let us take the example of Able Corporation which is a California corporation manufacturing and selling disc drives. It is a privately owned company. The principal shareholder and President of the company is John Able. Able Corporation hopes that it could develop a market for its products in Europe and particularly in the EEC. It is planning to establish a manufacturing subsidiary in Ireland. The Irish subsidiary would manufacture one particular type of disc drive in Ireland and would ship the products to customers throughout Europe. John knows that the labour costs in Ireland are much lower than in the United States and that the Irish Government would furnish the Irish company with valuable financial and other assistance. Among other things, a suitable factory could be leased at a very favorable rent. John already has found four very capable Irishmen who will run the Irish operations. These people know how to do business in Europe which would be helpful. The profits of the Irish company would be further increased since the cost of freight of shipping the disc drives from the United States to Europe will be saved and it will not be necessary to pay the EEC customs duty. As a matter of fact, careful studies indicate that the only way Able Corporation would be able to develop a market for its products in Europe would be through the Irish facility.

Of course, Able Corporation would have to grant a license to the Irish subsidiary to use the corporation's patents and related industrial property rights in Ireland and the rest of Europe. The question would then arise as to what should be the rate of royalty payable by the Irish subsidiary to Able Corporation.

There are many excellent disc manufacturing companies in California. One such company is Brown Corporation which is a publicly held corporation. Its founder and President is Sam Brown. Even though Able Corporation and Brown Corporation are competitors, John and Sam became friends some time ago. Some 20 years ago, they used to work together for IBM. Since then, they have established their respective companies and both of them have been quite successful. John meets Sam from time to time on the golf course.

Brown Corporation entered the European market two years ago. It has done so by granting a license to an unrelated Irish company which manufactures two types of Brown Corporation's disc drives for sale to customers in Europe. Information regarding the licensing arrangements between Brown Corporation and its unrelated Irish licensee is set forth in a report filed by Brown Corporation with the Securities and Exchange Commission. From such report, John learned that the Irish company pays Brown Corporation a 10 percent royalty and that Brown Corporation also furnishes the Irish company with certain parts at a price equal to cost plus 35 percent mark-up. Able Corporation will probably furnish its Irish subsidiary with similar parts also. John obtained some further relevant information from Sam regarding Brown Corporation's Irish operations. John, Sam and others in the industry know that the two types of disc drives licensed by Brown Corporation to its unrelated Irish licensee include a somewhat more advanced, efficient and valuable technology than the technology incorporated in the disc drive which Able Corporation's Irish subsidiary will manufacture and sell in Europe. The difference is perhaps 10 percent. Therefore, if the arm's length rate of royalty payable for the industrial property rights relating to Brown Corporation's disc drive is 10 percent, the arm's length rate of royalty for the license to manufacture Able Corporation's disc drive should be 9 percent. John concludes that, to be on the conservative side with the IRS, Able Corporation should be using a 10 percent rate. Also, if certain components or parts will be supplied by Able Corporation to its Irish subsidiary, they will be sold at cost plus 35 percent mark-up.

John feels that this arrangement should be as arm's length as humanly possible. Tax saving is not John's main objective. He wants to enter the European market and be able to remain in competition in this business. He does hope, however, that the Irish subsidiary will do well. In view of the good management of the Irish company, its efficiency, savings in labour and transportation costs, it is possible that the Irish subsidiary will end up with a profit equal to 25 percent of its sales even after paying the 10 percent royalty to Able Corporation.

John is a person who likes to do business and is willing to take such substantial risks as are involved in establishing manufacturing operations abroad. He is not a person who likes to spend much time with tax advisors, attorneys, economists and similar professionals and incur large expenses in connection with the services of such professionals.

Under these circumstances, would John be well advised to proceed with his plans, have Able Corporation grant a license to the disc drive to the Irish subsidiary for a 10 percent royalty, based on a short contract between the two companies?

The answer to this question under the tax laws of many other countries would most likely be positive. Able Corporation would seem to have a strong comparable and the arrangements would seem to be reasonable. There would be a good chance that the auditing agents in such countries would not take serious issue with such arrangements.

However, in the United States, under the new regulations, the answer to the question would be a definite "No." John would have to realize that, under the new regulations, Able Corporation would not have assurance that the 10 percent rate of royalty would hold up on audit. If the rate of royalty would be increased to, say, 21 percent, Able Corporation would expose itself to the risk of being subject to the 20 percent nondeductible penalty imposed by Section 6662. If at that time the basic rate of US corporate tax would be 36 percent, the 20 percent penalty would amount to 7.2 percent which, in effect, would increase the effective rate of US corporate tax imposed on the reallocated royalty income to 43.2 percent. If, on audit, the rate of the intercompany royalty would be increased to, say, 41 percent, Able Corporation could be subject to penalty at the rate of 40 percent which would amount to 14.4 percent (40 percent of 36 percent), thus increasing the effective rate of total US taxes imposed on reallocated royalties to 50.4 percent!

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These would be too high risks for John to take. At least, he would have a much better chance of eliminating the Section 6662 penalties by having his homework done in detail, which would include obtaining tax opinions from professionals, making a detailed analysis of complying with the new Section 482 regulations and conducting the relevant economic studies.

In the above analysis, we were assuming that Able Corporation is establishing a manufacturing subsidiary in a relatively low-tax country. What would be the situation if the manufacturing subsidiary would be established in a high-tax country? Would then the analysis of the tax considerations be different?

By way of illustration, let us assume that Able Corporation is also planning to establish a manufacturing subsidiary in Japan to manufacture the same disc drive which the Irish subsidiary would manufacture for the European market. The Japanese subsidiary will manufacture and sell the disc drive in Japan, mainly to customers in Japan and perhaps also to customers in other countries of the Far East. Again, Able Corporation may find that the only way to develop a market for its products in Japan is to establish a local manufacturing subsidiary and to license such subsidiary to manufacture the disc drives in Japan.

What should be the rate of royalty to be charged to the Japanese subsidiary?

This time, John would not mind if the Japanese subsidiary could pay a higher royalty, perhaps as high as 30 percent of sales. The Japanese corporate tax burden is likely to be in the area of 55 percent. Royalties are subject to only a 10 percent Japanese withholding tax. Since the Japanese tax burden is much higher than the US corporate tax rate, this would be a preferable arrangement. However, John would realize that this would be difficult to accomplish. First of all, he would know that 10 percent is more likely to be the arm's length rate of royalty. Able Corporation would already have a licensing arrangement with its Irish subsidiary providing for a 10 percent royalty. How could then a 30 percent rate of royalty be justified to the Japanese tax inspector when the operations of the Japanese subsidiary in Japan would be quite similar to the operations of the Irish subsidiary in Europe? Therefore, Able Corporation might be content to use the 10 percent rate of royalty with respect to the Japanese subsidiary also. In this manner, at least, the arrangements are consistent.

However, this would not be the end of Able Corporation's problems. When, in connection with the audit of Able Corporation's intercompany licensing arrangements, the IRS would determine that the arm's length rate of royalty, perhaps under the comparable profits method, is equal to 30 percent of sales, then a substantial reallocation of additional royalty income would be made both from Ireland and Japan. However, of course, the Japanese tax inspector would be under no obligation to accept such reallocation. He would say that this is a purely domestic matter between the IRS and Able Corporation and that, for Japanese tax purposes, the additional 20 percent royalty will not be allowed as a deduction. This would mean that the amount represented by such royalty would remain fully taxable in Japan. If the moneys have been in fact paid out as royalties by the Japanese subsidiary to Able Corporation, such distribution would most likely be treated as dividends, not deductible, but subject to an additional 10 percent Japanese withholding tax. In this case, Able Corporation could easily find itself in a situation where it would be subject to what one could call "triple taxation". First, the amount reallocated by the IRS would remain subject to Japanese corporate taxes, at the effective rate of approximately 55 percent. The same amount would also be subject to the 10 percent Japanese withholding tax. The reallocated amount would also be taxable, of course, in the United States where the combined effective rate of US and state corporate taxes is likely to be in the area of 45 percent. Thus, the total tax burden would be approximately 110 percent.

Of course, normally, Able Corporation should be entitled to claim a credit against its US corporate tax liability for the Japanese corporate tax and for the 10 percent withholding tax (under IRC Sections 901 and 902). However, particularly if Able Corporation has substantial interest expense, the requirement that a portion of such interest expense and certain other expenses be allocated against the foreign source gross income in determining the amount of foreign source taxable income, could very substantially reduce Able Corporation's ability to obtain credit for a substantial portion of Japanese taxes.[25]

Able Corporation could also seek assistance under the so-called "Competent Authority Procedure" referred to in the income tax treaty between the United States and Japan, but would have no assurance whatsoever that such procedure would eliminate or reduce any of the mentioned taxes.

The above computation does not include yet the 20 or 40 percent penalties that could be imposed by the IRS under IRC Section 6662.

It should be noted in this connection that the regulations do not contain an exception to this harsh treatment merely because the foreign subsidiary is subject to high foreign corporate taxes.

As can be seen, the result would be disastrous. The principal losers in this tragic situation would be the US corporations trying to maintain markets for their products abroad. The losers would not be the Japanese, German or other foreign governments because they would not have to give credit to the novel approaches contained in the new Section 482 regulations. If the result would be that the US corporations could not compete in the Japanese, European or other foreign markets, this would not be a tragedy for the governments of such countries or for the Japanese, European or other foreign competitors. A German company operating in Japan would not be exposed to the same problem. A Japanese company operating in Germany would not be exposed to the same problem either. Thus, the damage would be to the US corporations which would eventually be forced to withdraw from the foreign markets. This would weaken the US corporations' overall world competitive position which could then further lead to the foreign competitors gaining the upper hand over US corporations even in the US market. The final result would be

25. IRC Sec. 904.

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the increasing control and dominance of US economy by foreign-controlled businesses.

Even though John would be fairly confident about the chances of the 10 percent royalty arrangement satisfying the arm's length test, Able Corporation would be well advised to conduct studies to see whether it could develop additional arguments and evidence under the other methods specified in the new regulations, such as the comparable profits method and the profit split method. Since the results under the comparable profits method are likely to be rather arbitrary, it is possible that evidence of profit level indicators of unrelated licensees could be found showing a relatively high rate of profit realized by such unrelated licensees.

Even gathering information under the profit split method would not be a waste of time, even though Able Corporation would not technically make the election to use such method. The fact that the taxpayer has not made an election to use the profit split method would not prevent the IRS from using such method. Usually, even the profit split method is likely to produce higher profits at the Irish subsidiary than the application of the comparable profits method. Therefore, it would be prudent for Able Corporation to have some helpful evidence available under the profit split method. A situation could develop that even the auditing IRS agent would consider it too harsh to use the results of the comparable profits method and would be inclined to do justice to the matter on the basis of some reasonable evidence under the profit split method in which case the information and evidence the taxpayer would have available might help to bring the audit to a reasonably favourable conclusion.

VI. HOW TO PREVAIL WITH THE CUT METHOD

Going back to the example of Able Corporation, John would now inquire how could he ensure that Able Corporation would be able to sustain the validity of the 10 percent royalty charged to the foreign subsidiaries under the CUT method. Of course, the very first rule, which is to the effect that normally the CUT method would produce the "most accurate" measure of arm's length royalty, is helpful. However, the approach of the new regulations is to impose numerous requirements for the actual application of the CUT method. The taxpayer must overcome a large number of hurdles to be able to prevail with the CUT method. Thus, the company will have to review a list of such "hurdles" or requirements to strengthen the chances that the CUT method will actually be applied. The checklist of factors to be considered in this connection is like a checklist of battle grounds in which Able Corporation will have to perform and prevail. Able Corporation could feel like a professional boxer facing a 12 (or more) rounds bout. It is important for the champ to score well in every round. If he goes down in round 5 for a minute, and also gets shaken up in rounds 8 and 9, he may lose. As the taxpayer's position and evidence would be shaken up in connection with some of these factors, the shadow of Thrasybulus' sword would grow.

While, as a rule of thumb, the CUT method may still be the preferred method, the approach of the regulations is to make the application of the method contingent on proving that it is the best method considering the various factors listed in the regulations. If the taxpayer does not succeed in proving that the CUT method is the best method under the regulations, considering the mentioned factors, then the IRS could assert that the comparable profits method should be applied and the profit of the Irish licensee should be cut back in accordance with the evidence presented pursuant to such method. For example, when the audit of Able Corporation's return for the taxable year commences, Able Corporation may feel that its 10 percent royalty arrangement with its foreign subsidiaries is 90-100 percent strong and safe under the CUT method, 100 being the maximum for certainty. However, if the IRS can cast doubt on whether the CUT method should be recognized as the applicable method pursuant to the best method rule, insofar as one or several factors are concerned, then it could take the position that some evidence available under the comparable profits method should be applied. The IRS could point out that even though the comparables it has in applying the comparable profits method are not very strong (perhaps the financial statements presented are of companies operating not in Ireland, but in Brazil and Argentina), but nevertheless, on the scale of 100, such evidence under the comparable profits method deserves a rank of 70 and since the somewhat discredited evidence the taxpayer has under the CUT method has now been reduced to 60, the comparable profits method should be applied. If the taxpayer then can discredit somewhat the evidence submitted by the IRS, for example, by pointing out that the financial statements of the Brazilian and Argentinian companies applied by the IRS involve sales of power supplies and similar products and not disc drives at all, this could reduce the value of evidence offered under the comparable profits method to, say, 50, on the scale of 100, in which case the evidence under the CUT method would still be better and more qualified under the best method rule and therefore the taxpayer should prevail with its position that the 10 percent royalty is arm's length under the new regulations.

VII. FACTORS TO BE CONSIDERED IN ASCERTAINING WHETHER THE CUT METHOD COULD BE USED TO DETERMINE THE ARM'S LENGTH RATE OF ROYALTY

There are numerous factors listed in the regulations that must be considered in determining whether the CUT method would prevail under the best method rule and therefore could be used to determine the arm's length rate of royalty in the particular case. Some of these factors are mentioned in Temp. Reg. §1.482-1T which summarizes some general principles applicable to all intercompany transactions. Other factors are mentioned in Temp. Reg. §1.482-4T which contains the provisions relating specifically to licensing of intangible properties.

For the sake of convenience, I shall list here the factors in the chronological order in which they appear in the regulations. As we go over these factors, we may briefly check to see how well would Able Corporation do under these factors which would determine whether its reliance on the CUT method to support the 10 percent intercompany royalty is justified.

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1. *Completeness and accuracy of data used to apply the method.* In order to make the CUT method applicable, one would have to show that it qualifies under the "best method rule".[26] The first factor to be considered under this rule is completeness and accuracy of data used to apply the particular method.

In the case of Able Corporation, the taxpayer would, of course, have information concerning the Irish subsidiary's operations and financial performance. It would also have the financial statements of the Irish subsidiary and data from its own financial statements and information regarding the arrangements between Brown Corporation and its unrelated Irish subsidiary, including the statements submitted by Brown Corporation to the SEC. To John, this would indicate that the company would be able to comply with the completeness and accuracy data requirement.

2. *Degree of comparability.* The second factor mentioned under the best method rule is the degree of comparability between controlled and uncontrolled transactions.

Here again, John would feel that the degree of comparability is extremely high since the technology relating to Brown Corporation's disc drives and Able Corporation's disc drive licensed to its Irish subsidiary are very comparable, the two Irish companies will receive about the same degree of support from the California licensors and will basically perform the same functions and assume the same risks.

3. *Number, magnitude and accuracy of adjustments.* The third factor mentioned under the best method rule is the number, magnitude, and accuracy of the adjustments required to apply to a particular method.

Here again, John would feel fairly confident. The only adjustment that would be required to be made, if any, would be a downward adjustment, from 10 percent to 9 percent, in the rate of royalty. To make the arrangements simpler and, in effect, to favour the IRS, and be on the conservative side, Able Corporation is using a 10 percent royalty.

4. *The majority of methods rule or the tie-breaker rule.* The regulations make it clear that the mere fact that the taxpayer is claiming that it has evidence under the CUT method would not prevent the IRS from putting on the table and considering evidence under other methods at the same time.[27] The regulations state:

> An arm's length result may be determined under any of the available methods without first establishing the inapplicability of any other method. If additional evidence becomes available permitting the application of another method that is more accurate, the district director will apply such method to determine an arm's length result.

As a result of this approach, several methods would be considered at the same time. For example, the taxpayer would maintain that the CUT method is applicable and furnish evidence under such method, while the IRS would take the position that the comparable profits method is applicable or perhaps the profit split method is applicable (even though the taxpayer has not made an election to use the profit split method).

The regulations then go on to state that:

> If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most accurate determination of an arm's length result under the facts and circumstances, without establishing a priority or presumption of correctness to any one method. If the best method rule does not *clearly indicate* which method should be preferred, an additional factor that may be taken into account in selecting a method is whether any of the complete methods produce results that are consistent with the results obtained under another appropriate method. Further, in choosing between two or more applications of the same method that produce different results, the fact that another method produces results that are consistent with one or more of the competing applications may be taken into account (emphasis added).

Thus, while Able Corporation may have fairly good evidence under the CUT method, showing that the 10 percent rate of royalty was arm's length, the IRS could submit data and other information showing that, applying the comparable profits method, the rate of royalty should be 30 percent and applying the profit split method, the rate of royalty should be 29 percent. Since the results under the latter two methods (30 percent and 29 percent) would be more consistent with each other, these two methods could gang up on Able Corporation and destroy the possibility of using the CUT method unless the best method rule would clearly indicate that the CUT method should be preferred.

At this point, Able Corporation could feel somewhat less confident and John less comfortable. Indeed, it would be quite unfair that the rate of royalty could be increased to 30 percent as a result of rather questionable "evidence" under the comparable profits method and the profit split method, but the question would be how could Able Corporation make sure that the best method will "clearly indicate" that the CUT method is applicable.

5. *Comparability of results.* Throughout the regulations, the emphasis is on results and comparability of results. The comparability of results would make sense in case of such methods as the comparable profits method or the profit split method. When such methods are applied, one looks at the "bottom line figures", i.e. final financial "results". However, what is the meaning of the emphasis on results when the CUT method is applicable?

Temp. Reg. §1.482-1T(c)(1) states the general rule that:

> The arm's length character of a controlled transaction is tested by comparing the results of that transaction with the results of uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.

What does the requirement of comparing results mean in the case of Able Corporation? Is the "result" which should be compared the rate of royalty received by Brown Corporation from its unrelated licensee (which is 10 percent) to be compared with the rate of royalty received by Able Corporation from its Irish subsidiary (which is also 10 percent), so that the comparability test would be satisfied, or does it mean comparing the "results" achieved by the two licensees? The regulations do not clarify this matter. If the requirement would be to compare the profits realized by the two licensees, it would

26. Temp. Reg. §1.482-1T(b)(2)(iii)(A).
27. Temp. Reg. §1.482-1T(b)(2)(iii)(A).

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be difficult for Able Corporation to satisfy this requirement. It is very unlikely that Able Corporation could even ask Brown Corporation for such information, but if Able Corporation would try, Brown Corporation would most likely answer that it does not have such information itself (since it is proprietary information of its Irish licensee).

6. *Functions*. The regulations state that the comparability of transactions and circumstances must be evaluated using five factors, namely functions, risks, contractual terms, economic conditions and property or services.[28]

The regulations require performance of a functional analysis. This functional analysis would identify and compare the economically significant activities actually undertaken or to be undertaken by the taxpayers in both controlled and uncontrolled transactions. The regulations indicate that particularly the following functions will have to be reviewed: research and development, product design and engineering, manufacturing or process engineering, product fabrication, extraction and assembly, purchasing and materials management, marketing and distribution functions including inventory management, warranty administration, advertising and marketing activities, transportation and warehousing, managerial, legal, accounting and finance, credit and collection, training and personal management services.[29]

Of course, the functional analysis approach has been used by the IRS for many years. The IRS Internal Revenue Manual places much emphasis on the functional approach. Thus, the functional analysis approach would not be a new development, although this is the first time that it gets its blessing in the regulations.

The regulations indicate that in the event the CUT method is applied in determining the arm's length rate of royalty, the emphasis is more on product comparables than on functional comparables. This would lessen somewhat the emphasis on the functional analysis with respect to the CUT method used by Able Corporation based on the comparison of the arrangements between Brown Corporation and its unrelated Irish licensee. Nevertheless, the regulations state also that "each method ordinarily requires analysis of all of the factors that affect comparability under that method. In particular, the analysis of functions and risks will be essential to the application of any method".[30]

Accordingly, Able Corporation will be required to do its best in performing the functional analysis in this case. This may not be easy since Able Corporation may not have the information on the exact functions performed by Brown Corporation's unrelated Irish licensee.

7. *Comparability of risks*. An analysis must also be made of the risks borne by the parties to the controlled and the uncontrolled licensing transaction. The more important risks to be considered are listed specifically in the regulations: market risks, including fluctuations in costs, demand, pricing and inventory levels; risks associated with the success or failure of research and development activities, financial risks including fluctuations in foreign currency rates of exchange and interest rates; credit and collection risks, product liability risks; and business risks relating to the ownership of property, plant and equipment.[31]

Even though Able Corporation's Irish subsidiary may expressly assume certain risks, the IRS could, in effect, take the position that such risks were borne by Able Corporation on the ground that the Irish company would not be financially capable of funding any losses that would be expected to occur as a result of the risk.[32] In addition, the Irish subsidiary would also have to have a reasonable opportunity to realize an economic benefit that is commensurate with the risk assumed and would have to be engaged in the active conduct of a trade or business to which the risk relates. Finally, Able Corporation and its Irish subsidiary would have to document in writing their allocation of the risk before the result of the risk would become known or knowable.

8. *Contractual terms*. This factor requires that the terms of the licensing contract between Able Corporation and its Irish subsidiary be comparable to the terms of the contract between Brown Corporation and its unrelated Irish licensee. Needless to say, it might be difficult to comply with this requirement since normally a company would not have in its files the contracts of its competitors. The regulations require the comparison of significant contractual terms that could affect the rate of royalty. With respect to licensing arrangements, such contractual terms listed in the regulations include payment terms, rights to updates, revisions or modifications, the duration of the relevant contracts and related termination or renegotiation rights and arrangements for the provision of ancillary or subsidiary services.[33]

Of course, if Able Corporation would be able to get hold of the licensing agreement between Brown Corporation and its unrelated Irish licensee, it would be well advised to copy much of such agreement verbatim in its licensing contract with the Irish subsidiary. In this manner, Able Corporation would have a particularly strong position to support the applicability of the CUT method insofar as this particular factor is concerned.

9. *Economic conditions*. This factor requires a comparison of the significant economic factors that could affect the royalties that would be charged or paid, or the profit that would be earned, in the two licensing transactions.

The regulations list the following factors to be considered in comparing the economic conditions present in the licensing arrangement with the controlled subsidiary and in the licensing arrangement between unrelated parties.

(a) "alternatives realistically available to a buyer and seller, respectively";
(b) similarity of geographic markets;
(c) relative size of each market and the extent of the overall economic development in each market;
(d) level of the markets;

28. Temp. Reg. §1.482-1T(c).
29. Temp. Reg. §1.482-1T(c)(3)(i).
30. Temp. Reg. §1.482-1T(c)(1)(ii).
31. Temp. Reg. §1.482-1T(c)(3)(ii)(A).
32. Temp. Reg. §1.482-1T(c)(3)(ii)(B)(2).
33. Temp. Reg. §1.482-1T(c)(3)(iii).

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(e) relevant market share for the products, properties or services transferred or provided;
(f) location – specific costs of the factors of production and distribution; and
(g) extent of competition in each market with regard to the property or services under review.

10. *Comparability of property or services.* This factor requires a comparison of the property or services transferred or licensed in the transactions.

11. *Consideration of the alternatives available to the licensor or the "make-or-license" analysis.* The regulations indicate that the IRS could consider the alternatives available to the taxpayer (licensor) in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances.[34] The example set forth in Temp. Reg. §1.482-1T(d)(3)(iv) illustrates the meaning of this particular factor. Pursuant to this example, Able Corporation would have to check the profit it could make if it would manufacture the disc drives (which it proposes to license to the Irish subsidiary) itself and ship the products to the customers.

Under the actual circumstances of Able Corporation, probably it would be rather easy to demonstrate that Able Corporation would not be able to conduct such business at all (because of the prohibitive cost of transportation, foreign customs duty, etc.) or that the profit realized by Able Corporation would be smaller if it would conduct the business in such a manner as compared with the profit realized by it if it licenses the manufacture of the disc drives to the Irish subsidiary.

The problem would become more serious, however, if the Irish subsidiary would sell a part of its products back to Able Corporation (or a US subsidiary of Able Corporation) for resale in the US market, as illustrated in the example set forth in Temp. Reg. §1.482-4T(c)(2)(iv). This "realistic alternative" rule in effect overrules the decision of the Tax Court in *Bausch & Lomb, Inc. v. Commissioner*.[35] In such a case, it would be helpful for Able Corporation to document the fact that it does not have excess manufacturing capacity that would allow it to produce such additional products, if this is in fact the case.

12. *Evidence of contemporaneous comparable transaction.* Now we turn to the additional factors and requirements described in Temp. Reg. §1.482-4T(c) which deals specifically with the CUT method. Thus, the factors mentioned in this particular regulation apply most directly in determining whether the evidence of comparable would qualify under the CUT method.

The regulation states:

> Factors to be considered in the application of this method include access to relevant pricing and other financial information and the existence of an active market, including contemporaneous transactions involving comparable property between uncontrolled taxpayers.

The emphasis on "contemporaneous transactions" is likely to mean that the taxpayer should have evidence, for purposes of the CUT method, of a comparable transaction between two unrelated parties in the same taxable year.

If this rather harsh interpretation of the regulatory language would be used, it could mean that even though Able Corporation would be able to use the CUT method in 1994 and 1995, it could no longer use the CUT method in 1996 when, at the beginning of 1996, Brown Corporation and its unrelated Irish licensee would terminate their contract. It would seem unreasonable that such unfortunate event would have such a negative and immediate impact on determining the arm's length rate of royalty to be used between Able Corporation and its Irish subsidiary. Would it not be more reasonable to allow Able Corporation a grace period, such as a year or two, to find other evidence of comparables to support the use of the CUT method?

13. *The comparable must relate to the same class of intangible.* This requirement is contained in Temp. Reg. §1.482-4T(c)(2)(ii)(A)(1). The general requirement is that the intangible property involved in the transaction between two unrelated parties must be a "comparable intangible property". In order to qualify as a "comparable intangible property", three requirements must be met, the first of which is that the intangibles must fall into the same class of intangibles. The classes of intangibles for this purpose are determined in Temp. Reg. §1.482-4T(b). For example, patents, inventions, formula, processes, designs, patents or know-how all fall into the same class. Thus, insofar as this particular requirement is concerned, it would seem that the intangible properties would qualify as "comparable" even if the licensing agreement between Able Corporation and its Irish subsidiary would involve patents, while the licensing agreement between Brown Corporation and its unrelated Irish licensee would cover only know-how.

14. *Same types of products, processes or know-how.* The second requirement to make the intangible properties involved in the two transactions comparable is that the intangibles must relate to the same type of products, processes or know-how within the same general industry or market.

15. *Comparable profit potential requirement.* Finally, the last requirement to make the intangibles involved in the two transactions comparable is that two intangibles should have "substantially the same profit potential". The regulations add that:[36]

> For this purpose, the profit potential of an intangible is measured by the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, taking into consideration the capital investment and start-up expenses required, the risk to be assumed, and other relevant considerations.

This particular requirement could be troublesome to the US taxpayer. For example, Able Corporation, in our case, would have to be able to demonstrate that the intangibles it licensed to its Irish subsidiary and the intangibles which Brown Corporation licensed to its unrelated Irish licensee had substantially the same profit potential. It is very unlikely that Able

34. Temp. Reg. §1.482-1T(d)(3)(iii).
35. 92 T.C. 925 (1989), affd. 933 F.2d 1084 (Second Circuit 1991).
36. Temp. Reg. §1.482-4T(c)(2)(ii)(A).

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Corporation would be able to obtain any data or financial information from either Brown Corporation or its unrelated Irish licensee regarding the profit potential considered by such two companies. Able Corporation could obtain the opinion or report of an expert economist who would have appraised the profit potential of the intangibles involved and would have concluded that the intangibles licensed by Able Corporation to its Irish subsidiary had substantially the same profit potential as the intangibles licensed by Brown Corporation to is unrelated Irish licensee.

16. *Comparable circumstances*. In addition to the factors listed above in items 6 and 10, Reg. §1.482-4T(c)(2)(ii)(B) states certain specific factors which must be considered in determining whether the CUT method could be applied in determining the arm's length rate of royalty.

The more important factors listed include the terms of the license, including the exploitation rights granted in the intangible, the exclusive or non-exclusive character of the license, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited, stage of the development of the intangible, any rights to receive periodic updates or improvements to the intangible by uniqueness of the intangible and the period for which the intangible will remain unique and the duration of the license.

17. *Periodic adjustments*. If the US licensor has prevailed in fighting on so many battle fields, there is still the danger that whatever was established as an arm's length rate of royalty could be adjusted in a subsequent taxable year. The regulations specifically provide for such possibility in Temp. Reg. §1.482-4T(e)(2). The regulations state, in effect, that the rate of royalty may be adjusted in a subsequent taxable year "to ensure that it is commensurate with the income attributable to the intangible". For example, let us assume that Able Corporation established its licensing arrangement with the Irish subsidiary on the basis of a 10 percent royalty and that such royalty rate was even approved by the IRS on audit of Able Corporation's corporate tax returns for 1994 and 1995 under the CUT method. At that time, the Irish subsidiary realized a net profit of 20 percent of sales after the payment of the 10 percent royalty. In connection with the audit of Able Corporation's corporate tax returns for 1996 and 1997, the facts indicate that the Irish subsidiary ended up with a net profit of approximately 40 percent of sales after payment of the 10 percent royalty to Able Corporation. In such audit, the IRS would most likely take the position that the increased profitability of the Irish subsidiary required commensurately increased rate of royalty.

In order to prevent the increase of the rate of royalty, Able Corporation would have to establish each of the following six facts:[37]

(a) Able Corporation entered into a written agreement (controlled agreement) with the Irish subsidiary which provided for the royalty with respect to each taxable year covered by such agreement, the rate of royalty was arm's length under the CUT method for the first taxable year in which substantial royalty was required to be paid under the agreement, and such agreement remains in effect for the taxable year under review.

(b) There is a written agreement setting forth the terms of the comparable uncontrolled licensing arrangement relied upon to establish the arm's length rate of royalty (uncontrolled agreement), which contained no provision that would have permitted any change to the amount of the royalty, a renegotiation or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contained provisions permitting any specified, noncontingent, periodic changes to the amount of royalty). Obviously, it would be difficult for Able Corporation to get hold of the written agreement between Brown Corporation and its unrelated Irish subsidiary to demonstrate this particular fact.

(c) The controlled agreement was substantially similar to the uncontrolled agreement with respect to the time period for which it is effective and the provisions described in the preceding point (b).

(d) The controlled agreement limited the use of the intangible to a specified field or purpose in a manner that was consistent with industry practice and any such limitation in the uncontrolled agreement.

(e) There were no substantial changes in the functions performed by the controlled licensee (the Irish subsidiary) since the controlled agreement was executed, except for changes necessitated by events that were not foreseeable.

(f) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in all open years are not less than 80 percent and no more than 120 percent of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established.

As can be seen, the regulations impose an enormous burden on the taxpayer to be able to qualify to use the CUT method in determining the arm's length rate of intercompany royalty. There are so many factors, requirements, conditions, restrictions, surprising limitations and arbitrary distinctions that the taxpayer is bound to slip on one or more of such factors, conditions, etc. or that at least it may not be able to fully comply with the requirements. As this occurs, the chances of applying Thrasybulus' sword to the taxpayer's arrangement with its foreign licensee subsidiary will greatly increase. It is reasonable to assume that when there are so many conditions and prerequisites in applying a certain rule, the application of such rule, such as the CUT method in this case, becomes very uncertain. Therefore, the new regulations are likely to increase the degree of uncertainty in applying the arm's length standard very substantially.

If the IRS would in fact insist on using the Thrasybulus sword, this would make it more difficult for US corporations to compete in foreign markets through local manufacturing subsidiaries. One hope would be that, as in the past, auditing IRS agents themselves would find such approach too drastic and unreasonable and the cases would in fact be settled on some other reasonable grounds.

37. Temp. Reg. §1.482-4T(e)(2)(ii).

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VIII. FOREIGN PARENT CORPORATION LICENSING ITS US SUBSIDIARY

In many cases, the impact of the new regulations on foreign parent corporations operating in the United States through US manufacturing subsidiaries would be the opposite to that of the impact on US corporations operating abroad through foreign manufacturing subsidiaries. The exact impact would depend on several other circumstances, including particularly whether there is an income tax treaty between the country of the foreign parent corporation and the United States, which treaty is likely to reduce the rate of the US withholding tax imposed on royalties to a small percentage, such as 10 percent, or perhaps it might even completely eliminate any US withholding tax on such royalties (which is the case, for example, with respect to royalties paid by a US licensee to licensors in England, Germany, France and many other European countries).

For example, if the foreign parent corporation is interested in reducing the US tax burden imposed on its US manufacturing subsidiary and there is a favorable tax treaty between the United States and the country in which the foreign parent corporation is incorporated, the company would prefer to use the comparable profits method rather than the CUT method. The use of the comparable profits method is likely to increase the rate of royalty payable by the US manufacturing subsidiary to the parent corporation. Since such royalties would be allowed as deduction to the US subsidiary, the effective rate of US taxes could be substantially reduced.

The basic idea behind the comparable profits method was that much of the overall profit should belong to the party which owns the valuable intangibles. Congress was thinking about a large US pharmaceutical company which has a substantial R&D department inventing highly profitable new drugs at the cost of large R&D expenditures. The company also owns patents, know-how, trademarks, trade names and other valuable industrial property rights used in connection with its business. The company may have manufacturing subsidiaries in Ireland, Singapore or Puerto Rico and it may also have sales subsidiaries in various other countries, but all of those "deserve" only a modest profit on their costs or functions and the bulk of the profit should properly belong to the "owner of the intangibles" which is the US pharmaceutical company. The problem is that there are now many foreign corporations which own valuable intangibles and the number of such corporations is steadily growing. Thus, when they come to the United States and establish a manufacturing subsidiary in this country, the Thrasybulus rule may start working in the other direction. Much of the profit should belong to the foreign corporation (in form of large royalties) which owns the valuable intangibles and only a modest profit should be allocated to the US manufacturing subsidiary.

This means also that many foreign corporations already operating in the United States through a US manufacturing subsidiary may now find that they would be able to charge higher royalties to the US subsidiary for the use of their intangibles and this, of course, would reduce the US tax payable by the US subsidiary. Royalties remitted to the foreign parent corporation are likely to be subject to a very modest US withholding tax or be completely exempt from tax as a result of the provisions of the applicable income tax treaty.

There could be, of course, some evidence of comparable licensing arrangements with third parties, but, as indicated above, in many cases it should not be too difficult to prevent the application of the CUT method because of the failure to satisfy one or several of the numerous requirements and conditions of the application of such method.

A good illustration of this development would be the case of *Ciba-Geigy Corp. v. Commissioner*.[38] Ciba-Geigy is a large and reputable Swiss pharmaceutical company. It is engaged in the business of inventing, manufacturing and selling pharmaceutical products. It does not focus on producing profits by avoiding tax rules. In the 1960s Ciba-Geigy established a wholly-owned US subsidiary to manufacture and sell some of its products in the United States. The US subsidiary paid a 10 percent royalty to the Swiss parent corporation. The IRS audited the tax returns of the US subsidiary for the years 1965-1969 and determined that such rate was too high. The IRS claimed that the arm's length rate of royalty was lower, perhaps 6 percent. After much litigation, the Tax Court determined that the taxpayer was correct and that the arm's length rate of royalty was 10 percent.

It is quite likely that, under the new regulations, the comparable profits method could be applied in determining the arm's length rate of royalty. Using such method would most likely result in a royalty rate in the range of 30-35 percent or several times higher than what the Swiss parent corporation has been charging to its US subsidiary. This means that, in the future, Ciba-Geigy could increase the rate of royalty to a much higher percentage. The royalties would be exempt from US withholding tax under the US–Swiss income tax treaty. Thus, the net result would be a substantial reduction of taxes payable to the US Government. Indeed, Ciba-Geigy, and many similarly situated licensors, could also consider filing amended tax returns for those taxable years which are still open and claim refund of the US taxes unnecessarily paid, in view of the provisions of the new regulations.

The use of the new methodology introduced by the new regulations and particularly the comparable profits method could prove beneficial from the standpoint of preserving US tax revenues in those extreme cases where the foreign parent corporation was perhaps too greedy and allowed no profit or extremely low profit to its US manufacturing subsidiary. In such a case, the application of the comparable profits method could assure that at least a modest profit would be allocated to the US manufacturing subsidiary and be subject to US tax in the hands of the subsidiary.

38. 85 T.C. 172 (1985).

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INTERNATIONAL:

RECENT TAX REVENUE DEVELOPMENTS IN OECD COUNTRIES AND SOME POLICY IMPLICATIONS

Ken Messere

Contents

I. Introduction

II. Recent Tax Revenue Developments
- A. Preliminary remarks
  - 1. Scope and summary of findings
  - 2. Methodology and concepts
- B. Tax level developments (1985-90)
  - 1. Total tax ratios (TTRs)
  - 2. Some particular tax ratios
- C. Tax structure developments (1985-90)
- D. Developments in sub-central government taxes 1985-90
  - 1. Changes in the share of tax revenues
  - 2. Changes in local tax structures
- E. Developments in general government financial balances (1986-94)

III. Some Policy Implications
- A. Presuppositions
- B. General recommendations
  - 1. Increasing consumption taxation
  - 2. Increasing personal income taxes rather than social security contributions
  - 3. Reducing tax eccentricities
- C. Relevance to tax policy in France, Germany, the United Kingdom and the United States

IV. Summary and Conclusion

Appendix: Changes between 1990 and 1991 in tax levels and tax structures

List of tables

1. The OECD classification of taxes and average revenue yields
2. Developments in TTRs 1985-1990
3. Convergence and divergence of TTRs
4. Shifts in particular tax ratios between 1985 and 1990 of more than 0.5 percentage points
5. Convergence and divergence of social security and excises etc. ratios between 1985 and 1990
6. Exceptionally high deviations from average tax ratios 1985 and 1990
7. Shifts in particular tax structures between 1985 and 1990 of more than one percentage point
8. Exceptionally high deviations from average tax structures 1985 and 1990
9. Share of total tax revenues accruing to sub-central levels of government in 1985 and 1990
10. Tax revenues from state and local taxes as a percentage of total tax revenues of those levels of government in 1985 and 1990 (federal countries)
11. Tax revenues from local taxes as a percentage of total tax revenues of this level of government in 1985 and 1990 (unitary countries)
12. General government financial balances 1986 to 1994
13. Tax eccentricities, tax effort and main constraints on improving tax effort in the G7 countries
14. Total and particular tax ratios for 1990 compared to 1991 estimates

I. INTRODUCTION

As indicated by its title, this article is divided into two parts: the first describes and the second more shortly prescribes. The objective of the first part is to update my recently published book[1] and to supplement it by providing a commentary on recent trends in government tax revenue levels and structures, sub-central government tax revenues and general government financial balances.[2] The second part gives more subjective reactions to the fiscal policy implications of these revenue developments, mainly in the so-called G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom, United States), with special reference to what should be government reactions to the increase in fiscal deficits that are predicted to continue over the next few years in most of these countries.

The author was Head of the OECD Fiscal Affairs Division from 1971 to 1991. *He thanks Sijbren Cnossen and Verity Russell for some useful comments on an earlier draft, which does not commit them to agreement with anything that is written here.*

II. RECENT TAX REVENUE DEVELOPMENTS

A. *Preliminary remarks*

1. Scope and summary of findings

A first question to resolve in an article with this title is when should 'recent' begin and end. On the starting date, if one goes too far forward, there will in many coun-

1. K. Messere, *Tax Policy in OECD Countries: Choices and Conflicts* (Amsterdam: IBFD, 1993).
2. This part is also intended to be self contained for those without my book, which leads to some repetition with my book particularly in Section II.A.2.

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tries be no developments to describe, and if too far back it is not recent. 1985 seemed a good solution in this regard, except that 1986 proved a more convenient starting year for providing information on general government financial balances. The end date is evidently the last for which firm data or estimates are available, which varies among the four topics discussed.[3]

There is not very much of a coherent story to tell about trends in recent tax developments in these four areas, because the very diverse movements among OECD countries were almost certainly due to the special circumstances prevailing in each country. While international considerations have had a great influence on certain tax developments (e.g. rate lowering and base broadening of income taxes, the move to VAT) there is no reason to believe that these have affected countries' choices in their tax levels, tax structures, local government financing and deficit financing.

Within this country diversity, however, a few overall trends can be identified which are later commented on in greater detail:

- the end of the almost automatic annual growth of total tax receipts to GDP ratio;
- a much greater convergence in tax level and tax structure developments than existed during earlier years;
- an almost universal increase over recent and forthcoming years in deficit financing.

On the other hand, it is impossible to detect any trend in major shifts from one tax to another either at general or local government level, or major changes between the tax share of federal/central and state/local government.

Though there have been many advocates of a move from income towards consumption taxation and of a greater share of tax revenues for sub-central levels of government, neither change has taken place over recent years in most OECD countries.

2. Methodology and concepts

This section refers briefly to some of the methodological problems and concepts used in the analysis, and also stresses that international tax revenue comparisons require heroic assumptions and simplifications which inevitably involve limitations on their validity, as set out in detail in Chapter 2E of Messere (1993). Nevertheless, as I have frequently argued, they do have value for policymakers.[4]

To be able to make any international comparisons of tax levels and structures it is necessary to agree on what counts as a tax and to have a standardized classification of taxes. This has been done since the early 1970s by the OECD on an annual basis and Table 1 reproduces the standardized OECD classification of taxes[5] together with unweighted averages of receipts from each of the main revenue sources as a percentage of total tax receipts. This table indicates that in 1990 around 82 percent of total tax revenues derive from personal income taxes (1100), social security contributions (2000) and consumption taxes levied directly on goods (5110 general plus 5120 specific), so the analysis that follows focuses mainly on these four kinds of taxes. If corporation income taxes (1200 = nearly 8 percent) and the various taxes on property 4000 (5.4 percent), on which some comments are also made, are added, around 95 percent of OECD tax revenues are covered, so no attention is paid in this article to the other very small tax revenue sources.

The following abbreviations are used:
'*Total tax ratio*' (henceforth TTR) refers to the ratio of total tax revenues to gross domestic product (GDP) at market prices.
'*Personal income tax ratio*', '*social security ratio*', etc. refers to the ratio of receipts from these specified revenue sources to GDP at market prices.
'*Tax structures*', '*tax mix*' and '*tax share*' each refers to the relative importance of receipts from particular kinds of tax to those from total tax receipts.
'*VAT, etc.*' refers to 5110 and includes not only value added taxes existing in 21 of the 24 OECD countries but also various kinds of sales taxes levied by subordinate levels of government in Canada and the United States, and by federal levels in Australia and Switzerland.
'*Excises, etc.*' refers not only to 5121 (excises) but to all the subheadings of 5120 (Table 1).

Although comparisons of tax levels and structures are designed to answer two separate questions (how much tax revenue and what tax mix, respectively), data on tax structures could be simply derived from those on tax levels by some multiplication and division. However, it is useful for a number of reasons to have some separate information on tax structures. If total tax receipts rather than GDP at market prices is chosen as the denominator, trends as between different kinds of tax are more clearly revealed: for example, though the unweighted average corporation tax ratio increased slightly between 1965 and 1990 and that of the property tax remained stable, the share of receipts from both of these kinds of tax decreased as a percentage of total tax receipts; and while the unweighted average of employees' social security ratio increased, its share of total tax receipts remained stable. Also tables providing data solely on tax levels would obscure country choices on their tax mix, since Denmark and Sweden would appear near the top and Turkey and the United States near the bottom of most particular tax ratios, simply because of the extreme difference in their total tax ratios. However, the snag about tax structure statistics is that they are not very helpful in indicating revenue trends of particular taxes, since they may indicate more about what has

3. For tax levels and structures the last firm data are for 1990, though estimates are available for 1991, and since these estimates are incomplete and subject to change they are not covered in the commentaries in Sections B and C, but in an Appendix to this article which compares 1990 data with 1991 estimated data.
For sub-central tax revenues in Section D the last year is 1990.
For general government financial balances in Section E, estimates extend to 1994.
Sources are *Revenue Statistics of OECD Countries (1965-91)* - referred to subsequently as OECD RS (1992) - for the first three topics and tables 8 of OECD Economic Outlook N° 51 and 52 (respectively, OECD June 1992 and December 1992) for data on general government financial balances.
4. E.g. K. Messere and J. Owens, *International Comparisons of Tax Levels: Pitfalls and Insights* (Paris: OECD Economic Studies N°8 Spring 1987).
5. OECD RS (1992), *supra* note 3 also provides an interpretative guide to this classification which indicates how the many borderline cases are resolved.

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TABLE 1

THE OECD CLASSIFICATION OF TAXES

		Unweighted OECD average percentage of total tax receipts	
1000	Taxes on Income, Profits and Capital Gains	1985	1990
1100	Taxes on income, profits and capital gains of individuals	38.2	38.3
1110	On income and profits	30.6	30.1
1120	On capital gains		
1200	Corporate taxes on income, profits and capital gains	7.9	7.7
1210	On income and profits		
1220	On capital gains		
1300	Unallocable as between 1100 and 1200		
2000	Social Security Contributions	23.5	23.5
2100	Employees	7.8	9.6
2200	Employers	13.7	13.2
2300	Self-employed or non-employed		
2400	Unallocable as between 2100, 2200 and 2300		
3000	Taxes on Payroll and Workforce	1.2	1.1
4000	Taxes on Property	5.1	5.4
4100	Recurrent taxes on immovable property		
4110	Households		
4120	Other		
4200	Recurrent taxes on net wealth		
4210	Individual		
4220	Corporate		
4300	Estate, inheritance and gift taxes		
4310	Estate and inheritance taxes		
4320	Gift taxes		
4400	Taxes on financial and capital transactions		
4500	Other non-recurrent taxes on property		
4510	On net wealth		
4520	Other non-recurrent		
4600	Other recurrent taxes on property		
5000	Taxes on Goods and Services	31.1	30.3
5100	Taxes on production, sale, transfer, leasing and delivery of goods and rendering of services	29.4	28.6
5110	General taxes	15.6	17.3
5111	Value added taxes		
5112	Sales taxes		
5113	Other general taxes on goods and services		
5120	Taxes on specific goods and services	13.7	11.3
5121	Excises		
5122	Profits of fiscal monopolies		
5123	Customs and imports duties		
5124	Taxes on exports		
5125	Taxes on investment goods		
5126	Taxes on specific services		
5127	Other taxes on international trade transactions		
5128	Other taxes on specific goods and services		
5130	Unallocable as between 5110 and 5120		
5200	Taxes on use of goods, or on permission to use goods or perform activities	2.0	1.7
5210	Recurrent taxes		
5211	Paid by households in respect of motor vehicles		
5212	Paid by others in respect of motor vehicles		
5213	Other recurrent taxes		
5220	Non-recurrent taxes		
5300	Unallocable as between 5100 and 5200		
6000	Other taxes	0.9	1.4
6100	Paid solely by business		
6200	Paid by other than business or unidentifiable		

happened to the levels of other kinds of tax and for this reason more attention is devoted to tax levels than to tax structures.

Useful concepts for the analysis of tax revenue developments are 'convergence' and 'divergence'. *Convergence* occurs over a period of time if the deviation of a country from an average OECD tax ratio is less in the second year than the first and *divergence* when the reverse is the case. In practice, convergence entails that *either* a country with a below average tax ratio increases it by more than the average tax increase between the two periods *or* that a country with an above average ratio increases it by less than average: likewise, divergence occurs when above average tax ratio countries increase the ratio by more than the average or below average tax ratio countries increase it by less than the average. Trends in convergence and divergence regarding total tax ratios can give some indication as to whether governments which rely less on the public sector are compelled to catch up (convergence), or alternatively whether a particular attitude to public expenditure gathers momentum, so that spending-prone governments are compelled to spend even more and tax even more, while those governments relying more on the private sector continue to do so (divergence). An analysis of the convergence and divergence of *particular* tax ratios, as distinct from *total* tax ratios illuminates the different question of whether governments can continue to rely more and more on those taxes which have brought them most revenues in the past and/or to continue to neglect those revenue sources which they have neglected in the past (divergence) or whether they are obliged to diversify their sources of revenue towards an OECD average (convergence).

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TABLE 2

DEVELOPMENTS IN TOTAL TAX RATIOS SINCE 1985

	(1) Ranking order 1985	(2) Ranking order 1990	(3) Highest ever ratio	(4) Year
Australia	(19) 30.0	(22) 30.8	31.1	1987
Austria	(8) 43.1	(8) 41.6	43.1	1985
Belgium	(4) 47.6	(6) 44.9	47.6	1985
Canada	(16) 33.1	(14) 37.1	(39.4)*	1991*
Denmark	(3) 49.0	(3) 48.6	51.7	1988
Finland	(12) 37.0	(11) 38.0	38.5	1986
France	(7) 44.5	(7) 43.7	44.6	1984
Germany	(9) 38.1	(12) 37.7	38.3	1989
Greece	(13) 35.1	(16) 36.5	37.3	1987
Iceland	(21) 28.8	(19) 32.6	32.8	1989
Ireland	(10) 38.0	(13) 37.2	40.6	1988
Italy	(14) 34.4	(9) 39.1	(40.5)*	1991*
Japan	(23) 27.6	(21) 31.3	31.3	1990
Luxembourg	(2) 50.1	(2) 50.3	50.8	1983
Netherlands	(6) 44.9	(5) 45.2	48.5	1987
New Zealand	(15) 34.1	(10) 38.2	39.3	1989
Norway	(4) 47.6	(4) 46.3	50.0	1986
Portugal	(18) 31.6	(17) 34.6	(35.5)*	1991*
Spain	(21) 28.8	(18) 34.4	34.6	1989
Sweden	(1) 50.4	(1) 56.9	56.9	1990
Switzerland	(17) 32.0	(20) 31.7	32.6	1988
Turkey	(24) 19.7	(24) 27.8	(31.4)*	1991*
United Kingdom	(11) 37.9	(15) 36.7	39.1	1982
United States	(20) 29.2	(23) 29.9	30.0	1981
Unweighted average	37.2	38.8		

* = provisional

TABLE 3

CONVERGENCE OR DIVERGENCE OF TOTAL TAX RATIOS BETWEEN 1985-90 COMPARED TO EARLIER RESULTS

	1985 to 1990				SOME EARLIER RESULTS					
	(1) Change in ratio between 1985-90	(2) 1985-90 convergent or divergent	(3) High or low tax country in 1985	(4) 85-90 increase higer or lower than average	(5) 1965-81 convergent or divergent (a)	(b)	(6) 1966-79 convergent or divergent	(7) 1966-74 convergent or divergent (a)	(b)	(8) 1966-72 convergent divergent
Australia	+0.8	C	L	H	D	–	D	D	–	D
Austria	–1.5	C	H	L	C	C	C	C	C	C
Belgium	–2.7	C	H	L	D	C	D	D	C	D
Canada	+4.0	C	L	H	D	–	D	C	–	C
Denmark	–0.4	C	H	L	D	C	D	D	C	D
Finland	+1.0	C	L	H	C	–	C	–	–	–
France	–0.8	C	H	L	C	C	C	C	C	C
Germany	–0.4	C	H	L	C	D	C	C	C	C
Greece	+1.4	D	L	L	D	–	–	–	–	–
Iceland	+4.2	C	L	L	–	–	–	–	–	–
Ireland	–0.8	C	H	L	C	C	D	C	C	C
Italy	+4.7	C	L	H	C	D	D	D	D	D
Japan	+3.6	C	L	H	D	–	D	D	–	D
Luxembourg	+0.2	C	H	L	C	–	–	–	–	–
Netherlands	+0.3	C	H	L	D	D	D	D	D	D
New Zealand	+4.1	C	L	L	D	–	–	–	–	–
Norway	–1.3	C	H	L	D	D	D	D	D	D
Portugal	+3.0	C	L	H	C	–	–	–	–	–
Spain	+5.8	C	L	H	C	–	–	–	–	–
Sweden	+6.5	D	H	H	D	D	D	D	D	D
Switzerland	–0.3	D	L	L	C	–	C	–	–	–
Turkey	+8.1	C	L	H	D	–	–	–	–	–
UK	–1.2	C	H	L	C	D	C	C	D	C
US	+0.7	D	L	H	D	–	D	D	–	D
Convergent		20			11	5	6	6	6	6
Divergent		4			12	6	11	9	5	9

C = Convergent D = Divergent Average 1985 = 37.2 Average1990 = 38.8 Average difference = +1.6 (a) OECD area generally (b) Industrialized Europe – not included in earlier tests

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B. *Tax level developments (1985-90)*

1. Total tax ratios (TTRs)

Recent TTR trends exhibit two contrasts with those in earlier years: first, the almost inevitable annual increase in unweighted average TTR that occurred between 1965 and 1987 came to an end in that latter year (Table 2),[6] and second the divergence in TTR developments that mostly predominated between 1965 and 1985, especially in the earlier years, has been replaced by an almost total convergence since 1985 (Table 3).

The decline or stagnation of TTRs in many countries since 1987[7] has a multitude of causes such as the recession, the predominance of governments wishing to tax less, and the reduction of former buoyant revenue sources (e.g. North Sea oil in Norway and the United Kingdom). It is true that overall ratios increased between 1989 and 1990 but 1991 estimates suggest there is likely to be little change between the 1990 and the 1991 average (see Appendix). On the other hand, it may be noted (last column Table 2) that the total tax ratio has peaked in most OECD countries since 1987, the exceptions being Austria (1985), Belgium (1985), Finland (1986), France (1984), Luxembourg (1983), Norway (1986), United Kingdom (1982) and United States (1981).

It is interesting to speculate what will happen to TTRs during the 1990s. My own guess is that they will continue to stagnate during 1992 and perhaps 1993 as OECD countries gradually climb out of the recession, but thereafter will increase in most OECD countries; first because of the trade cycle, second because of changes in political and economic fashion where Keynesianism looks like becoming respectable again after so long a domination by monetarists and supply-siders, and third because governments are increasingly recognizing as an imperative the need to reduce their deficits – of which more in the final section of Part II and most of Part III.

6. Table 2 also shows the ranking order of countries' TTRs for 1985 and 1990. Whilst the same eight countries inevitably top the list, elsewhere there are many changes: e.g. Italy from 12th to 9th, New Zealand from 15th to 10th, Germany from 9th to 12th, United Kingdom from 11th to 15th and United States from 20th to 23rd.

7. Since 1985, the average unweighted TTR has been:
1986: 38.0
1987: 38.5
1988: 38.6
1989: 38.4
1990: 38.8.

TABLE 4

SHIFTS IN TAX RATIOS BETWEEN 1985 AND 1990 OF 0.5 PERCENTAGE POINTS OR MORE

	Personal income tax	Corporation tax	Social security contributions	VAT etc. taxes	Excises etc.	Property taxes
Australia		+1.8			−1.5	
Austria	1.1				−0.6	
Belgium	−2.4					
Canada	+3.6		+0.8	+0.8	−0.6	
Denmark	+1.0	−0.8			−1.0	
Finland		+0.6	−0.6	+1.3	−0.5	
France	−0.5			−0.7		
Germany	−0.6	−0.5				
Greece		+1.1	−2.1	+3.9	−1.5	+0.8
Iceland	+3.1			+1.1	−2.0	+0.7
Ireland		+0.6			−0.9	
Italy	+1.1	+0.7	+1.0	+0.7	+1.0	
Japan	+1.6	+0.9	+0.8		−1.0	
Luxembourg	−1.0	−0.9	+1.3	+0.6	−0.7	+1.5
Netherlands	+2.5		−3.0			
New Zealand	−2.6			+5.1	−0.5	
Norway	+1.4	−4.0	+3.3		−1.4	
Portugal[1]			+1.4	+2.8	−1.0	
Spain	+1.8	+1.5		+1.3		
Sweden	+2.2		+3.2	+1.3	−0.7	+0.8
Switzerland						
Turkey[2]	+2.0		+2.7	+1.0		
United Kingdom		−0.8			−0.7	−1.4
United States						
Unweighted coverage						
1985	11.5	2.9	8.9	5.9	5.0	1.8
1990	11.7	2.9	9.3	6.7	4.4	2.0
1990 minus 1985	+0.2	zero	+0.4	+0.8	−0.6	+0.2

1. Until 1990 Portugal could not distinguish between personal and corporate income tax.
2. Turkey increases probably understated, since unidentifiable taxes of 6000 represent 4.6 of GDP in 1990.

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Table 3 contrasts the almost total convergence of TTRs with the predominance of divergence prevailing[8] in earlier years, especially 1965 to around 1975 to 1980. Broadly the picture during these earlier years was that TTRs were increasing most in those countries which already had high ratios (industrialized Europe) moderately in countries with medium ratios (non-Europe less Japan) and least of all in those countries with the lowest ratios (less-industrialized Southern Europe plus Japan). Between around 1975 and 1985 most industrialized European countries continued to increase their TTR quite considerably, the medium non-European countries hardly at all, but less industrialized Greece, Portugal and Spain most of all. Since 1985 there has been much less homogeneity among geographical groupings, but as Table 3 shows, nearly all high TTR countries have increased their ratio below the average or even decreased it, and nearly all low TTR countries have increased their ratio above the average between 1985 and 1990. Sweden is the only high TTR country to increase it above (considerably above) average, but a sharp fall is predicted for 1991 (see Appendix). Of the low TTR countries only Greece, Switzerland and the United States have increased the TTR less than average. As a consequence of these recent changes New Zealand from 1965 to 1988 a below average TTR country became an above average TTR country in 1989 (though not in 1990), and in 1990 for the first time since 1965, Italy also became an above average TTR country. On the other hand, Germany and the United Kingdom both from 1965 to 1985 above average TTR countries have become below average since then.

2. Some particular tax ratios

Table 4 summarizes major changes (taken to be at least 0.5 of GDP) in six particular tax ratios between 1985 and 1990. Such major changes have occurred in at least one tax ratio in all OECD countries except for Switzerland and the United States; in Luxembourg they have occurred in all six ratios, and in Greece and Sweden in five of the six.

The following sub-table summarizes the number of countries significantly increasing or decreasing each of the six ratios between 1985 and 1989.

Personal income tax ratio:	inc 10	dec 6	little change 8
Corporation tax ratio:	inc 7	dec 5	little change 12
Social security ratio:	inc 8	dec 3	little change 13
VAT etc. ratio:	inc 11	dec 1	little change 12
Excises etc. ratio:	inc 1	dec 15	little change 8
Property tax ratio:	inc 4	dec 1	little change 19

Among the two kinds of income tax, increases in both the personal and corporate tax ratio occurred in Italy, Japan and Spain, decreases in both ratios in Germany and Luxembourg and increases in the personal and decreases in the corporation ratio in Denmark and Norway. Of the main components of the social security ratio, the increase is predominantly in the employers' ratio in Canada, Italy and Portugal and in the employees' ratio in Norway, while the large decrease in the Netherlands' social security ratio was in respect of the employers' share.[9] Of the general consumption taxes, there were large increases in VAT, etc. ratios of many countries, including the five countries (Greece, New Zealand, Portugal, Spain and Turkey) adopting VAT in the mid-1980s, and a fall only in France, but large decreases in most countries in the excises, etc. ratio which increased only in Italy, so the average 5000 taxes on goods and services ratio barely changed (11.5 in 1985 and 11.8 in 1990). The relative smallness of property tax ratios makes it more convenient to refer to changes in such taxes in the next section on tax structures.

Without an examination of policy statements and tax legislation in each country it is difficult to know how far changes (or lack thereof) in various tax ratios have been a result of governments' intentions, how far due to exogenous factors having nothing to do with tax policy objectives. There follows short comments on changes in certain tax ratios where the reasons for them are believed to be known or where other reflections are provoked.

Denmark: Already with the highest OECD personal income tax ratio in 1985, Denmark increased it by another percentage point between 1985 and 1990. A partial explanation is that outside Australia and New Zealand Denmark has the lowest social security ratio in the OECD, since employees' earmarked contributions are levied on an income tax base and are classified in 1000, not 2000, of the OECD list, as is also the case in Finland and Sweden.

France: Already with the lowest OECD personal income tax ratio (save Greece, Iceland and Turkey) in 1985, there has been a further decline of 0.5 percentage points between 1985 and 1990, when at 7.5 percent France in 1990 was above only Greece (7.4 percent). One explanation is that the French central government income tax on earned income is the only such tax in the OECD not to be automatically withheld at source, another that the threshold is so high that nearly half the population do not pay income tax.

Netherlands: The decline in social security ratios and increase in income tax ratios was the consequence of a tax reform which partially integrated these two levies.

New Zealand: A rare case of a deliberate switch from income taxation to consumption taxation with the adoption of a VAT type tax.

Norway: Loss of revenues from North Sea oil was responsible for the sharp fall in the corporation tax ratio and perhaps contributed to the need to raise the personal income tax and social security ratios, but it does not explain the drop in the 5000 (all taxes on goods and services) ratio from 17.8 to 16.4.[10]

8. For a more detailed description and discussion and possible explanations see Chapters 2, 3 and 4 of Messere (1993), *supra* note 1.

9. Social security ratio breakdowns are not reproduced here; see Tables 16 and 18 of OECD RS (1992), *supra* note 3. However, Table 1 suggests that the much lower employees' share has been increasing on average and the employers' share declining.

10. One explanation could be that Norway is the only country where there has been pressure to replace VAT by a retail sales tax, and though this pressure was resisted, it may be why unlike nearly all other VAT countries, Norway has never increased the VAT rate.

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TABLE 5

CONVERGENCE AND DIVERGENCE OF SOCIAL SECURITY AND EXCISE ETC RATIOS BETWEEN 1985 AND 1990

	Social security ratio			Excises etc ratio		
	Convergent or divergent	Lower or higher than 1985 average	Lower or higher than average betwwen 1985-1990	Convergent or divergent	Lower or higher than 1985 average	Lower or higer than average change between 1985 and 1990
Australia	D	L	L	C	H	L
Austria	NT	H	=	NT	L	=
Belgium	C	H	L	C	L	H
Canada	C	L	H	C	L	H
Denmark	D	L	L	C	H	L
Finland	D	L	L	C	H	L
France	C	H	L	C	L	H
Germany	C	H	L	C	L	H
Greece	C	H	L	C	L	H
Iceland	D	L	L	C	H	L
Ireland	D	L	L	C	H	L
Italy	D	H	H	C	H	L
Japan	C	L	H	C	L	H
Luxembourg	D	H	H	D	L	L
Netherlands	C	H	L	C	H	L
New Zealand	D	L	L	C	L	H
Norway	D	H	H	C	L	H
Portugal	C	L	H	C	H	L
Spain	C	H	L	C	L	H
Sweden	D	H	H	C	H	L
Switzerland	C	H	L	C	L	H
Turkey	C	L	H	C	L	H
United Kingdom	D	L	L	C	H	L
United States	D	L	L	C	L	H
Average 1985		37.2		5.0		
Average 1990		38.8		4.4		
Average difference		+1.6		–0.6		
Convergent		11		22		
Divergent		12		1		
No trend		1		1		

Notes:
C = Convergent NT = No trend C = Lower than average
D = Divergent H = Higher than average = = exactly average

United Kingdom: The drop in the property tax ratio occurred between 1989 and 1990 when the poll tax replaced the rates.

United States: The avowed objective of the 1986 tax reform to reverse the burden of previous years from corporations to individuals worked for 1988, but 1990 personal and corporate income tax ratios resemble those of 1985.

	1985	1986	1987	1988	1989	1990
Pers. income tax ratios	10.4	10.2	10.9	10.2	10.6	10.7
Corp. income tax ratios	2.1	2.0	2.4	2.5	2.5	2.2

It involves many calculations to establish the convergence and divergence of particular tax ratios, but out of curiosity I did it several times during the 1970s and early 1980s.[11] For most of the main tax ratios (personal and corporation income tax and VAT, etc.), the results were not too interesting, convergence and divergence being roughly equal, but changing somewhat over time and between countries – the consequences of adopting VAT being the only general explanation

11. K Messere, *Recent and Prospective Trends in Tax Levels* (Institute of Fiscal Studies, 1975); "Tax levels, structures and systems: some intertemporal and international comparisons", from proceedings of the 32d IIPF Congress of the International Institute of Public Finance, Edinburgh 1976 (Editions Cujas Paris, 1978), and "Quantitative Developments in OECD Tax Levels and Structures (1965-1981)", *Intertax* (August 1985).

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that could be offered. However, there were two interesting exceptions: no matter what periods were being considered social security ratios were almost invariably divergent, increasing in all OECD countries but most in those with high ratios in the earlier of the two years being compared. On the contrary excises, etc. ratios were almost invariably convergent, decreasing in virtually all countries, but decreasing most in those countries which had high excises, etc. ratios in the earlier year. It is for this reason that in Table 5 I have revisited only these two last tax ratios to see what has happened between 1985 and 1990.

Table 5 results show that the divergence of social security ratios, though much abated nevertheless continued in many countries between 1985 and 1990 (Italy, Luxembourg, Norway and Sweden being high ratio countries increasing them by more than average and Denmark, Finland, Iceland, Ireland, United Kingdom and United States being below average reducing them or increasing them by less than average), while Australia and New Zealand remain without social security contributions. Convergence predominates over this period more than ever before with excises, etc. ratios, only Luxembourg (low excise ratio country reducing it by very slightly more than average) being a divergent country.

This very slight Luxembourg deviation recalls that a major limitation of the Table 5 type analysis is that countries have to be forced into the convergence/divergence dichotomy, irrespective of whether such convergence/divergence is very heavy or very slight. Table 6 provides a sort of corrective by

TABLE 6

EXCEPTIONALLY HIGH DEVIATIONS FROM AVERAGE TAX RATIOS
(TO NEAREST PERCENTAGE POINT IN 1985 AND 1990)*

	Total tax ratios		Personal income tax		Corporation income tax		Employees' social security		Employers' social security		VAT etc.		Excises etc.		Number extreme cases	
	1985	1990	1985	1190	1985	1990	1985	1190	1985	1990	1985	1990	1985	1990	1985	1990
OECD Average	37.2	38.8	11.5	11.7	2.9	2.9	2.9	3.1	5.2	5.2	5.9	6.7	5.0	4.4		
Exceptionally high deviation taken to be more than plus or minus percentage points	9	9	5	5	2	2	2	2	3	3	3	3	3	3		
Australia							–3	–3	–5	–5		–4			2	3
Austria							+3								1	0
Belgium	+10						+3		+4	+4					3	1
Canada															0	0
Denmark	+12	+10	+13	+14			–3	–3			+4				4	3
Finland			+ 6	+ 6			–3	–3	+7	+6					3	3
France			– 6	– 6			+3	+3							2	2
Germany							+3	+3							1	1
Greece			– 7	– 6											1	1
Iceland							–3	–3			+4	+4			2	2
Ireland															0	0
Italy									+3	+4					1	1
Japan	–10				+3	+4					–6	–5			3	2
Luxembourg	+13	+11			+5	+5									2	2
Netherlands							+6	+7							1	1
New Zealand			+ 9	+ 7			–3	–3	–5	–5					3	3
Norway	+10				+5										2	0
Portugal									+4	+4			+4	+4	2	2
Spain			– 6												1	0
Sweden	+13	+17	+ 8	+10			–3	–3	+7	+9					4	4
Switzerland															0	0
Turkey	–17	–16	– 6												2	1
United Kingdom															0	0
United States		–10									–3	–4			1	2
Number of extreme cases	7	5	8	6	3	2	11	9	7	7	4	4	1	1	41	34

* Property taxes (average 1.8 in 1985 and 2.0 in 1990) too small to be included. Extremes in 1985 UK 4.5, Portugal 0.6. Extremes in 1990 Luxembourg 4.3, Turkey 0.6.

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concentrating on those countries which have either exceptionally high or exceptionally low particular tax ratios. Evidently what constitutes 'exceptionally' as defined in the second column of that table has to be a subjective choice and little commentary is provided on the table.

It is, however, worth pointing out that under the criteria applied recent convergence is manifested in another way in that the number of extreme cases has been reduced from 41 to 34 between 1985 and 1990.

Another observation is that some countries have typical tax ratios (Canada, Ireland, Switzerland, United Kingdom) and others eccentric tax ratios (Australia, Denmark, Finland, New Zealand, Sweden) – see last column of Table 6.

C. *Tax structure developments (1985-90)*

For the reasons already indicated, less is said about changes in countries' tax structures than has been said about changes in their tax levels. Table 7 echoes Table 4 in providing details of major shifts between 1985 and 1990 and Table 8 echoes Table 6 in providing examples of extreme high reliance and low reliance on particular sources of revenue for the years 1985 and 1990. For these tables, taxes on goods and services (5000) are considered as a whole, no split being made between their main components – VAT, etc. (5110) and excises, etc. (5120) since the usual situation is a heavy VAT, etc. increased share accompanied by a heavy decreased excises, etc. share and what is perhaps more interesting is to see what changes there have been in the tax mix between consumption taxes as a whole and income taxes and social security contributions.

TABLE 7

SHIFTS IN PARTICULAR TAX STRUCTURES BETWEEN 1985 AND 1990
OF ONE PERCENTAGE POINT ORE MORE

	Personal income tax	Corporation income tax	Social security contributions	Consumption taxes	Property taxes
Australia	–2.1	+4.7		–4.1	+1.1
Austria	–1.7		+1.1	–1.1	
Belgium	–3.5		+1.6		
Canada	+5.6	–1.4		–4.4	
Denmark	+2.5[1]	–1.6		+1.2	
Finland		+1.5	–1.7	+1.1	
France	–1.0[2]		+1.1	–1.5	
Germany	–1.3	–1.4		+1.7	
Greece		+2.9	–7.2	+3.0	+2.1
Iceland	+7.0			–9.6	+1.2
Ireland				–2.1	
Italy			–1.8	+2.6	
Japan	+2.1		–1.1		
Luxembourg	–2.2	–2.1	+2.5		+2.8
Netherlands	+5.3		–6.0		
New Zealand	–13.3	–1.8		+10.6	–1.2
Norway	+3.6	–8.1	+5.6	–2.3	+1.0
Portugal[3]			+1.7	+1.2	
Spain	+2.1	+3.6	–5.9		+2.0
Sweden			+2.8	–1.9	+1.2
Switzerland					
Turkey[4]		–2.8	+5.4	–8.1	–2.3
United Kingdom	+1.9	–1.6			–3.5[5]
United States				–1.3[6]	
Unweighted average 1985	30.6	7.9	23.5	31.1	5.1
Unweighted average 1990	30.1	7.7	23.5	30.3	5.4
Difference between unweighted average	–0.5	–0.2	zero	–0.8	+0.3

1. Replaces New Zealand (1985) as highest income tax share of OECD countries.
2. In both 1985 and 1990 lowest income tax share of OECD countries.
3. Breakdown between personal and corporate income tax unavailable before 1990.
4. Changes doubtful since in 1990 16.6% of tax receipts are unidentifiable.
5. Drop occurred between 1989 and 1990 when poll tax replaced rates.
6. In 1985 and 1990 lowest consumption tax share in OECD, except for Japan.

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TABLE 8

EXCEPTIONALLY HIGH DEVIATIONS FROM AVERAGE TAX STRUCTURES – 1985 AND 1990
(SHARE IN TOTAL TAX RECEIPTS TO NEAREST PERCENTAGE POINT

	1100 Personal income tax		1200 Corporate income tax		2000		5000 Taxes on goods and services		4000 Property taxes		Number of large deviations	
OECD average	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990
Exceptionally high deviations taken to be more than plus or minor in ?? points	11	11	4	4	10	10	11	11	3	3		
Australia	+15	+12		+6	–23	–23					2	3
Austria											0	0
Belgium											0	0
Canada									+4	+4	1	1
Denmark	+21	+23			–20	–20					2	2
Finland	+16	+16			–14	–16					2	2
France	–18	–19			+20	+21					2	2
Germany					+13						1	0
Greece	–17	–15	–5		+12		+12	+12			4	2
Iceland			–5	–5	–21	–20	+30	+15			3	3
Ireland			–5				+13	+12			2	1
Italy					+11						1	0
Japan			+13	+14			–17	–17	+5	+4	3	3
Luxembourg			+10	+9							1	1
Netherlands					+21						1	0
New Zealand	+29	+15			–23	–23					2	2
Norway			+9								1	0
Portugal	n/a	–14					+12	+14			1	2
Spain	–13										1	0
Sweden			–5								0	1
Switzerland							–12	–12			1	1
Turkey											0	0
United Kingdom			+5						+7		2	0
United States							–13	–14	+5	+5	2	2
Number and high deviations	7	7	7	5	10	6	7	7	4	3	35	28

Table 7 suggests an absence of any clear trend in the tax mix of the major revenue sources between 1985 and 1990 as the following sub-table brings out:

Changes of one or more percentage points between 1985 and 1990 in shares of total tax receipts

	Personal Income	Corporation	Social Security	Consumption	Property
No. of countries with increases	8	4	7	7	7
No. of countries with decreases	7	8	6	10	3

One trend worth commenting on is the rise in the share of property tax receipts since 1985, which had been consistently declining until then. In addition to the countries referred to in Table 7, where the share rose by at least one percentage point, there were also increases in the property tax share of 0.9 percentage points in Belgium, 0.8 in France and 0.7 in Ireland and the United States, though a decline of 0.7 in Japan.

Although for many years there has been much advocacy of switching from income and payroll taxation to consumption taxation, this rarely seems to have happened except in some of the countries newly introducing VAT (Greece, New Zealand and Portugal). Rather the reverse has more often happened.

Table 8 concludes this brief survey of tax structure developments by indentifying countries with very heavy or very light reliance on the main revenue sources in 1985 and 1990. It calls for only two observations: first, countries with extreme tax structures are by no means identical to those with extreme tax ratios (e.g. compare Tables 6 and 8 for Greece and Sweden) even if sometimes there is a positive correlation (e.g. Australia many deviations in both and the United Kingdom

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few); second, the number of cases of extreme tax structures were fewer in 1990 than in 1985 (28 instead of 35).

D. *Developments in sub-central government taxes between 1985-90*

The wider questions and issues arising in financing expenditures of sub-central levels of government and country practices between 1965 and 1989 were dealt with in Chapter 9 of Messere (1993). This section merely notes changes between 1985 and 1990 in two respects: how far have there been changes in the percentage of tax revenues allocated to sub-central levels of government (Table 9) and how far have there been changes in the kinds of tax allocated to them (Tables 10 and 11).

TABLE 9

SHARE OF TOTAL TAX REVENUES ACCRUING TO SUB-CENTRAL LEVELS OF GOVERNMENT IN 1985 AND 1990*

Federal Countries

	State Government			Local Government			
	(For reference 1990 federal government share)	1985	1990	Difference	1985	1990	Difference	Other changes of more than one percentage point
Australia	74.6	14.9	16.8	+1.9	3.7	3.5	–0.2	Federal –1.8
Austria	50.3	13.1	10.7	–2.6	10.7	11.2	+0.5	Federal +1.4
Canada	41.9	36.0	35.1	–0.9	9.3	8.9	–0.4	
Germany	32.9	22.0	21.1	–0.9	8.9	8.3	–0.6	Federal +1.3
Switzerland	29.6	22.6	21.6	–1.0	16.7	16.0	–0.7	
United States	39.0	19.0	18,8	–0,2	11.9	12.6	+0.7	
Unweighted average	45.6	21.3	20.7	–0.6	10.2	10.1	–0.1	

Unitary Countries

	(For reference Central government share)	Local Government 1985	1990	Difference	Other changes of more than one percentage point
Belgium	60.8	5.1	3.7	–1.4	Central –1.1 SS + 2.6
Denmark	65.6	28.3	30.7	+2.4	Central –2.9
Finland	60.8	26.1	27.3	+1.2	SS – 2.1
France	46.2	8.7	9.0	+0.3	Central –1.0
Greece	69.8	1.3	1.2	–0.1	Central +7.3 SS –7.2
Iceland	71.4	18.6	17.7	–0.9	
Ireland	82.7	2.3	2.5	+0.2	
Italy	63.7	2.3	2.9	+0.6	Central +1.4 SS –1.8
Japan	46.2	26.0	24.6	–1.4	Central +2.5 SS –1.1
Luxembourg	61.1	11.7	11.2	–0.5	Central –1.9 SS +2.4
Netherlands	59.0	2.4	2.2	–0.2	Central +8 SS –6.0
New Zealand	44.6	6.5	5.4	–1.1	Central +1.1
Norway	54.8	18.0	20.7	+2.7	Central –3.7 SS +1.9
Portugal	67.8	3.5	4.6	+1.1	Central –2.8 SS +1.7
Spain	51.9	11.2	12.5	+1.3	Central +4.1 SS –4.9
Sweden	52.5	30.2	28.8	–1.4	Central –1.7 SS +3.1
Turkey	71.6	10.2	8.8	–1.4	Central –3.9 SS +5.4
United Kingdom	75.7	10.0	5.7	–4.3	Central +4.6
Unweighted average excluding Turkey	63.8	12.5	12.4	–0.1	

SS = Social security funds.

* Adapted from table 122 of OECD RS (1992).

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TABLE 10

TAX REVENUES FROM STATE AND LOCAL TAXES AS PERCENTAGE OF TOTAL TAX REVENUES OF THESE LEVELS OF GOVERNMENT (FEDERAL COUNTRIES)*

	1100 Personal income taxes		1200 Corporation income taxes		3000 Payroll taxes		4000 Property taxes		5110 VAT etc		5120 Excises etc.		5200 Ownership and use taxes		Other taxes	
	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990
Australia																
State					31.3	29.7	25.7	30.6			16.6	14.1	26.5	25.6		
Local							99.6	99.8					0.4	0.2		
Austria																
State	48.1	42.6	3.4	2.5	4.6		1.0	0.9	29.7	36.2	5.1	6.2	3.8	4.9	2.8	4.0
Local	32.2	32.3	5.2	5.8	11.0	11.4	10.2	8.9	22.7	21.6	10.7	10.4	1.5	1.9	4.5	5.5
Canada																
State	37.8	44.6	7.1	6.5			4.0	4.3	20.3	20.6	15.5	14.4	15.4	9.6		
Local							84.8	84.5	0.2	0.2	0.2	0.1	1.3	1.6		
Germany																
State	51.9	51.0	3.0	8.5			5.4	7.2	24.8	27.0	2.1	2.0	4.8	4.3		
Local	66.1	65.6	14.8	14.7			18.1	18.6			0.4	0.4	0.4	0.4	0.2	0.3
Switzerland																
State	44.6	43.6	32.3	33.0			15.5	16.4			1.3	1.3	6.4	5.7		
Local	77.6	77.5	12.5	8.9			12.6	13.2			0.2	0.3	0.1	0.1		
United States																
State	29.5	31.9	8.2	8.7			3.7	4.0	32.3	33.1	16.7	15.9	9.7	7.9		
Local	4.8	4.7	1.1	1.0			74.2	74.5	10.9	10.7	4.7	4.6	4.3	4.5		
Unweighted average																
State	35.1	35.6	14.8	12.1	6.0	4.9	9.2	10.6	17.8	19.5	9.6	9.0	11.1	9.7	0.5	0.7
Local	30.1	30.0	5.5	5.4	1.8	1.9	49.9	49.9	5.6	5.4	2.7	2.7	1.3	1.4	3.1	3.2

* Adapted from table 126 of OECD (RS) 1992.

TABLE 11

TAX REVENUES FROM LOCAL TAXES AS A PERCENTAGE OF TOTAL TAX REVENUE OF THIS LEVEL OF GOVERNMENT (IN UNITARY COUNTRIES)**

	1100 Personal income taxes		1200 Corporation income taxes		4000 Property taxes		5110 VAT etc.		5120 Excises etc.		5200 Ownership and use taxes		Other taxes	
	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990	1985	1990
Belgium	66.3	72.6	12.5	17.9							15.8		5.4	9.6
Denmark	90.9	91.3	2.5	1.2	6.4	7.3			0.1	0.1				
Finland	90.5	90.4	8.5	8.2	0.9	0.8					0.1			
France	15.5	13.2			31.7	35.3			5.1	4.9	8.0	7.4	39.7	39.2
Greece	9.5				9.5		2.5	4.9	20.3	20.6	11.4	15.3	40.8	59.2
Iceland	5.3	57.8	8.2	2.3	15.3	16.4			5.5	5.3			15.7	18.2
Ireland					100	100								
Italy	16.0	11.1	10.7	7.4					10.2	14.5	0.3	0.2	22.7	33.0
Japan	28.9	31.1	29.2	32.6	23.7	23.0			12.4	8.3	4.8	4.1	1.0	1.0
Luxembourg	34.2	34.3	48.8	50.7	4.2	3.2	7.0	10.7	0.3	0.3	0.8	0.8	4.7	
Netherlands					75.1	73.2			1.1	1.2	23.8	25.5	0.2	
New Zealand					93.3	93.0			1.8	1.4	4.8	5.7		
Norway	83.4	80.3	6.8	7.4	6.4	8.6					0.5	0.7	2.9	3.0
Portugal	(63.7)*	11.6	(63.7)*	3.1	1.6	41.8	9.2	22.3	20.2	11.6	4.3	3.3	1.0	0.3
Spain	14.4	13.3	1.4		16.8	41.4	31.7	12.0	15.7	15.0	5.5	13.9	3.5	0.2
Sweden	98.3	99.6							0.2	0.4	0.1			
Turkey	30.6	35.9	11.8	8.9	5.3	3.1	25.6	26.9	12.7	9.8	0.4	0.6	13.6	14.8
United Kingdom					100	26.6								73.4
Unweighted average	40.0	35.5	7.7	8.0	28.5	27.7	3.0	2.9	5.8	4.9	4.7	4.5	8.1	14.0

* Personal and corporate tax receipts cannot be disaggregated. ** Adapted from table 128 of OECD (RS) 1992.

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Federal and unitary countries are treated separately because data are divided into federal, state and local for the former and only into central and local for the latter. Whilst it is mostly the case that state governments in federal countries have greater taxing powers than local government in unitary countries this is not necessarily so, local government authorities in the Nordic countries having greater taxing powers than the Australian or German intermediate governments for example. Ideally one would like to separate out 'own taxes' where sub-central government has some control over the rate and/or base of the tax from shared taxes where revenues are divided between federal/central and subordinate levels of government according to a negotiated formula, but the OECD RS (1992) data do not permit this, and in the tables that follow sub-central taxes include both receipts from own taxes and the shared portion of receipts accruing to such sub-central levels of government.

1. Changes in the share of tax revenues

Leaving aside the relatively small amounts of tax revenues allocated by EC member countries to the EC Commission, rival candidates to state and/or local government are not only the claims of central/federal government but also social security funds. Where there are large changes (defined as more than plus or minus one percentage point of total tax revenues) between 1985 and 1990 in the proportion of tax revenues allocated to state or local government, some indication is given in Table 9 as to how far this is combined with changes in the central government and how far in the social security fund share.

Among federal countries, intermediate (state) government gained most in Australia and lost most in Austria, and local government gained most in the United States and lost most in Switzerland, where it nevertheless continues to have a greater share of total tax revenues than in any other federal country.

Over the same period in unitary countries, local government has gained most in Denmark, where its share has been well above the average for many years, and lost most in the United Kingdom. Other local government gains of one percentage point or more occurred in Portugal and Spain and losses in Belgium, Turkey, Japan and Sweden, though in the last two countries the local government share remains well above average.

There appears no apparent correlation between changes in the sub-central government share and political demands for greater decentralization as has occurred in recent years, for example, in Belgium, Canada, France and Spain. Nor does there appear to be any general recent trend towards an increased or decreased share of revenue for sub-central governments, since it increases in about as many countries as it decreases, and apart from the countries referred to above shifts are relatively slight.

2. Changes in local tax structures

Table 10 (federal countries) and Table 11 (unitary) display the large variety of tax instruments used by governments to finance sub-central government and the great changes that have taken place between 1985 and 1990.

Because federal countries both at state and local level tend to diversify their revenues more than is usually done in unitary countries, and because from a constitutional point of view changing the structures in a federal country is likely to be more complicated, one would expect changes in revenue structures to be less volatile than in unitary states, and a comparison of Tables 10 and 11 shows this is indeed the case. However, though there are no great changes in local taxation in federal countries, at state level large shifts have occurred between 1985 and 1990 in Australia, Austria, Canada and Germany, as summarized below, though not in Switzerland and the United States.

Australia: An increase of five percentage points in the share of property taxes, together with smaller reductions in the share of payroll taxes, excises and use taxes.

Austria: A five percentage point decrease in the personal income tax share and two percentage points in the corporate tax share together with a six percentage point increase in the VAT, etc. share.

Canada: An increase of nearly seven percentage points in the income tax share, with a corresponding decrease in use taxes.

Germany: A five percentage point increase in business income taxes, with smaller adjustments to other kinds of state taxes.

In unitary countries large shifts in the composition of local government revenues between 1985 and 1990 are so frequent that it seems simplest to indicate changes in percentage points by the following sub-table:

	1100	1200	4000	5110	5120	5200	Other
Belgium	+9	+5				−16	+4
France			+4				
Greece	−9		−9			+4	+19
Italy	−5					+4	
Japan			+3			−4	
Luxembourg			+4				−5
Spain			+25	−20	+8		
United Kingdom	−73						+73

1100 = personal income tax
1200 = corporation tax
4000 = property tax
5110 = VAT etc.
5120 = excises etc.
5200 = use taxes

Except for a 4.5 percentage point decline in the unweighted personal income tax share and a six percentage point increase in the residual heading share (due to the British change from the rates to the poll tax and the high proportion of unidentifiable local taxes in Greece) there is not much change in unweighted averages, confirming what is shown in the above sub-table, that there is no clear international trend in types of tax used to finance local government.

E. *Developments in general government financial balances (1986-94)*

Table 12 records general government financial balances between 1986 and 1991 with estimates for 1992, 1993 and

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1994. Not only do the revised estimates for 1992 (column 8) indicate record deficits but 1994 estimates (column 10) suggest that these will be little better. Indeed they may be worse, since recent estimates have generally been on the optimistic side (e.g. compare columns 7 and 8 of Table 12), reflecting governmental wishes to let the rest of the world know that things are not as bad as they seem. Moreover, every OECD country except Japan is likely to remain in deficit over the next two years.

TABLE 12

GENERAL GOVERNMENT FINANCIAL BALANCES

	(1) 1986	(2) 1987	(3) 1988	(4) 1989	(5) 1990	(6) 1991	(7) 1992	(8) 1992 (revised)	(9) 1993	(10) 1994
United States	–3.4	–2.5	–2.0	–1.6	–2.5	–3.0	–3.8	–4.7	–2.7	–3.4
Japan	–0.9	+0.5	+1.5	+2.4	+3.1	+2.4	+1.9	+1.3	+1.8	+0.5
Germany	–1.3	–1.9	–2.1	+0.2	–1.8	–2.9	–3.4	–3.2	–3.3	–2.7
France	–2.7	–1.9	–1.7	–1.1	–1.4	–2.1	–2.3	–2.8	–2.3	–2.9
Italy	–11.6	–11.0	–10.7	–9.9	–10.9	–10.2	–11.3	–11.1	–10.8	–8.9
United Kingdom	–2.3	–1.2	+1.2	+1.2	–0.7	–1.7	–4.6	–6.6	–5.2	–6.7
Canada	–5.4	–3.8	–2.6	–3.1	–3.8	–5.5	–4.6	–5.8	–3.2	–3.2
Average of above countries	–3.2	–2.3	–1.6	–0.9	–1.6	–2.3	–3.0	–4.6	–2.5	–4.0
Australia	–1.8	–0.2	+1.5	+1.6	+1.4	–2.2	–4.0	–4.9	–2.7	–3.1
Austria	–3.7	–4.3	–3.0	–2.7	–2.1	–2.3	–2.0	–1.9	–2.1	–1.4
Belgium	–9.0	–7.2	–6.4	–6.3	–5.3	–6.0	–5.5	–6.1	–5.0	–4.4
Denmark	+3.4	+2.4	+0.6	–0.5	–1.4	–2.0	–2.1	–2.6	–1.1	–1.8
Finland	+0.8	–1.5	+1.3	+2.9	+1.4	–5.0	–7.7	–8.2	–6.3	–5.7
Greece	–12.6	–12.3	–13.8	–17.7	–18.6	–17.1	–14.5	–13.2	–12.3	–9.5
Ireland	–11.5	–9.1	–4.9	–1.8	–2.0	–1.9	–1.9	–2.5	–2.5	–2.8
Netherlands	–6.1	–6.5	–5.1	–5.1	–5.3	–2.7	–3.4	–3.8	–2.7	–3.1
Norway	+5.9	+4.8	+2.7	+1.6	+2.6	–0.5	–2.9	–3.4	–2.8	–2.6
Spain	–6.0	–3.2	–3.2	–2.8	–4.0	–4.4	–4.9	–4.7	–3.9	–3.8
Sweden	–1.3	+4.3	+3.5	+5.5	+4.1	–1.5	–4.1	–7.9	–4.8	–9.8
Average of above small countries	–3.6	–2.3	–1.9	–1.7	–2.1	–3.6	–4.4	–5.4	–3.8	–4.3
Average of above European countries	–4.0	–3.5	–3.0	–2.2	–3.3	–4.0	–4.9	–5.6	–4.8	–4.7
Average of above OECD countries	–3.2	–2.3	–1.7	–1.0	–1.7	–2.4	–3.2	–5.1	–2.6	–4.2

During most of the 1980s governments were generally successful in their fiscal consolidation objectives but as Table 12 shows, since 1989 things have got worse in nearly all OECD countries. There is a consensus that deficit financing may be a valid short-term strategy in times of recession, and provided that it remains relatively moderate even in the longer term, given normal growth assumptions, but the level of long-term deficits now prevalent is generally regarded as unacceptable.

Two methods of reducing budgetary deficits are privatization of government assets and introducing or increasing user charges (e.g. road tolls), but both have their limits and drawbacks. It would seem that a reduction of budgetary deficits has also to require a cut in government expenditure, increased taxation or some combination of both. Cutting the deficit over the next few years is becoming an increasingly important priority of OECD governments, as exemplified by the maximum 3 percent of GDP deficit objective enshrined in the Maastricht treaty, as well as innumerable government statements over the last few years to this effect. It seems unlikely that sufficient cuts in government expenditures to realize this target will be feasible in most OECD countries. The 'peace dividend' may help to reduce government expenditure in some OECD countries (especially the United States) and many OECD countries are currently examining the possibility of cutting back on universal welfare benefits paid to pensioners and parents who have sufficiently high incomes or capital assets not to need them. However, for most OECD countries cutting government expenditures significantly in real terms scarcely seems a realistic option over the next years when unemployment is likely to remain high and economic growth low, while longer-term demographic trends entail an increase in the ratio of elderly non-producers to the total population.

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Thus it seems that in many OECD countries during the 1990s a major problem for governments will be how to increase TTRs (and reduce expenditures) in a way that does the least economic and social damage and alienates voters as little as possible. Part III of this article discusses this, in relation to the G7 countries[12] but only on the tax side, not the spending side, though it is recalled that the abolition or reduction of tax relief for certain qualifying expenditures can be seen as either cuts in government expenditures or increases in taxation or both.

III. SOME POLICY IMPLICATIONS

A. *Presuppositions*

It is henceforth assumed that the G7 governments mean what they say when most of them announce that their main priority for the next few years is to reduce, or at least stabilize, their fiscal deficits and that this cannot be done in practice without some increase in TTRs.

It is under this presupposition that provocative and normative language is deliberately used in the headings of Table 13, which introduces Part III. Though such language will displease many readers who regard tax-cutting as a virtue rather than a vice, under the presuppositions made, which have been echoed by many fiscal conservatives in favour of reduced government expenditure, if tax-cutting is a virtue it is one that can no longer be afforded.

12. Space limitations restrict the discussion to the Group of 7 -G7 countries - but evidently some of the points made apply to other OECD countries.

TABLE 13

TAX ECCENTRICITIES, TAX EFFORT AND MAIN CONSTRAINTS ON IMPROVING TAX EFFORT IN THE G7 COUNTRIES

COUNTRY	MAIN TAX ECCENTRICITIES	EVALUATION OF TAX EFFORT 1985-1992	MAIN CONSTRAINTS ON IMPROVING TAX EFFORT
Canada	i) General consumption taxes at federal and provincial level uncoordinated ii) No death or gift taxes	Good. Increases in TTR over recent years suggests that deficit is under greater control than in most countries (see tables 12 and 14)	Federal/provincial competition for tax revenues
France	i) Lowest income tax ratio of any industrialised country due mainly to antiquated collection methods and exemption of nearly half the population from income tax ii) Greater reliance on social security contributions than any other industrialised country	Good. TTR has fallen slighly in recent years, but is appreciably higher than that of the other six and until very recently the deficit has remained stable and relatively small	Once a pioneer in tax reform (inventors of VAT), over the last two decades successive French governments have been too afraid of taxpayer resistance to undertake serious tax reform
Germany	No great tax eccentricity, but lowest VAT rate in industrialised Europe and well below average European VAT and income tax ratio	Bad. TTR has fallen in recent years at a time when more revenues are needed for reunification costs as well as for the deficit	i) The disproportionate influence of anti-tax business pressure groups on the governemnt ii) Tax sharing formulae between federal and länder government
Japan	Absence of rational and consumption taxation	Very good. Recent increases in TTR have enabled Japan to remain the only OECD country not in deficit	Opposition of business to a proper invoice VAT system, generally believed to be to hide their tax evasion
Italy	No great tax eccentricity, but no great tax administration	Good but inadequate. TTR has risen greatly in recent years, but not enough to reduce the very heavy deficit	The underground or informal economy and mafia
United Kingdom	i) The narrowest VAT tax base in Europe ii) Ways of financing local government expenditure never considered outside the UK	Very bad. TTR has consistently fallen since 1985, and since 1989 deficits have increased considerably	An ideological government which neither seeks consensus with non-government, nor pays attention to solutions adopted in other countries
United States	i) Absence of sufficient consumption taxation at federal level (especially under-taxation of gasoline and lack of federal VAT or retail sales tax). ii) Only OECD country to allow deductability of mortgage interest on secondary residence without taxing rental value	Very bad. No recent increase in TTR and budget deficit does not abate. (In 1991 has probably overtaken Turkey as the OECD country with the lowest TTR).	i) Exceptional aversion of citizens to tax increases ii) Separation of powers between executive and legislative and congressional pressure groups iii) Federal/state competition for tax revenues

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The left hand column of Table 13 attempts to identify some of the reasons why most of the G7 are in deficit, by drawing attention to under-taxation *vis-à-vis* other OECD countries from particular revenue sources; the middle column notes how these countries have coped with their usually increasing budgetary deficits over the last few years; and the last column indicates some of the constraints that are likely to inhibit reduction of budget deficits in the future.

As to terminology, in the left hand column 'tax eccentricity' for excessive under-taxation – or occasional over-taxation like French employers' social security contributions – will be unacceptable to many who would prefer to talk of 'subsidiarity', 'tax sovereignty', or 'tax diversity', but as argued in the next section if governments are really serious about reducing deficits, one approach would be to consider whether they should continue to neglect substantially under-taxed revenue sources, that is to say, under-taxed in relation to what other OECD countries are doing. Likewise, in the present context where it is presupposed that increasing TTRs is a priority the unambiguously normative 'tax effort' is used rather than the more ambivalent 'tax consolidation'.[13]

B. *General recommendations*

In deciding how they can increase TTRs governments have to take account not only of rational tax policy, but also of a number of other factors, such as the economic situation, their political commitments, the expected reaction among fellow politicians, the media, the business community and voters at large. As Table 13 suggests, different decisions are likely to be taken by different governments for these reasons, but there do seem three areas where a number of countries might seek similar solutions:

- an increase in consumption taxation;
- an increase in personal income tax rather than social security contributions;
- a reduction of tax eccentricity.

1. Increasing consumption taxation

Over the last 15 years there have been many statements from governments and the academic world that expenditure should be taxed more and income less, but it has happened only in a few countries (see II.C. above). There are many reasons for this: increasing consumption taxes probably contributes to inflationary pressures – partly because of their transparency, partly because of shifting effects – more than equivalent revenue increases in any other form of tax; consumption taxes are perceived as, and are to some extent, regressive; they are unpopular with voters.[14] On the first two problems there are many ways in which the potentially inflationary and inequitable effects of increased consumption tax can be reduced or eliminated[15] and on the last point governments just have to enact consumption tax increases as long as possible before the next election. Most of the recommendations that follow involve increases in general consumption taxes – in France and Germany to increase the rate, in Italy to improve the collection mechanism, in the United Kingdom to widen the base and in the United States to introduce such a tax.

Whilst increases in general consumption taxes (mostly VAT) are probably the most important means of increasing TTRs, the 'sumptuary' or 'sin' taxes on motoring above all, drinking and smoking are also potential candidates for such an increase in all the G7 countries. They were in practice increased in the late 1970s and early 1980s, but, gasoline apart, yields have generally declined in real terms since then for various reasons (pressure group lobbying on the potential effect on employment levels and export performance, as well as the inflation and unpopularity constraint): nevertheless rational tax policy as well as environmental and health considerations would suggest that such products should be more heavily taxed.

Taking consumption tax ratios as a whole, it is interesting to note, that France apart, there is very little difference in TTR in the G7 if the taxation of consumption is discounted, as the following subtable shows for the year 1990.

	TTR ratio OECD heading 5000	Consumption tax Consumption tax ratio	TTR minus
Canada	37.1	10.2	26.9
France	43.7	12.3	31.4
Germany	37.7	10.3	27.4
Italy	39.1	11.0	28.1
Japan	31.3	4.1	27.2
UK	36.7	11.1	25.6
US	29.9	4.9	25.0
OECD average	38.8	11.8	27.0

2. Increasing personal income taxes rather than social security contributions

If consumption tax increases cannot reduce the deficit sufficiently, a choice has to be made between raising personal income taxes and/or social security contributions – the only other two important sources of revenue.

Some governments (notably the French and German, but others when it suits them) continue to argue that social security contributions are insurance premiums and not taxes. This is a complex issue, which I have discussed at length in Chapters 5F, 8 and 10 D6 of Messere (1993) but I believe the OECD is correct in classifying these unilateral, compulsory levies to the State as taxes,[16] and in practice they compete with the personal income tax as a source of revenue, for high contribution countries are almost always low personal income tax coun-

13. 'Tax effort' was the expression used in the IMF literature in the 1960s and 1970s to exhort developing countries for various reasons to increase their TTR: 'tax consolidation' is used by the OECD in "Economic Outlook" and the annual country studies and is more descriptive than normative, for whether 'tax consolidation' or 'deficit financing' is the more desirable, may depend on conjunctural factors.

14. For example, the threefold rejection of VAT by Swiss referenda and the result of the March 1993 Australian election was generally believed to have been heavily influenced by the opposition commitment to introduce a VAT type tax.

15. For example, on the inflation problem by temporary price controls or by timing the introduction of or increase in VAT to a deflationary period in the business cycle, and on the redistribution problem by providing non-wastable tax credits for those with low incomes for amounts of extra VAT on essentials and/or increasing child allowances, pensions or other welfare benefits, all of which have been applied in countries introducing or increasing VAT.

16. See the annual publication, *Revenue Statistics of OECD Member Countries* (Paris: OECD).

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tries and conversely, and there may be major changes in the mix between these two levies, as occurred in Italy and Spain.

When the economy is overheated, there is much to be said for increasing contributions, but not in the present era of high unemployment levels which are one of the main causes of the deficits. On the employers' side such increases will be an additional disincentive to taking on unskilled or part-time labour while potential workers are likely to fall into the 'unemployment trap' under which the earnings they could expect to secure on becoming employed may be little more than their present unemployment benefits plus the contributions which are usually payable on total earnings. Because there are thresholds which ensure that unskilled and part-time workers pay little or no income tax, the tax unemployment trap does not apply to this tax. It thus seems more efficient as well as more fair to prefer an increase in personal income tax to an increase in contributions. (Another alternative is to integrate the personal income tax with contributions as a few countries have done, rather than to charge in an uncoordinated way progressive income tax on net income and regressive contributions on gross income, as often happens.)

3. Reducing tax eccentricities

Any watcher of revenue developments over the last 30 years can hardly fail to be struck by the irrationality of countries' tax policies over most of this period, even if understanding the reasons why such irrationality has prevailed. One irrationality is that until recent years, most OECD countries have paid very little attention to what other OECD countries were doing in trying to solve similar problems to their own, except where EC coordination could be involved or where there are neighbouring countries one of which is economically predominant (United States/Canada, United Kingdom/Ireland, Australia/New Zealand.) A second irrationality has been the earlier predominance of divergence over convergence (see II.B.1. and II.B.2. above) in attempts to squeeze more revenue from revenue resources already over-exploited, for there are limits to the milk which one cow can yield. As has been increasingly, though by no means universally, recognized over the last decade, it is sensible to diversify sources in increasing TTRs, if only because diversification is likely to reduce taxpayer discontent, since income tax and employees' social security contributions are deducted at source, consumption taxes are charged when shoppers buy goods and employers' social security contributions and corporation taxes are paid initially by business.

C. *Relevance to tax policy in France, Germany, the United Kingdom and the United States*

Nothing is said here about Canada and Japan, for I have nothing to add to what is shown in Table 13. Evidently cures for the Italian malaise have to be outside the realm of tax policy, and 1993 political developments provide some grounds for optimism. On the tax side it is worth noting that there is empirical support for what is said about Italy in Table 13.[17] There follow some remarks on taxation in the other four G7 countries.

France: As noted in various tables, the main French anomaly *vis-à-vis* the OECD as a whole is excessive reliance on employers' social security contributions and neglect of the

17. For example, in 1990 Italy had a standard VAT rate of 18% with an additional higher rate of 36% on certain luxury items and it applied to most consumer expenditure, whereas the UK VAT rate was 15% and covered not much more than 50% of consumer expenditure: yet as regards VAT actually collected for 1990, in Italy the VAT ratio was 5.7% and in the United Kingdom it was 6.1%. "In this context A. Pedrone observed that reliable estimates of evasion are difficult to make. Under any plausible interpretation, however, evasion is pervasive and large, reducing value added tax collections by as much as two-thirds in some broad sectors and two-fifths overall." The Value Added Tax: Lessons from Europe (Brookings Institutions, 1981).

TABLE 14

TOTAL AND PARTICULAR TAX RATIOS FOR 1990 COMPARED TO 1991 ESTIMATES[1]

	TTR		1000 Income taxes		2000 Social security		4000 Property		5000 Goods and services	
	90	91	90	91	90	91	90	91	90	91
Austria	41.6	42.0	10.6	11.2	13.7	13.7	1.1	1.2	13.1	12.9
Belgium	44.9	42.0	16.7	16.0	15.6	14.4	1.2	?	11.4	11.5
Canada	37.1	39.4	17.9	18.5	5.3	5.8	3.3	3.6	10.2	11.0
Denmark	48.6	48.2	28.5	28.5	1.5	1.4	2.0	1.8	16.2	16.1
Finland	38.0	37.2	19.9	19.4	2.8	2.8	1.1	1.0	14.2	13.9
France	43.7	43.9	7.5	7.9	19.3	19.3	2.3	2.5	12.3	11.9
Germany	37.7	36.6	12.1	12.4	13.9	12.6	1.2	1.1	10.3	10.5
Iceland	32.6	32.5	9.6	9.4	1.0	2.3	2.8	2.9	16.3	16.5
Ireland	37.2	37.9	13.7	14.5	5.5	5.7	1.7	1.8	15.8	15.4
Italy	39.1	40.5	14.3	14.9	12.9	13.1	0.9	1.5	11.0	10.8
Netherlands	45.2	47.2	14.6	16.0	16.9	17.4	1.7	1.7	11.9	12.0
Norway	46.3	47.0	16.1	16.7	12.1	12.2	1.3	1.4	16.4	16.4
Portugal	34.6	35.5	8.8	10.0	9.6	9.2	0.8	0.9	15.2	14.9
Spain	34.4	34.6	10.6	10.8	12.2	12.6	1.9	1.7	9.7	9.7
Sweden	56.9	51.8	23.3	19.4	15.7	14.7	2.0	1.5	14.0	14.3
Switzerland	31.7	31.4	13.0	12.5	10.4	10.8	2.5	2.5	5.8	5.7
Turkey	27.8	30.0	9.3	10.1	5.5	5.8	0.6	0.6	7.8	8.5
United Kingdom	36.7	36.2	14.5	14.0	6.4	6.4	3.1	2.9	11.1	11.5

1. Estimates unavailable for Australia, Greece, Japan, Luxembourg, New Zealand and United States.

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personal income tax. A move away from employers' payroll taxes to personal income taxes would seem to be sensible, but is not helped by the French government's assumption that the former are not taxes.[18] The obvious way of increasing the personal income tax ratio is to follow the example of other OECD countries by withholding it at source along with social security contributions and to reduce the threshold to bring more people into the income tax net. It would seem that France would do well to follow the examples of Italy and Spain which in earlier years had a French type tax structure and method of collection.

While Table 12 suggests that the French deficit has over recent years been relatively small and stable, it has in practice already reached 4 percent of GDP and is likely to continue to increase over the next years partly as a result of the decline of consumption tax ratios and stagnation of others. Modernizing the personal income tax system would seem the first priority, but increasing the relatively low rates of excises on alcoholic drinks and cigarettes would also seem rational. The decline in the VAT ratio from 8.9 in 1985 to 8.2 in 1990 is due in part to a reduction in higher rates on luxury goods to meet EC objectives without any increase in the standard rate which it might now be necessary to increase.

Germany: Over recent years Germany has had a very lax fiscal policy, somewhat surprisingly in view of the need to pay for the costs of reunification. TTRs have remained virtually unchanged since 1976 while in recent years deficits have been increasing, and as everyone knows this lax fiscal policy has necessitated a tight financial policy with in particular high interest rates which has had an adverse effect on currency stabilization in the EC area. Obvious candidates for increasing TTRs would be to raise the VAT rate which at 15 percent is the lowest in industrialized Europe (VAT ratio for 1990 10.0 percent against a European average of 11.1 percent) and also personal income tax ratios (personal income tax ratio 10.3 percent against a European average of 11.4 percent). A special difficulty in making such increases may be due to the revenue sharing formulae between federal and länder government, whereby each gets a predetermined share of income tax and VAT yields.

The March 1993 agreement to impose a 7.5 percent income tax surcharge on higher income groups from 1995 is evidently a step in the right direction, but could be seen as too little and too late.

United Kingdom: Whilst it may be economically prudent to delay until 1994 increases in the UK TTR, there is now a consensus that it should be increased in the near future to reduce the heavy deficit. Since the United Kingdom is virtually alone among European VAT countries in excluding nearly half consumer expenditure from the base, which itself has many disadvantages,[19] an obvious way of increasing TTRs, is to bring in food, books, newspapers, children's clothing, etc. into the VAT net, realistically at a reduced rate of around 5 to 10 percent. Such a move would have some regressive distributive effects and should be accompanied by other offsetting measures.[20] In the March 1993 budget statement a first step was taken to widen the VAT base by ending the zero rating of gas and electricity as from 1994, with compensation promised[21] to low income groups. Whilst rational tax policy would suggest a similar approach to other zero-rated items it seems unlikely to happen for a long time, mainly because both the two main British political parties have become prisoners of their own rhetoric.

Another UK eccentricity is for ideological or voter appeal reasons to avoid at all costs increasing personal income tax rates, now well below the OECD average and that accounts for the 1993 budget statement which provided for an increase in social security contributions instead of in income tax. It also accounts for the fact that unlike 17 of the 24 OECD countries the United Kingdom does not use a local income tax as the main source for financing local government.[22] Indeed along with Australia, Greece, Ireland, the Netherlands and New Zealand it does not use it at all: instead the United Kingdom goes in for bizarre instruments like the poll tax and council tax, never contemplated in any other OECD country. If, for understandable political reasons, the British government cannot *appear* to increase income tax rates, it may be able to increase the ratio by phasing out tax expenditures such as the mortgage interest relief.

As suggested in my book,[23] the insularity and irrationality of British tax policy may be due to the fact that the British electoral system usually provides governments with a sufficiently large majority not to have to seek a consensus with non-government. The belated coordination in 1993 of taxing and expenditure decisions plus the eventual abandonment of budgetry secrecy for which there is growing pressure, could make for greater rationality in the future.

United States: The February 1993 statement of President Clinton that the US Administration is willing to increase TTRs in order to reduce the US budget deficit is good news. Newspaper reports have focused on a higher marginal rate of tax for the wealthier plus the proposed new energy tax, but as the left hand column of Table 13 suggests, there are three other routes that could be taken in ascending order of political difficulty:

– First, increasing the federal gasoline tax. There is an obvious environmental rationale for doing so and even assuming the energy tax under-taxation of gasoline in the United States in relation to other OECD countries is likely to remain quite

18. For example, when sending out income declaration forms in 1993 the French tax authorities informed taxpayers that French tax revenues consisted of 45% VAT, 21% personal income tax, 10% corporation tax and 24% other taxes, whereas under the OECD classification – for 1990 – the figures would be 42% social security contributions, 19% VAT, 12% personal income tax, 8% excises, 5% corporation tax, 5% property tax, 9% other taxes – a very different story.
19. Distortion of producers' and consumers' choices, facilitation of tax evasion.
20. See *supra* note 15.
21. The form of compensation remaining to be decided and in view of the regressive tax/benefit policies of British conservative governments since 1979, much sceptism has been expressed on whether this compensation will be adequate.
22. British unawareness of what happens elsewhere is typified by a remark in an article in *The Economist* (22 August 1992) which usually does better. It stated that "as a source of local government revenue in Britain *as in most of Europe* (emphasis added) only taxing property works". As Table 11 shows, this is untrue. Among European countries property tax represents more than 20% of local taxation only in France, Ireland, the Netherlands, Portugal and Spain.
23. Chapters 4F and 9E7.

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large. The tax component in the price of gasoline at end 1991 was above 65 percent in half of the OECD countries, and above 54 percent in the remainder with the exception of New Zealand 48 percent, Canada 45 percent and the United States 33.5 percent.[24]

– Second, the economic and social case for granting mortgage interest relief beyond a limited amount on even the *principal* place of residence is doubtful and OECD practice over the last years has generally been to reduce considerably or even abolish this particular tax privilege. To give such mortgage interest relief for a *secondary* place of residence has even less justification and is clearly regressive and exploitable as a tax avoidance device, so its abolition would clearly be an equitable way of increasing TTRs, especially as unlike other countries granting mortgage interest relief for secondary residences, the United States does not even tax their rentable value.[25]

– Third, the most important, and politically and constitutionally difficult, way of reducing the deficit would be to introduce a general consumption tax for national government, as every other OECD country does. Though there are some federal excises, the right to tax consumption generally has always been reserved to state and local government. However, the introduction of a VAT or RST seems a rational way of trying to tackle the budget deficit in the longer term, even if it may have to begin with a modest general consumption tax (Japanese style) of around 3 percent. Whether such a tax would initially take the form of VAT or RST and apply to food and services would seem of secondary importance.[26]

IV. SUMMARY AND CONCLUSION

It has to be accepted that first there will never be total agreement on what constitutes rational tax policy, because too many subjective factors arise, such as what is the optimal size of the public sector, and second, even to the extent that technical agreement can be reached on what is rational tax policy under common presuppositions, other considerations may be held more important by governments taking decisions on changes in tax laws, for example, apart from what is politically possible, the limitations imposed by the domestic and global economic situation.

The foregoing paragraphs assume that in most of the G7 countries reducing budgetary deficits has to be the priority and that this necessitates an increase in TTRs over the next few years. They further offer three suggestions on how this might rationally be done, namely to increase consumption taxation and also income tax in preference to social security contributions and at a different level of generality to rely more on any major tax source which has been substantially neglected in relation to what most other OECD countries do.

At the implementational level a more rational tax policy would be greatly facilitated if governments, politicians, pressure groups, etc. reversed their propaganda in perpetuating the following two myths: that increased consumption taxation has to be inflationary and regressive (for any such effects can be offset by other measures), and that social security contributions are different in any fundamental way from personal income taxes except in their greater regressivity.

In a few small countries, such as some of those in Northern Europe and New Zealand, these myths have been dispelled, with the consequence that their tax systems have become more efficient and more equitable in recent years. Little progress seems to have been made in this direction in the G7, except perhaps to some extent in Canada and Italy.

24. See *Energy Prices and Taxes* (Paris: OECD, 1991).

25. It has been alleged that the reason for this is that Congressmen require two residences. Apart from the fact that they could rent in Washington D.C., if this is the justification, such relief could be restricted to Congressmen, even if they found such a provision embarrassing, for the impact on government spending and TTRs would be negligible, whereas its availability for all US citizens is extremely expensive in revenue forgone.

26. An excellent analysis of how to get a rational general consumption tax at federal level in countries such as Canada and the US is provided in Richard Bird, "Cost and Complexity: the GST in International Perspective" (paper presented to Canadian Tax Foundation, November 1992).

APPENDIX

Changes between 1990 and 1991 in tax levels and tax structures

Too much significance should not be given to changes in tax levels or structures between adjacent years which may be a result of special circumstances, including the 'correction' of atypically large movements in the opposite direction in the previous two adjacent years. This applies even more so to comparisons between data for the last firm year and estimated data, since experience has shown that estimates are often substantially changed, especially tax ratios because of revisions to GDP figures. Table 14, nevertheless compares 1990 TTRs and the main particular tax ratios to those estimated for 1991. The following subtable draws attention to apparent major shifts:

	Total tax ratios	1000 Income tax ratios	2000 Social Security ratios	5000 Consumption ratios
Belgium	–2.9		–1.2	
Canada	+2.3 (also +1.7 89-90)			+0.8
Germany	–1.1		–1.3	
Iceland			+1.3	
Italy	+1.4 (also +1.2 89-90)			
Netherlands	+2.1	+1.4(a)		
Sweden	–5.1	–3.9	–1.0(b)	
Turkey	+2.2 (also +1.2 89-90)			+0.7

(a) also plus 1.6 89-90. (b) but plus 1.1 89-90

Tax structure data for 1990 and estimates for 1991 are not reproduced here, but the following subtable shows estimated shifts in tax structures exceeding two percentage points:

	1000 Income taxes	2000 Social security	5000 Consumption taxes
Belgium	-3.3	+2.1	
Germany	-2.4		
Iceland	+3.8		
Portugal	+2.7	-2.1	
Sweden	-5.4	-1.0	+3.8

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THE US–NETHERLANDS INCOME TAX TREATY: TAX COLLECTION ASSISTANCE AND EVIDENCE-GATHERING

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This paper was presented at a tax seminar held in New York on 9 February 1993 entitled "The New US–Netherlands Tax Convention".

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I. INTRODUCTION

On 18 December 1992, the US Department of Treasury released the proposed income tax treaty between the Netherlands and the United States. With respect to international tax enforcement, the treaty is significant in that the two signatory countries, in addition to the standard agreement to engage in exchange of information and administrative assistance,[1] have agreed to provide comprehensive assistance and support to each other in the collection of the taxes that are the subject of the present treaty, together with interest, costs and additions to the taxes and fines not being of a penal character.[2] Although several income tax treaties provide for more limited assistance in tax collection, none of them are as broad or can be invoked as early by law enforcement authorities as the US–Netherlands treaty. In addition, none of the provisions are as detailed as the treaty and the Memorandum of Understanding (MOU) exchanged.

This article discusses the Dutch-US collection assistance provisions in the new treaty. In particular, it discusses how the provisions operate generally and the requirements to exhaust the treaty evidence-gathering prior to the right of the US government to invoke the controversial evidence-gathering techniques under Section 6038 of the Internal Revenue Code (IRC). The procedural aspects of the exchange of information and tax collection assistance are discussed. To indicate the unique nature of some of the provisions in the protocol, the tax collection assistance provisions in other US treaties are discussed. The article also considers the OECD/Council of Europe (COE) Convention on Mutual Administrative Assistance in Tax Matters since both the United States and the Dutch governments are signatories and will be a party to the OECD/COE Convention once it takes effect, even though for the time being the United States has reserved on the tax collection portion. Finally, to bring the US-Netherlands treaty into proper perspective, the article looks at other means to gather evidence to collect taxes, namely the Mutual Legal Assistance in Criminal Matters Convention between the two governments.

Contents

I. Introduction
II. Dutch–US Collection Assistance Provisions in General
III. Requirements to Exhaust the Treaty Evidence-Gathering Prior to Invoking IRC Section 6038A
IV. Procedural Aspects of Exchange of Information and Collection Assistance
V. Tax Collection Assistance in Other US Treaties
  A. In general
  B. US–Finland treaty
  C. US–Danish treaty
  D. US–France treaty
  E. Existing US–Netherlands treaty
  F. US–Sweden treaty
  G. US–Greece treaty
VI. OECD/COE Convention on Mutual Administrative Assistance in Tax Matters
VII. Other Means of Collection Assistance
VIII. Summary and Conclusion

II. DUTCH-US COLLECTION ASSISTANCE PROVISIONS IN GENERAL

Applications for assistance and support can be made for revenue claims of each of the states which have been finally determined. A requesting state must submit with any application documents establishing that under the laws of the state making the application the taxes have been finally determined.[3] In particular, the request for administrative assistance in the recovery of a tax claim must be accompanied by: (a) an official copy of the instrument permitting enforcement in the applicant state; (b) where appropriate, certified copies of any other document required for recovery; (c) a certification by the competent authority of the applicant state that, under the laws of that state, the revenue claim has been finally determined.

The majority of US tax treaties that provide for assistance in collection do so only to ensure that exemptions and reduced tax benefits claimed pursuant to the tax treaty in question are proper. Applications for assistance may be accepted for enforcement by the other state and collected in that state in accordance with the laws applicable to the enforcement and collection of its own taxes. The state to

1. For background on the exchange of information and administrative assistance provisions, see Art. 30 of the treaty.
2. Treaty Art. 31(1). The competent authorities can grant assistance in collecting any capital gains tax deferred by operation of Art. 14(8) of the treaty. MOU, para. XXX(9).
3. Treaty Art. 31(3). A revenue claim is finally determined when the applicant state has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant state have lapsed or been exhausted. Understanding, para. XXX.

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which application is made does not have to enforce executory measures for which there is no provision in the law of the state making the application.[4] A major development in these provisions is that under existing treaties with tax collection assistance provisions, it is necessary for a requesting state to reduce the claim to a judicial judgement. The additional step can be time-consuming and can provide ample opportunity for a delinquent taxpayer to remove assets and prevent collection.

Tax collection assistance will not be made with respect to citizens, corporations or other entities of the state to which application is made, except in cases where the exemption or reduced rate of tax granted under the treaty to such citizens, corporations or other entities has, according to mutual agreement between the competent authorities of the states, been enjoyed by persons not entitled to such benefits.[5] Hence, if the United States is the requesting state and a Dutch person is the taxpayer, the United States would have to show that the application is made for a case in which such Dutch person claimed an exemption or reduced rate (such as for dividends, interest or royalties) to which he was not entitled.

III. REQUIREMENTS TO EXHAUST THE TREATY EVIDENCE-GATHERING PRIOR TO INVOKING IRC SECTION 6038A

The MOU exchanged between the signatory countries addresses the controversial evidence-gathering techniques in the United States under IRC Section 6038A.[6] The Understanding provides that, if a US "reporting corporation" as defined for purposes of Section 6038A, has neither possession of nor access to records that may be relevant to the US income tax treatment of any transaction between it and a foreign "related party", and such records are under control of a Dutch resident and are maintained outside the United States, the United States will request such records from the Netherlands through an exchange of information under Article 30 (Exchange of Information and Administrative Assistance) before issuing a summons for such records to the US "reporting corporation". However, the provision is conditioned on being able to obtain the records through the request on a timely and efficient basis. Records will be considered to be available on a timely and efficient basis if they can be obtained within 180 days of the request or such other period agreed upon in mutual agreement between the competent authorities, except where the statute of limitations may expire in a shorter period. Similar principles will apply with respect to the application of Section 6038C.[7]

The MOU also limits applications made for purposes of applying the conduit base reduction test in Article 26(d)(5) of the treaty. As an initial matter, the requesting state must confine its requests for information with respect to a resident of the other state to the information necessary to determine whether such resident is a conduit company as defined in Article 26(8)(m). The requesting state will request additional information required to determine whether the conduit base reduction test has been satisfied only after determining that a company is a conduit company.[8]

IV. PROCEDURAL ASPECTS OF EXCHANGE OF INFORMATION AND COLLECTION ASSISTANCE

The MOU states that, with respect to exchange of information and administrative assistance, persons concerned with the "administration" of taxes include in the United States, the "tax-writing committees of Congress" and the "General Accounting Office". Information exchanged under the treaty that is otherwise confidential under the treaty can be received under the same requirement of confidentiality by these bodies and can be used only in the performance of their role of overseeing the administration of US tax laws. Furthermore, it states that Congress' and the General Accounting Office's role in overseeing the administration of US tax law is understood to be limited to ensuring that the administration of the tax law by the executive branch is honest, efficient and consistent with legislative intent.[9]

The MOU explains that in applying the assistance provisions, the requested state will not be obliged to accede to the request of the applicant state:

- if the applicant state has not pursued all appropriate collection action in its own jurisdiction;
- in those cases where the administrative burden for the requested state is disproportionate to the benefit to be derived by the applicant state.[10]

A revenue claim of the applicant state that has been finally determined may be accepted for collection by the requested state and, if accepted, will be collected by the requested state as though such revenue claim were the requested state's own revenue claim finally determined in accordance with the laws applicable to the collection of the requested state's own laws.[11] The treaty provides that a taxpayer does not have any rights of administrative or judicial review of the applicant state's finally determined revenue claim by the requested

4. Treaty Art. 31(2).
5. *Id.* Art. 31(4).
6. Sec. 6038A requires a domestic corporation that is 25% foreign owned to provide certain information to the IRS on Form 5472 (Information Return of a Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business). A corporation required to file Form 5472 must also maintain records or cause another party to maintain records necessary to determine the correct treatment of transactions with related parties. In addition, any foreign related party must agree to authorize the domestic reporting corporation to act as its agent for purposes of the IRS examination of books and records and for the service and enforcement of a summons with respect to any transaction that it has with the reporting corporation. If the related party does not make the requisite agency authorization or substantially comply with a summons for records or testimony, a non-compliance penalty may apply.
7. The enactment of Sec. 6038C provides the IRS with greater tax information-gathering authority over foreign investors and the foreign corporations they own. Sec. 6038C provides for reporting responsibility if a foreign corporation is engaged in a trade or business within the United States. These corporations are required to identify their principal foreign investors (i.e. foreign investors who own at least 25% of a corporation) and to report transactions that occur between them and the investors. The corporations must maintain tax records, an obligation not generally found in foreign law. Compliance with these obligations will permit the IRS to determine the part of a foreign corporation's income and deductions that is effectively connected to a US trade or business. The IRS has the power to impose penalties, starting at $ 10,000 annually for the failure to maintain or provide information.
8. MOU, para. XXVIII.
9. *Id.* para. XXIX.
10. *Id.* para. XXX.
11. *Id.* para. XXX(3).

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state based on any such rights that may be available under the laws of either state.[12] However, if at any time pending execution of a request for assistance under the treaty, the applicant state loses the right under its internal law to collect the revenue claim, the applicant state must promptly withdraw the request for assistance in collection.[13]

Amounts collected by the requested state must be sent to the applicant state. Unless the competent authorities agree otherwise, the ordinary costs incurred in providing collection assistance will be met by the requested state, save that any extraordinary costs so incurred will be borne by the applicant state.[14]

If its laws or administrative practice allow it in similar circumstances, the requested state can permit deferral of payment or payment by instalments, provided it first informs the applicant state. Any interest obtained by the requested state as a result of the allowance of a deferral of payment or payment by instalments must be sent to the applicant state.[15]

A revenue claim of an applicant state accepted for collection does not have in the requested state any priority accorded to the revenue claims of the requested state.[16]

The competent authorities will agree on the mode of application of the tax collection assistance provisions. They may further agree to modify or supplement the provisions in the treaty and MOU, but will continue to be bound by the general principles established in the treaty.

V. TAX COLLECTION ASSISTANCE IN OTHER US TREATIES

A. *In general*

Some of the more recent income tax treaties have a provision requiring assistance in collection. Such provisions are found either in the exchange of information article or in a separate article on assistance in the collection of taxes. The bulk of these provisions are limited and provide that each of the signatory countries will endeavour to collect on behalf of the other signatory country amounts equal to such taxes imposed by the other state as will ensure that any exemption or reduction in the rate of tax granted under this treaty by that other state will not be enjoyed by persons not entitled to such benefits.[17]

Some treaties have a similar provision followed by a paragraph that states that in no case will the article be construed so as to impose on a signatory country the obligation to implement administrative measures at variance with the regulations and practices of either signatory country or which would be contrary to the first-mentioned signatory country's sovereignty, security or public policy.[18]

B. *US–Finland treaty*

The assistance in collection provisions in the US–Finland tax treaty are slightly more comprehensive, but essentially the same.[19] They provide that the signatory countries must endeavour to collect such taxes imposed by the other signatory country as will ensure that any exemption or reduced rate of tax granted under the treaty by the other signatory country will not be enjoyed by persons not entitled to such benefits. The signatory country making such collections will be responsible to the other signatory country for the sums thus collected. The competent authority of each of the signatory countries will consult with the competent authority of the other signatory country for the purposes of cooperating with and advising that other signatory country in respect of any action taken by it within the former signatory country to collect its tax. The US-Finland treaty also has the same preceding paragraph as the other treaties limiting the obligations of the requested signatory country.[20]

C. *US–Danish treaty*

The provisions in the US–Danish income tax are very broad.[21] They provide as follows:

- the signatory countries undertake to assist and support each other in the collection of taxes which are the subject of the treaty, together with interest, costs and additions to the taxes;
- in cases of applications for enforcement of taxes, revenue claims of each of the signatory countries that have been finally determined may be accepted for enforcement by the other signatory country and may be collected in that country pursuant to the laws applicable to the enforcement and collection of its own taxes;
- any application will include a certification that under the laws of the country making the application, the taxes have been finally determined;
- the assistance provided for will not be accorded with respect to citizens, corporations or other entities of the country to which application is made, except as is necessary to insure that the exemption or reduced rate of tax

12. *Id.* para. XXX(5).
13. *Id.*
14. *Id.*
15. *Id.* para. XXX(7).
16. *Id.* para. XXX(8).
17. See, e.g. US–Australia treaty, Art. 25(5).
18. See, e.g. US–Belgium treaty, Art. 27; US–Canada treaty, Art. XXVI(4) (the two paragraphs are combined into one); US–Cyprus treaty, Art. 29; US–Egypt treaty, Art. 29; the US–Germany treaty of 1954 (currently in force), Art. XVI(2) and (3); the proposed US–German treaty of 1989 is identical on assistance in collection; US–Iceland treaty, Art. 30; US–Indonesia treaty, Art. 29; The 1984 Protocol to the US–Italy treaty, Art. 6 (the two paragraphs are combined into one); the US–Jamaica treaty, Art. 27; US–Japan treaty, Art. 27 (assistance is limited to residents of a country; the requested country is responsible for any amounts collected; and the countries may consult regarding the provision); the US–Korea treaty, Art. 30; US–Norway treaty, Art. 29; US–Philippines treaty, Art. 27; US–Romania treaty, Art. 26; US–Swiss treaty,Art. XVI(2) (specifically limited to the taxes mentioned in four of the articles); US–Trinidad treaty, Art. 25 (the requested country will be responsible to the requesting country for the sums collected and that the competent authorities may consult together to give effect to the article); US–UK treaty, Art. 26 (the United Kingdom will be regarded as fulfilling this obligation by the continuation of its existing arrangements for ensuring that relief from taxation imposed by the laws of the United States does not enure to the benefit of persons not entitled thereto; the competent authorities may consult with each other for cooperating and advising in respect of any action to be taken in implementing the article).
19. US–Finland treaty of 1970, Art. 30(1). The proposed treaty, signed in 1989, has identical language.
20. *Id.* Art. 30(2).
21. US–Denmark treaty, Art. XVIII.

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granted under the present treaty to such citizens, corporations or other entities will not be enjoyed by persons not entitled to such benefits.

There is a second article in the Danish-US income tax treaty which provides that the signatory country to which application is made for information or assistance must comply as soon as possible with the request addressed to it, except that such country may refuse to comply with the request for reasons of public policy or if compliance would involve violation of a trade, business, industrial or professional secret or trade process.

D. *US–France treaty*

The US–France income tax treaty has an unusually broad assistance in collection provision.[22] It states:

- the signatory countries undertake to assist and support each other in the collection of taxes to which the present treaty relates, together with interest, costs and additions to the taxes and fines not being of a penal character according to the laws of the country requested, in the cases where the taxes are definitively due according to the laws of the country making the application;
- in the case of an application for enforcement of taxes, revenue claims of each signatory country which have been finally determined will be accepted for enforcement by the country to which application is made and collected in that country pursuant to the laws applicable to the enforcement and collection of its own taxes;
- the application will be accompanied by such documents as are required by the laws of the country making the application to establish that the taxes have been finally determined;
- if the revenue claim has not been finally determined, the country to which application is made will take such measures of conservancy (including measures with respect to transfer of property of non-resident aliens) as are authorized by its laws for the enforcement of its own taxes;
- the assistance provided for in this article will not be accorded with respect to citizens, corporations or other entities of the country to which application is made.

E. *Existing US–Netherlands treaty*

The US–Netherlands treaty now in force has similar provisions on assistance in collection.[23] Paragraph 2 provides that the requested country need not enforce executory measures for which there is no provision in the requesting country's law in lieu of the fourth paragraph in the US–France article. The US–Netherlands Antilles provisions are almost identical.[24]

F. *US–Sweden treaty*

The US–Sweden treaty has provisions similar to the US-France treaty although the assistance in collection is limited to citizens, corporations or other entities of the requesting state.[25]

The US–Sweden treaty has an additional article which provides that a requested country is not required to carry out administrative measures at variance with the regulations and practice of either country or to furnish particulars that are not procurable under its own legislation or that of the requesting country. Further, it provides that the requested country must comply as soon as possible with the request. However, a requested country may refuse to comply with the request for reasons of public policy or if compliance would involve violation of a business, industrial or trade secret or practice. In such case it must inform the requesting country as soon as possible.[26]

G. *US–Greece treaty*

The US–Greece treaty has similar provisions to those of the US-France treaty although a protocol states that the article is confined and limited as granting authority to each signatory country to collect only such taxes imposed by the other signatory country as will insure that the exemption or reduced rate of tax granted under the treaty by the other country will not be enjoyed by persons not entitled to such benefits.[27] The US–Greece treaty also provides that the requested country will not be required to enforce executory measures for which there is no provision in the law of the requesting country.

VI. OECD/COE CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS

In 1988, the Council of Europe and the Organization of Economic Cooperation and Development (OECD) concluded the Convention on Mutual Administrative Assistance in Tax Matters,[28] a multilateral convention that will affect the ability of the United States and the other parties to obtain information regarding investors in those countries.[29] The parties began negotiating the Convention in order to improve cooperation in tax matters, reduce the incidence of tax evasion and otherwise enhance tax administration. The Convention will substantially affect investor confidentiality because of its provisions for multilateral administrative assistance with respect to income, capital (wealth), social security and other taxes.[30] Administrative assistance will include exchanges of

22. US–France treaty, Art. 27.
23. US–Netherlands treaty, Art. XXII.
24. US–Netherlands Antilles treaty, Art. XXII.
25. US–Sweden treaty, Art. XVII.
26. US–Sweden treaty, Art. XIX.
27. US–Greece treaty, Art. XIX.
28. Convention on Mutual Administrative Assistance in Tax Matters, opened for signature 25 January 1988, I.L.M. 1160 (1988) [hereinafter Convention], reprinted in R. Rhoades and M. Langer, 5 *Income Taxation of Foreign Related Transactions* ch. 85 (1989).
29. *Id.*
30. Convention Art. 1.

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information and simultaneous tax service of documents.[31] The Convention should eventually result in standardized procedures for information exchanges and enhanced worldwide cooperation in tax matters.

Before the Convention can enter into force at least five governments must consent to be bound by its provisions.[32] Three Nordic countries and the United States have signed and deposited their instruments of ratification. The Netherlands has signed. Once the Dutch government deposits its instruments of ratification the Convention will be in force. Hence it is expected to go into effect shortly. The Convention provides for the exchange of tax information either on request, automatically or spontaneously.[33] Two or more parties can examine the tax liabilities of a taxpayer simultaneously and examinations can occur abroad.[34] However, the Convention allows signatory countries, through reservations, to limit its applicability to certain types of taxes (e.g. social security or local taxes) and to limit the duty to assist either in collecting taxes or serving tax documents.[35] A party may also refrain from actions that are at variance with its own public policy or laws, and decline to furnish information regarding trade secrets or processes.[36] Information obtained through the Convention may be used only for tax enforcement purposes and must be treated as a secret according to the most restrictive secrecy laws among the particular countries exchanging information.[37]

The Convention covers a broad variety of taxes – far beyond the coverage of bilateral tax treaties – including income, capital gains, net wealth, state and local, social security contributions, estate, inheritance, gift and other taxes.[38] The Convention's scope is not restricted by the residence or nationality of the taxpayer.[39]

The Convention provides for rendering assistance in the recovery of tax claims. At the request of an applicant state, the requested state must take the necessary steps to recover tax claims as if they were its own tax claims.[40] The assistance provisions will apply only to tax claims that form the subject of an instrument allowing their enforcement in the applicant state and, unless otherwise agreed between signatory countries, that are not contested.[41] If the claim is against a person who is not a resident of the applicant state, the requested state must only give assistance if the claim may no longer be contested.[42]

The obligation to assist in the recovery of tax claims concerning a deceased person or his estate is limited to the value of the estate or of the property acquired by each beneficiary of the estate, according to whether the claim is to be recovered from the estate or from the beneficiaries thereof.[43]

At the request of the applicant state, the requested state must, with a view to the recovery of an amount of tax, take measures of conservancy even if the claim is contested or is not yet the subject of an instrument allowing enforcement.[44]

The Convention sets forth the documents that must accompany the request for tax collection assistance.[45] The statutes of limitations are governed by the applicant state, which must provide the particulars concerning that period.[46] The requested state must not comply with a request for assistance that is submitted after a period of 15 years from the date of the original instrument permitting enforcement.[47]

The tax claim in the recovery of which assistance is provided will not have in the requested state any priority specially accorded to the tax claims of that state even if the recovery procedure used is the one applicable to its own tax claims.[48]

The requested state may permit deferral of payment or payment by instalments if its laws or administrative practice allow it to do so in similar circumstances, but it must first inform the applicant state.[49]

The United States has reserved on the section of the Convention dealing with assistance in recovery. However, it is expected that shortly after the Convention is ratified, the US government will take up the matter of acceding to the assistance in recovery portion.

VII. OTHER MEANS OF COLLECTION ASSISTANCE

A tax official, prosecutor of tax offences, counsel for taxpayer-defendant and third-party recordkeeper must be aware of the various mechanisms by which to collect evidence and obtain assistance in tax collection.

An important mechanism between the United States and the Netherlands is the Mutual Legal Assistance in Criminal Matters Convention (MLAT). The MLAT obligates the signatory countries to provide a broad range of mutual assistance to the requesting country. It specifically includes tax offenses to the extent and under the same conditions that they would be available in criminal investigations and proceedings in the requested state.[50] Search and seizure provisions are available for violations of IRC Section 7203, which is a misde-

31. *Id.* Art. 28(2). The following countries are eligible to sign the Convention: Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Italy, Japan, Liechtenstein, Luxembourg, Malta, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The Convention may also be extended to cover some or all of the overseas territories of these countries. Art. 28(1). It seems likely that once the United States and United Kingdom sign the Convention, they will extend its coverage to their overseas territories, i.e. American Samoa, Bermuda, the Cayman Islands, the Commonwealth of the Northern Mariana Islands, Guam, Puerto Rico, the Turks & Caicos, and the US Virgin Islands, respectively.
32. Tax Convention Arts. 5-7.
33. *Id.* Arts. 8-9.
34. *Id.* Art. 21.
35. *Id.* Art. 30(1).
36. *Id.* Art. 21.
37. *Id.*
38. *Id.* Art. 2(1)(a)-(b).
39. *Id.* Art. 1(3).
40. *Id.* Art. 11(1).
41. *Id.* Art. 11(2).
42. *Id.* Art. 11(3).
43. *Id.*
44. *Id.* Art. 12.
45. *Id.* Art. 13.
46. *Id.* Art. 14.
47. *Id.*
48. *Id.* Art. 15.
49. *Id.* Art. 17.
50. US–Dutch MLAT, signed 12 June 1981, entered into force, 15 September 1983, T.I.A.S. No. 10734, Annex II.

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meanour, although the Dutch government in a note has asserted that it will only execute such requests in a discretionary manner and under a policy of restraint.[51] Prosecutors who are investigating criminal violations can utilize the MLAT to obtain a broad range of information and to immobilize and require forfeiture of the proceeds of offenses. Several of the recent MLATs, such as the ones with the Bahamas, the Cayman Islands, Panama and Uruguay do not include tax crimes in the covered offenses unless they are connected to drug trafficking. The inclusion of such offenses in the US-Netherlands treaty indicates the importance given to selected tax crimes in the context of the US-Netherlands MLAT, especially since the Netherlands is an important centre for holding companies and other entities seeking to maximize their global tax planning opportunities.

Letters rogatory and many unilateral compulsory measures are additional means to gather information that may be useful to collect taxes. In addition, when a government is investigating or prosecuting a tax crime together with a money laundering offense, it can use anti-money laundering enforcement treaties to obtain information that may be useful in prosecuting and/or collecting taxes as well as in prosecuting the money laundering case. Another effective evidence-gathering technique, especially in the United States, is to hire a private investigator and merely search the public records and other avenues to find assets and evidence upon which a collection case may be based. These methods are beyond the scope of this article.[52]

VIII. SUMMARY AND CONCLUSION

The provisions in the US–Netherlands tax treaty on collection assistance and evidence-gathering demonstrate a trend towards enhanced cooperation in tax enforcement among tax authorities and may well presage increased emphasis on such cooperation in the Clinton Administration. One of the likely contested issues with respect to the tax collection provisions will be whether they are of a penal nature and therefore not within the treaty's scope.

The requirement that a requested state must give assistance to applications for enforcement and assistance in collection of revenue claims that have been finally determined in the applicant state will be the most significant advance under the treaty.[53] The other tax collection provisions require that there be a judgment or are unclear about the extent to which the applicant state must have finally gone.

The detail with which the cooperation provisions are contained will also help set the stage for improved cooperation.

The OECD/COE Convention will provide enhanced momentum to assistance in tax collection.

The ability of tax authorities and prosecutors to use both the enhanced tax collection assistance provisions together with the MLAT provide the two governments with strengthened tax collection assistance provisions that may be a model for the future.

51. *Id.* See also Exchange of Notes dated 12 June 1981.
52. For further discussion of these methods, see Bruce Zagaris, "Exchange of Tax Information, the Regulation of International Money Movement, and the Legitimate Business Person", 11th Annual International Tax Conference § 7.1 et seq. (Fla Bar Assoc. and Fla. ICPA, 1993).
53. For additional information on tax collection assistance provisions of the United States generally, see *id.*

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

JUNE 1993

Application of Advanced Techniques for Tax & Accounting of Derivative Instruments, London, 30 June-1 July (English):
The International Faculty of Finance, IIR Ltd., 28th floor Centre Point, 103 New Oxford Street, London WC1A 1DD, England, Tel.: 44-71-412 0141, Fax: 44-71-412 0145.

JULY 1993

International Transfer Pricing: Working with the New Regime, London, 14 July 1993 (English):
Vicki Goffin, IBC Legal Studies & Services, Ltd., 57-61 Mortimer Street, London W1N 7TD, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

AUGUST 1993

49th Congress of the International Institute of Public Finance: Public Finance and Irregular Activities, Berlin, 23-26 August (English):
International Institute of Public Finance, General Secretariat, University of Saarland, 6600 Saarbrücken 11, Germany, Tel.: 49-681-302 3653, fax: 49-681-302 4369.

Principles of International Taxation, Amsterdam, 23 August-3 September 1993 (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel. 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1993

47th Annual IFA Conference, Florence, 3-8 October 1993; main subjects: interpretation of double taxation conventions, non-discrimination rules in international taxation (English, French, German, Spanish):
Secretary of the Conference, STRUMENTI, c/o ENIC, via Santa Caterina d'Alessandria 12, 50129 Florence, Italy, Tel.: 39-55-474737, Fax: 39-55-475037.

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FINLAND:

FUNDAMENTAL TAX REFORM:

25 PERCENT RATE ON CAPITAL INCOME AND CORPORATE INCOME

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I. INTRODUCTION

Finland launched a comprehensive income tax reform effective from 1 January 1993. The laws comprising the reform (Nos. 1535-1550/1992) were enacted on 30 December 1992. The reform covers the taxation of capital income of individuals and the taxation of business profits.

Through the enactment of this reform, Finland follows Sweden (1991) and Norway (1992). All three countries currently impose a fairly low flat rate of tax on capital income, and one can speak of a Nordic model of taxation of capital income. Other main features of the reform include a broadening of the tax base of capital income and business and a significant lowering of the corporate tax rate.

These changes in the tax system are more far-reaching than the changes carried out in Finland in 1989-90.[1] The 1989-90 reform followed the international trend of the late 1980s towards broader tax bases and lower tax rates, but because of the conservative reduction of marginal tax rates, it was not as fundamental as the reforms in the United States and the United Kingdom. The 1993 reform gives a new structure to the Finnish income tax system, and the extent of the radical revision is particularly apparent in the departure from the progressive taxation of capital income.

Contents

I. Introduction
II. Background of the Reform
III. Underlying Principles
IV. Tax Rates
V. The Taxation of Different Kinds of Capital income
  A. Interest income
  B. Dividends
  C. Capital gains and capital losses
  D. Income from forestry
VI. Deductions From Capital income
  A. General remarks
  B. Interest payments
VII. Taxation of Small Businesses and Their Owners
VIII. Tax Base in Business Taxation
  A. General remarks
  B. Capital gains
  C. Reserves
  D. Depreciation
  E. Entertainment expenses
  F. Losses
IX. Problems with the New System
X. Conclusion

II. BACKGROUND OF THE REFORM

For decades the Finnish individual income taxation has been characterized by steeply progressive and high tax rates.[2] In 1992, the tax rate for individuals ranged from zero to about 63 percent. The threshold for the highest marginal rate of 63 percent was at the modest level of 275,000 Fmk. The formal tax rates were unrealistically high in order to cover all kinds of capital income, and consequently, many items of capital income were subject to reduced taxation. For example, interest income from bank deposits and bonds was subject to a final withholding tax of 15 percent. Capital gains were taxed as ordinary income but with considerable exemptions and other forms of relief, which made the system very complicated.

The main problem with the old system was the inconsistent treatment of different types of income and investments. These deviations from neutrality were thought to result in efficiency losses in the financial market, and it was considered especially important to achieve more neutrality in the tax treatment of different methods of financing business (equity vs. debt) and the tax treatment of various methods of saving. Deviations from neutrality gave rise to diversity of tax planning operations (e.g. the transformation of various kinds of income into capital gains).

The deductibility of interest payments from taxable income gave rise to substantial problems in a system where tax rates were high and the fisc carried a large share of a taxpayer's interest cost. Despite complicated restrictive rules, the interest deductions produced generous benefits to taxpayers and were the main explanation for the fact that the taxation of capital income of individuals yielded no net tax revenue to the fisc. Additionally, the benefits derived from interest deductions encouraged heavy taxpayer borrowing, and unfavourably impacted on the national economy. Therefore, one of the most important aims of the reform was to reduce the value of

1. For a discussion of this reform see Kari S. Tikka, "Business Tax Reform in Finland", 29 *European Taxation* (April 1989), at 107-112.

2. For the background of the Finnish reform, see Kari S. Tikka, "Taxation of Capital in Finland and International Tax Competition – Survey of the Situation and Development Trends" in *Nordic Perspectives on European Financial Integration*, ed. Pekka Timonen (Helsinki: University of Helsinki, Institute of International Economic Law, 1992), at 333-347.

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interest deductions for taxpayers, while at the same time introducing a low flat rate to determine the benefits of deductions.

Furthermore, the reform of the taxation of capital income can also be seen as a reaction to international tax competition. The liberalization of exchange controls in Finland in the latter half of the 1980s placed great emphasis on this factor, and the reforms in Sweden and Norway have been particularly influential in the evolution of Finnish tax policy. Disappearing frontiers for financial capital offer no realistic opportunities to apply high nominal rates to income from financial assets.

In principle, the total tax burden on the foreign investments of a domestic investor is determined by the level of domestic taxation. A significant condition here is an effective international tax control. In Finland, this problem has been discussed mainly in connection with bank deposits and insurance carried abroad, especially in tax havens. It is a sad commentary that owners of wealth can be dishonest and find it easier to conceal their foreign than their domestic interest and other capital income. In addition, wealthy individuals will not find it very difficult to change their country of residence.

It was believed that the challenge of international tax competition was more effectively met by a system where capital income is taxed without progressiveness, and with a fairly low tax rate. Likewise, the tax competition argument was a compelling reason for the adoption of a low corporate tax rate.

III. UNDERLYING PRINCIPLES

Until 1993, the structure of the Finnish income taxation was fairly typical: both capital income and earned income of individuals were included in the tax base, and were taxed at progressive rates. One can perhaps speak of a uniform system. The 1993 reform, however, is based on a differentiated income tax system in which capital income and earned income are treated differently.

The main features of the new system are as follows:

- individual income is classified as capital income or as earned income;
- capital income is subject to to a flat rate, while earned income remains subject to a progressive schedule;
- capital income comprises any yield on capital assets, including interest income, dividends, rental income, capital gains, timber sales proceeds and a share of business and agricultural income representing an appropriate return on the capital of an enterprise;
- expenses to acquire income are allocated to the two categories and, for example, the tax value of the debt interest deduction is determined by the flat rate;
- a fairly significant difference between the flat rate on capital income and the highest progressive rates for earned income is tolerated (see below).

The relatively low flat rate on capital income is justified on the ground that it indirectly takes into account the effects of inflation. Therefore, no special inflation adjustments are needed in the new system.

Under proportional taxation of capital, income and deductions can be treated symmetrically. The pre-reform system was vulnerable to tax arbitrage. For example, a taxpayer utilized large debt interest deductions, but took the profits of investment in the form of a preferentially taxed capital gain. Chances for tax planning are also reduced in other ways. In the former system it was profitable to divert capital income to family members whose other taxable income was relatively low, but the flat rate system does not encourage tax-induced redistribution arrangements of assets.

IV. TAX RATES

With respect to the taxation of individuals, the flat rate of tax levied on capital income is 25 percent, and this tax is paid only to the State. The rate structure for earned income is more complicated. Earned income is subject to a municipal tax of approximately 17 percent, social security levies of approximately 5 percent, and a possible church tax of approximately 1.3 percent (1993). State tax is levied on earned income exceeding 40,000 Fmk., and the tax rises step-by-step to 39 percent for earned income in excess of 275,000 Fmk. The highest marginal rate thus exceeds 62 percent.[3]

The corporate tax rate is the same (25 percent) as the tax on capital income. This is an intentional symmetry in the income tax system. Beginning in 1993, corporate tax will be paid only to the State, which in turn will remit a portion of the revenue to municipalities and churches. Under the pre-reform system, corporations paid a State tax of 19 percent and a municipal tax of approximately 17 percent, resulting in an overall tax rate for corporations of 36 percent (1992). The lowering of the corporate tax rate under the 1993 reform is combined with a broadening of the tax base in business taxation.

It is hardly a coincidence that the flat rate for capital and corporate income is lower in Finland than in Sweden and Norway. Sweden started the race with 30 percent, Norway followed with 28 percent, and Finland was the last country to complete its reform.

To a large extent, the reform is supposed to be revenue neutral. After a transition period, the new taxation of capital income and of businesses is likely to slightly increase tax revenue.

V. THE TAXATION OF DIFFERENT KINDS OF CAPITAL INCOME

A. *Interest income*

In principle, the tax base for capital income which is taxed at the 25 percent rate covers an individual's interest income. In

3. Unlike the reforms in Sweden and in Norway, the Finnish reform did not encompass a reduction of the tax rates for earned income.

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practice, most items of interest income are taxed under a separate withholding system, or are fully tax-exempt.

A final withholding tax is levied on interest income from bank deposits and bonds. Finland introduced this tax in 1991 (at the rate of 10 percent). The withholding tax system has not been abolished under the 1993 reform, nor will it be abolished in the future. In 1992, the final withholding tax was 15 percent, in 1993 and 1994 it is 20 percent, and as from 1995 it will be 25 percent. Certain bank deposits will be tax-exempt during a transition period, including 36 month deposits with interest rates not exceeding the Bank of Finland's discount rate less one percentage point. As of 15 February 1993, this provision allows a tax-exempt interest of 6.5 percent for such deposits.

B. *Dividends*

Dividends are generally not subject to double taxation in Finland. The imputation system was introduced in 1990 to avoid double taxation of distributed corporate income, and this system has been retained under the 1993 reform. Corporate tax paid on distributed income is fully credited to domestic shareholders. The capital income tax rate and the corporate tax rate are equal, and therefore in general no tax is payable by the shareholder. The overall tax rate on distributed corporate income is thus only 25 percent.

The tax treatment of dividends and the function of the imputation system may be illustrated as follows:

COMPANY	
Profit before taxes	100
Corporate tax (25%)	(25)
Distributed profit	75
SHAREHOLDER	
Dividend	75
Credit for corporate tax	25
Taxable income	100
Shareholder's tax (25%)	25
Credit for corporate tax	(25)
Taxes owed	0

Under the reform, the tax treatment of distributed corporate profits is much more favourable than before. In the pre-reform system, the overall tax burden of dividends received by individuals could exceed 60 percent. The substantial difference between the treatment of interest income (maximum tax 15 percent) and dividends (maximum tax 63 percent) was considered a formidable obstacle to the use of equity financing through the issuing of shares, thus resulting in a serious problem in capital taxation.

The imputation credit granted to the shareholder is based on the idea that the distributing company has paid corporation tax in full on the profits distributed as dividends. Therefore, the distributing company must pay a minimum tax equal to the imputation credit (⅓ of the dividend) in order to safeguard a single taxation. If the tax paid by the company on the basis of its taxable income (comparison tax) is less than the minimum tax, the difference is levied as a complementary tax. If the comparison tax exceeds the minimum tax (e.g. profit but no distribution), the excess can be carried forward to the following ten years (previously five years).

The complementary tax can cause double taxation when a Finnish parent company receives dividends from abroad and distributes the dividends as part of its profit to its own shareholders. Thus, paying dividends out of dividend income from foreign subsidiaries can be quite burdensome. This problem is partially eased by the reform because the withholding (source) tax paid by the Finnish parent company in the subsidiary's country of residence is taken into account when determining the comparison tax and the possible complementary tax.

In the Finnish system, dividends are only taxed once, but that does not exclude the possibility of double taxation of undistributed corporate income. On the assumption that retained profits increase the price to be paid for a corporation's shares, the corporate tax on these profits and the shareholder's tax on the capital gains from the sale of the shares result in double taxation. Contrary to the situation in Norway, the deductible basis in calculating the capital gain is not increased by the shareholder's share of the taxed undistributed profits of the corporation.

C. *Capital gains and capital losses*

The removal of capital gains preferences is a major base-broadening feature of the reform. Like other items of capital income, capital gains are generally subject to taxation at the 25 percent tax rate. However, capital gains are still accorded special treatment in certain cases, i.e. capital gains on the sale of a permanent home remain tax exempt as are generation shifts of farms and business enterprises.

Other rules limit the taxable gain by replacing the actual acquisition cost with a higher deemed basis. When calculating taxable capital gains, the taxpayer has the option of deducting either the acquisition cost of the property or 30 percent of the sales proceeds. The maximum presumed cost is 50 percent if the property was acquired before 1989, and 80 percent if real estate is sold to the State or a municipality.

A natural counterpart to a broad-based taxation of capital gains is the broad deductibility of capital losses. Nevertheless, capital losses are not generally deductible in the computation of capital income. Capital losses may only be offset against capital gains arising in the same and three following years (previously offset was only allowed in the same year).

D. *Income from forestry*

A special, if not unique feature of the pre-reform system, was the tax treatment of income from forestry. This kind of income was taxed on an estimated, rather than on an actual basis. Estimates of net income were made for various categories of forest land in different rural districts, and the forestry income of an individual farmer or landowner was determined according to the area and classification of his forest land.

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This system has been abolished under the reform, but with a long transition period. As a general rule, timber sales proceeds are taxed as capital income. However, an individual farmer may choose to be taxed on the basis of the old system during 1993-2005, and if so, the estimated income is taxed as earned income.

VI. DEDUCTIONS IN THE CAPITAL INCOME TAXATION

A. *General remarks*

In a differentiated income tax system, expenses for acquiring income must be allocated to capital income and earned income. The actual tax rate determines the tax value of a deduction.[4]

Some personal allowances are granted for social policy reasons, e.g. child care, and are deducted from earned income.

The deductibility of voluntary pension insurance payments was curtailed to some extent under the reform in order to achieve more neutrality between different forms of saving.

B. *Interest payments*

Significant problems with deductions arise in the treatment of interest payments. The previous complicated interest deduction system has been replaced by a new system in which interest payments are generally deducted from capital income.

In its Bill (200/1992), the Government proposed legislation which provided for the deduction of interest payments at the capital income tax rate, regardless of the use of the loan. The Ministry of Finance argued against the earmarking of loans, but Parliament did not accept this argument.[5] Many modifications were made in the interest deduction rules during the enactment process in Parliament. The outcome produced a set of rules, favourable to a large number of taxpayers, to be valid during a transition period, and a set of permanent rules where interest payments are divided into numerous categories according to the purpose of the loan. Apart from interest paid on loans connected with business or agriculture, the categories of deductible interest include loans to purchase a permanent residence, loans to buy shares in a company or a partnership where the taxpayer is working as an entrepreneur, loans used for other income-generating purposes, and study loans. The idea is to exclude the deductibility of interest paid on consumer loans, other than permanent residences (e.g. loans to purchase a car, yacht, leisure residence, etc.).

It is not uncommon for taxable capital income to be negative when interest payments are deducted from capital income. This typically results from interest connected with the acquisition of a permanent residence while the taxpayer has no capital income. If there were no offset in the taxation of earned income, only taxpayers with capital income could receive a tax deduction for interest on their home loans. This would not be socially acceptable.[6]

To alleviate this situation, a deficit of capital income gives rise to a credit against tax payable on earned income. In general, the tax value of the credit is limited to the capital income tax rate, i.e. the credit is 25 percent of the deficit. The maximum credit for a single taxpayer is 8,000 Fmk. For a family of four or more, the maximum credit is 20,000 Fmk., corresponding to a deficit of 80,000 Fmk. For interest paid on a loan for acquisition of a first permanent residence, the credit is 30 percent of the deficit for ten years, but maximum amounts of the credit remain the same. The possible excess deficit of capital income is carried forward to be deducted from capital income later during the ten-year period.

VII. TAXATION OF SMALL BUSINESSES AND THEIR OWNERS

The tax treatment of partnerships has been unique in Finland. A general or limited partnership conducting business has been treated partly as a separate taxable entity: half of the partnership profit has been taxed as the partnership's income and the other half as income of the individual partners. This anomaly was abolished by the reform. Now all partnership income is taxed at the partner level, as in most countries.[7]

A complex issue in the differentiated income tax system is the treatment of income generated by enterprises where the entrepreneur has worked in his business and the profit consists in part of the value of the work performed by the entrepreneur. In principle, the yield on the capital should be taxed as capital income, whereas the yield on the owner's labour should be taxed as earned income. The problems presented by this distinction concern all forms of business enterprises, including private firms, partnerships and corporations.

Finland has established schematic rules to deal with the problem. Business income is regarded as capital income up to 15 percent of the taxpayer's share of the net worth of the enterprise. According to this formula, there is no need to define categories such as closely-held companies or active shareholders. Dividend income of an individual shareholder can be taxed as earned income, even if the shareholder is a passive shareholder. In practice, this may occur in cases where the distributed profit of the corporation is produced mainly by the work contribution of the shareholder. Dividends received from corporations listed on the Helsinki stock exchange or on a foreign stock exchange are always treated as capital income.

4. For example, costs of acquisition of professional literature are deductible from earned income (tax value 0->62), and a landlord can deduct the costs of maintenance of a rental unit from rental income (tax value 25%).
5. The deductibility of debt interest has long been a controversial tax policy issue in Finland. See Kari S. Tikka, "Deductibility of Interest Payments in the Finnish Income Taxation", *Scandinavian Studies in Law 1982* (Stockholm Institute for Scandinavian Law), at 229-242.
6. It should be noted that as of 1993 Finland does not impose a tax on imputed income from owner-occupied housing.
7. During the legislative process, it was discussed whether a partnership should be permitted the option of being taxed as if it were a corporation. When presenting the Bill to Parliament the Government announced that this issue will be examined in the near future.

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Complicated transition rules provide tax relief to owners of private firms, farms and partnerships. These rules were considered necessary because the net worth of many small businesses is negative and, according to the main rule would not produce any capital income, and because the pre-reform taxation of partnerships was lenient.

Capital gains can not be taxed as earned income upon the disposal of the business, so the yield of the entrepreneur working in his own company can be realized as a capital gain, which is taxed as capital income at the 25 percent rate. The company may also have been taxed on its retained profits at the 25 percent rate, but the overall tax burden can be lower than in a case where the value of the work had been taxed as earned income.

VIII. TAX BASE IN BUSINESS TAXATION

A. *General remarks*

In making an international comparison, the corporate tax rate of 25 percent is significantly low. A major lowering of the tax rate must be compensated by a broadening of the tax base. Despite the base broadening reforms in 1989-90, Finnish business tax law included special reserve rules, reliefs for capital gains and generous depreciation rates, causing a major discrepancy between the formal and the de facto tax rate of enterprises.

There was room for further broadening of the tax base. Furthermore, an underlying principle in the reform of business taxation has been to eliminate disparities in calculating the taxable profit and the accounting profit of an enterprise. Business taxation and accounting have traditionally been closely attached to each other. The most important changes in the tax base are discussed in the following paragraphs.

B. *Capital gains*

Before the 1993 reform, capital gains on real property and shares included in the fixed assets of an enterprise were subject to a partial exemption, i.e. only 60 percent of the sale proceeds were taxed if the real property was owned for at least ten years and shares for at least five years. This exemption has been abolished, and all capital gains are now taxed as ordinary income. There are no presumed cost rules in business taxation as there are in the taxation of personal capital income.

C. *Reserves*

A special feature of Finnish business taxation has been the taxpayer's right to reduce the taxable profit by creating different kinds of reserves. For example, an enterprise could create an inventory reserve on the basis of its stock of goods, not exceeding 25 percent of the acquisition cost (10 percent in the case of securities). This reserve has been abolished.

In addition to the inventory reserve, an operation reserve has been an economically important reserve. Taxpayers engaged in business (other than banks and insurance companies) were allowed to create an operation reserve not to exceed 30 percent of the amount of wages paid by the taxpayer during the 12 months preceding the end of the fiscal year.

For corporations, a maximum operation reserve not to exceed 10 percent is allowed in 1993, and thereafter the reserve is abolished for corporations. Private firms and partnerships may make transfers to the reserve in future years (such transfers not to exceed 30 percent of wages). This can be seen as compensation for the fact that the profit of such enterprises can be taxed as earned income (when the profit exceeds 15 percent of the net value of the enterprise), while retained profits of corporations are taxed at the rate of 25 percent.

The transition rules for old (but in the future disallowed) inventory and operation reserves are fair and flexible. Enterprises need not book these dissolving reserves as income for 1993. They may form a so-called transition reserve, which must be deducted from the acquisition cost of new machines or buildings or must be directly added to the taxable income of the enterprise not later than 1997. However, these untaxed reserves can not be added tax free to the equity capital of companies.

Enterprises have also been entitled to create a bad debt reserve, which could not exceed 2 percent of the amount of business claims outstanding at the end of the fiscal year. This reserve has been repealed. Enterprises may still deduct provisions for bad but unrealized sale claim losses according to accounting principles. Other bad debts may be deducted only as realized.

A guarantee reserve is allowed to taxpayers engaged in a qualifying construction or metal industry for possible costs arising from product guarantees. Such taxpayers were allowed to deduct from profits up to 3 percent of the price of products delivered during the fiscal year. Now, a guarantee reserve cannot be made on such a schematic basis, but rather on the basis of the likely cost of guaranteed work of which the taxpayer has given sufficient proof.

There are also rules for a replacement reserve. Under the pre-reform system, an enterprise deriving a gain on depreciable fixed assets was allowed to place the gain in the books as a replacement reserve. The reserve must be deducted from the acquisition cost of new assets taken into use during the following three years. Under the new rule, the reserve cannot be made in the case of a sale but only in the case of fire or similar involuntary losses, and the time limit is two years. However, the right to create a replacement reserve in the case of a sale of main business premises has been maintained.

Many changes to Finnish business taxation accord with the proposals of the Ruding Committee. The considerable curtailing of the possibilities to create replacement reserves is an exception to those proposals. As regards reinvestment of realized gains, the right to rollover the tax base of the old assets into the new assets are not as generous as those proposed in the Committee Report.[8]

8. See Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities, 1992, at 217-218.

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D. *Depreciation*

As a part of the broadening of the tax base, the taxpayer's right to depreciation allowances has been somewhat curtailed. Buildings may be depreciated only by the declining-balance method in Finland. The maximum rates of annual depreciation on buildings have been lowered as follows:

- industrial and commercial (shops, warehouses) buildings, 7 percent (previously 9 percent); and
- office and residential buildings, 4 percent (previously 5 percent).

The pre-reform maximum rate of depreciation for machinery and equipment was 30 percent, and this has not been changed. However, a new rule applies to leisure boats and yachts. If such a vessel can be classified as a business asset, the maximum rate of depreciation is 10 percent (previously 30 percent).

E. *Entertainment expenses*

Entertainment expenses have been deductible, but only up to a fair and reasonable amount. In tax practice, expenses not exceeding a certain percentage of turnover, varying according to the type of business, were accepted as deductible, and many enterprises were able to deduct the full amount of their entertainment expenses. A more rigorous restriction has now been introduced, i.e. only 50 percent of the total amount of entertainment expenses is deductible.

F. *Losses*

For the treatment of losses, the carry-forward method is used in Finland. Under the pre-reform system, losses could be carried forward to the following five years. The 1993 reform provides for a ten-year period. No provisions for carry-back of losses were introduced.

IX. PROBLEMS WITH THE NEW SYSTEM

Two commonly accepted targets of tax policy are efficiency and equity. The fairly low flat rate on capital income emphasizes efficiency and, in a way, relinquishes the goal of redistributing income. The change is perhaps not so dramatic.

There has been a wide gap between effective and formal progressiveness in the Finnish system. It is difficult to ascertain the fundamental justification for capital income being taxed proportionately while earned income is taxed progressively. Further, it is evident that the distribution of capital income before taxes is more uneven than the distribution of earned income. The future decrease in the progressiveness in the tax system could place more emphasis on distributional effects of public spending.

A serious weakness in the Finnish system is the large disparity between the tax burden on capital income and earned income. In many cases, the gap between the two tax rates may be close to 40 percentage points. The marginal tax rates on earned income should, at least in the long run, be reduced significantly. This is a difficult budgetary problem because of the large existing deficit. It is feared that a new profession will emerge in the society: alchemists who perform magic by transforming earned income into capital income.

Finland has applied for membership of the European Community. No EC country has a differentiated tax structure such as those in Sweden, Finland and Norway. The Ruding Committee has proposed a minimum corporate tax rate of 30 percent.[9] However, the adoption of such a minimum rate in the EC is improbable, and the EC is not likely to exert any pressure to impose a uniform income tax structure on its members. EC membership as such would hardly pose a threat to the corporate tax rate of 25 percent or to the Nordic model of income taxation. Another question arises if the future of the flat rate tax on capital income becomes an international success story.

X. CONCLUSION

The differentiated income tax system with its fairly low flat rate on capital income is not an ideal model wholeheartedly welcomed by Finnish experts and politicians. Rather it is a more defensive than offensive reaction to international tax competition.

Finland is a small open economy as well as a Nordic welfare state. As a domicile for wealthy individuals and a target country for investment, Finland must be attractive enough, even from a tax perspective. A remarkable change has taken place here, thanks to the tax reform. For example, if a subsidiary's profit before taxes is 100 Fmk., the foreign parent company gets 75 Fmk., while the corporate tax rate is 25 percent and the withholding tax on inter-group dividends is in many cases zero, under the provisions of a tax treaty. Compared internationally, this may be a quite favourable figure.

On the other hand, Finland can not compete as a low-tax country, due to the established levels of public spending and total tax revenues. Finland is among those countries who should favour a collectively planned harmonization, in order to set limits on international tax competition.[10] For welfare states, it would not be a desirable if the impact of taxation on capital flows would lead to international tax competition, with zero rate as the result.

9. Report of the Committee of Independent Experts on Company Taxation, at 209-210.

10. Hans-Werner Sinn concludes: "With a collectively planned harmonization, rather than one enforced by the competition of tax systems, Europe would not have to give up its social achievements...." See Sinn, "Tax Harmonization and Tax Competition in Europe", *European Economic Review* (1990), at 489-504.

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Because of technical problems the loose-leaf services section will be incorporated in the next *Bulletin* issue

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CUMULATIVE INDEX – 1993 Nos. 1-5

I. ARTICLES

Canada:
Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Reseach Incentives 255

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Jinyan Li:
The New Law on Tax Administration 263

Denmark:
Bente Moll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

France:
Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Hong Kong:
Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283

Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

G.K. Kawatra:
1993/94 Budget 294

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

John Prebble:
100 Years of Income Tax 59

Stanley C. Ruchelman:
US Tax Considerations in International Derivative Products 235

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Japan:
Alum Bati:
Taxation of Dividends and Interest 202

Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Singapore:
Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

United States:
Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

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Wim Wijnen:
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:

Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC: The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96, 219, 254

IV. CONFERENCE DIARY 39, 149, 285

V. BIBLIOGRAPHY

- Books 49, 100, 150, 226, 297
- Loose-leaf services 51, 103, 154, 231, 302
- List of addresses of the major publishing houses appearing in the Bibliography 53

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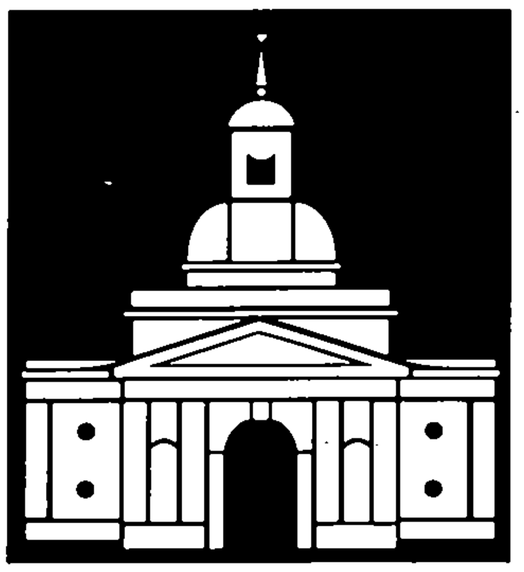
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CONTENTS

VOL. 47 NO. 7/8 **JULY/AUGUST 1993**

TAX DEVELOPMENTS IN THE UNITED KINGDOM OF INTEREST TO US TAX ADVISERS — 363 — *Guy Brannan*
The UK Inland Revenue has announced proposals to change the tax code in a number of areas, particularly as regards foreign exchange gains and losses and as regards the tax treatment of financial instruments intended to hedge interest rate risk. Mr Brannan considers these issues as well as thin capitalization rules and unitary taxation issues.

FRENCH INCOME TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS — 367 — *Olivier Delattre and Clothilde Fournier*
This paper highlights some recent tax legislation and court decisions affecting corporations. Also discussed are changes to the tax treatment of financial instruments in France.

NETHERLANDS: INCOME TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS — 371 — *Paul Sleurink*
Mr Sleurink takes a look at the measures implementing the parent-subsidiary and mergers directives in the Netherlands, the effects of the proposed directives on interest and royalties and losses of permanent establishments and subsidiaries, and updates the rules regarding the 35 percent concession. Last year's information note of the Under-Secretary of Finance on the fiscal climate for enterprises in the Netherlands is also summarized.

GERMANY: ADMINISTRATIVE AND LEGISLATIVE DEVELOPMENTS OF INTEREST TO US TAX ADVISERS — 383 — *Friedhelm Jacob*
Mr Jacob looks at both inbound and outbound investment issues, including the effects of the parent-subsidiary and mergers directive, changes to the fiscal unity rule, introduction of a withholding tax on interest, tightening of German CFC rules and rules on deductibility of foreign losses from domestic profits. Finally, Mr Jacob overviews some trends – proposals for relief from personal and corporate income tax and the introduction of a "solidarity surcharge".

CANADA: TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS — 389 — *Nathan Boidman*
A number of developments in Canadian tax law which may be of interest to US tax advisers have arisen over the last year of two. This article addresses matters from both the US outbound/Canada inbound context and from the US inbound/Canada outbound context. The author's comments seek to place in a workable perspective the Canadian response to certain recent US developments as well as other US developments affecting cross-border Canada-US practice.

MEXICO: TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS — 407 — *Juan Pablo de la Calle Pardo*
This article looks at recent changes in Mexico directed at modernizing the tax system, strengthening public finances and improving internal finances through increased tax collection and taxpayer compliance.

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European Tax Handbook 1993

and

Tax News Service
Now Weekly!

KNOWLEDGE AND TECHNOLOGY TRANSFERS TO AND FROM THE UNITED STATES – CHARACTERIZATION OF TRANSFERS OF COMPUTER SOFTWARE — 414 — *Melvin S. Adess and Barbara M. Angus*
Sale vs. licence: the characterization of transfers of technology has significant tax implications. This paper briefly describes the tax principles underlying the sale vs. licence characterization of patent, know-how and copyright transfers. The focus then shifts to the current debate regarding the proper characterization of transfers of copyrighted computer software, an issue which has global tax implications and could potentially have significant implications well beyond the tax law.

INTERNATIONAL: HOW DO REVENUE AUDITS AFFECT TAXPAYER COMPLIANCE? — 424 — *John Hasseldine*
This article assesses, from previous interdisciplinary research, the impact of audit strategies on compliance in two broad areas. The first area is the impact of audits on voluntary compliance, and the second area is the types of audit, strategies and features most effective in detecting non-compliance. The main findings are that all research methods reach the same conclusion – specific audits do promote compliance behaviour and, further, they provide both an education and a deterrent effect.

INTERNATIONAL: ISSUES RAISED BY INTERNATIONAL COOPERATION IN REVENUE ENFORCEMENT: DIRECTIONS FOR THE FUTURE — 436 — *Vicki L. Beyer*
This article examines the ways in which nations cooperate to enforce their revenue legislation. Focusing in particular on Australia's double taxation agreements with the United States and Japan, the article studies the provisions that mandate cooperation between the parties and considers the ways in which that cooperation takes place in light of those provisions. Finally, the future direction of information exchange is discussed.

KAZAKHSTAN AND RUSSIA: TAX FOUNDATION SIGNS AGREEMENTS WITH KAZAKHSTAN AND RUSSIA — 444 — *Charles E. McLure, Jr.*
In March the Tax Foundation led a delegation of representatives of American and British business to Kazakhstan to discuss with government officials tax aspects of improving the investment climate of the country. The delegation later met with various Russian officials in Moscow. The delegation concluded a joint protocol calling for adherence to generally accepted principles of tax policy and for specific measures needed to improve the investment climate in Russia and Kazakhstan.

UNITED STATES/ISRAEL: NEW INCOME TAX TREATY – AN ANALYSIS AND PROGNOSIS — 450 — *Leif Weizman*
On 26 January 1993 the United States and Israel signed a long overdue income tax treaty, which is based on the unratified 1975 treaty and amended by two protocols. This article discusses the provisions of the new treaty and examines its similarities and divergences from the US, UN and OECD models.

BIBLIOGRAPHY — 462
- Books — 462
- Loose-leaf services — 465

CONFERENCE DIARY — 413

CUMULATIVE INDEX — 467

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TAX DEVELOPMENTS IN THE UNITED KINGDOM OF INTEREST TO US TAX ADVISERS

Guy Brannan

Guy Brannan graduated with a law degree from Trinity Hall, Cambridge University in 1977 and received an LL.M. degree from the University of Virginia in 1979. He joined Linklaters & Paines' corporate tax department in 1981, becoming partner in 1987. Since 1989 he has been the resident tax partner in Linklaters & Paines' New York office.

Contents

I. Introduction
II. Taxation of Foreign Exchange Gains and Losses
III. Financial Instruments (Management of Interest Rate Risk)
IV. Equity Notes and Thin Capitalization
V. Use of Legislative History in Statutory Interpretation
VI. Unitary Taxation

I. INTRODUCTION

The economic scene in the United Kingdom makes familiar reading for those who have had to grapple with the prolonged recession in the United States. The UK economy has been in recession for at least the last 18 months and the gap between government spending and its income (and consequently the budget deficit) is increasing. The UK's Conservative government has long been committed to lowering direct taxation rates (both individual and corporate) and, indeed, much of the tax reform effort that has been seen in Europe and the United States was in part inspired by Margaret Thatcher's radical tax reforms (lower rates but wider base) in 1984. With this ideological background, and bearing in mind that opposition to income tax increases formed one of the major planks in the Conservative party's campaign platform in the last election in April 1992, it will be politically difficult for the UK government to tackle the growing budget deficit by making significant increases in individual tax rates. It seems more likely that additional revenues will be raised by the extension of indirect taxation (VAT) to areas which were previously outside the scope of the tax, by decreasing certain standard tax reliefs and by increasing social security contributions (national insurance) by means of abolishing ceilings on contributions. It is thought that significant increases in corporate taxes are unlikely, not least because corporate profits are already under considerable pressure as a result of the recession. Moreover, the government recently introduced enhanced depreciation allowances (capital allowances) for a one-year period starting on 1 November 1992 and ending on 31 October 1993. These allowances (40 percent in the first year and 25 percent thereafter on a reducing balance basis) were intended to spur on capital investment and will, in any event, significantly reduce revenues from corporation tax.

The Government's fiscal strategy was set out in the annual Budget on 16 March (thereafter the annual Budget is moved to the end of each calendar year), and it will be interesting to see how the budget deficit issue is to be tackled.[1]

On a more detailed level, the UK Inland Revenue has announced proposals to change the tax code in a number of areas, particularly as regards foreign exchange gains and losses and also as regards the tax treatment of financial instruments intended to hedge interest rate risk. The rest of this paper will consider these and other more detailed topics of interest to international tax advisers.

II. TAXATION OF FOREIGN EXCHANGE GAINS AND LOSSES

The UK tax treatment of foreign exchange gains and losses was widely regarded as unsatisfactory. There were many different tax issues which arose, but essentially the major difficulty was that a gain arising on a foreign currency asset could be taxable whilst the corresponding foreign currency loss on a borrowing to finance the asset was often not tax deductible. The effect was that many transactions which were perfectly matched both in economic and accounting terms turned out to be unmatched for tax purposes. Often, the tax result would depend on artificial distinctions such as whether a borrowing was on capital or on revenue account and bore no relation to economic and commercial reality. The general dissatisfaction with this regime resulted in a Consultative Document being published by the Inland Revenue in March 1991 containing proposals for the reform of the taxation of foreign exchange gains and losses. As a result of representations made during the consultative process, a further Consultative Document was issued in February 1993 containing draft

1. In the event, the UK budget contained few immediate tax increases, although some measures which would have the effect of raising the tax burden on certain taxpayers in subsequent years were introduced. One significant example was the reduction in the rate of Advance Corporation Tax ("ACT"). This will reduce the amount of tax which tax-exempt investors (e.g. pension funds and charities – major investors in the UK equity market) can reclaim. It will also result in a reduction in the amount of the tax credit which will be repayable to treaty-entitled investors in UK companies under the terms of many current UK double tax treaties. Finally in a Consultative Document, the Inland revenue has asked for comments on proposals to help UK companies avoid the "ACT trap" which penalizes the distribution of taxed foreign income by UK corporates. The proposal would enable a UK corporate to pay "foreign income dividends" which will be paid out of foreign income without incurring irrecoverable ACT (any surplus ACT would, broadly, be reclaimable by the company). In addition, regardless of the outcome of this first proposal, the Inland Revenue have given a commitment to introduce a new regime for international headquarter companies in the United Kingdom. This regime would allow the UK headquarter company to pass on foreign-source dividends to its foreign parent/shareholders without incurring ACT – thus removing the problem that conventionally prevented the United Kingdom from being a suitable location for an international holding company.

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legislation. The draft legislation covers over 45 pages and is of great complexity, which is only to be expected since foreign exchange gains and losses raise many intractable issues. There are also a number of areas where legislation will confer power on the Revenue to make regulations at a future date (particularly as regards matching a foreign exchange borrowing with certain foreign currency assets).

The main features of the proposed legislation are as follows:

- Exchange gains and losses on qualifying assets and qualifying liabilities and on forward contracts to buy or sell currency are recognized as they accrue between one "translation time" and the next. Qualifying assets include currency in the form of cash, and debts. Generally, shares in a corporation are not regarded as qualifying assets (except in certain cases where the shares are regarded as part of trading inventory and also where exchange differences on the shares are included in the profit and loss account on a translation basis). Qualifying liabilities include debts and, in some circumstances, provisions for contingent liabilities.
- Exchange gains and losses on trading account are taken into account in the computation of trading of profits or losses.
- Net non-trading exchange gains are taxed as income (previously they were taxed as capital gains) and there are special rules for non-trading exchange losses.
- There is a deferral mechanism where unrealized exchange gains on long-term capital items exceed 10 percent of the profit of an accounting period. In such a case, the excess can be deferred until the following year.
- Regulatory powers are given to the Revenue in order to make provision for the "matching" of exchange differences on borrowings with exchange differences in certain non-qualifying assets (e.g. shares in overseas subsidiaries, the net investment in an overseas branch, and ships and aircraft).
- Qualifying assets cease to be subject to capital gains tax.
- There are extensive anti-avoidance provisions to prevent the artificial manufacturing of exchange losses.
- There are special rules for insurance companies.

The effect of these rules will be to remove many of the anomalies and unexpected tax charges that bedevilled UK companies when dealing with foreign exchange gains and losses. For example, UK holding companies were effectively prevented from undertaking currency swaps to hedge foreign currency borrowings because of the mismatch in tax treatment between the currency swap (on which any gain would be taxable) and the foreign currency borrowing on which any currency loss would be non-tax deductible. The effect of these proposals (which taken together with the proposals regarding financial instruments described below) will be to eradicate the tax mismatch and to make it easier for UK companies to borrow in foreign currency and to hedge their currency exposure.

The consultation process for the proposed rules is continuing, and it is unlikely that legislation will be brought into effect until 1994 at the earliest. The proposed legislation is not retrospective, and, therefore, exchange gains and losses incurred during the past several months of upheaval in the currency markets will be subject to the old tax regime.

III. FINANCIAL INSTRUMENTS (MANAGEMENT OF INTEREST RATE RISK)

The Inland Revenue issued another important Consultative Document in 1991. There was concern that a variety of financial instruments used to reduce or eliminate a company's exposure to interest rate risks were being used against the background of a tax system which was devised long before these instruments existed. The financial markets were a long way ahead of the tax code. In some cases, the Inland Revenue had published extra-statutory concessions (e.g. in relation to interest swaps) in order to provide some certainty as to the tax treatment of some instruments. However, it was thought that the tax treatment of swaps, caps, collars, interest rate options and forward rate agreements (to name but a few of the more common examples) ought to be put on a statutory basis. In setting out this statutory framework, it was hoped to eliminate uncertainties as to whether certain payments and receipts would be dealt with under the UK rules for taxing income or under the separate rules for taxation of capital gains. Other anomalies that were intended to be removed were the uncertainties as to when payments or receipts should be recognized for tax purposes and, generally, to alleviate many of the problems or anomalies that investment companies, particularly those with a treasury management function, might experience. Most of these difficulties resulted from the fact that these companies generally are not treated as carrying on a trading activity, even though such companies constitute the main users of these financial instruments.

Draft legislation is expected shortly (but has not been published at the time of writing). The key elements of the proposals put forward in the 1991 Consultative Document were as follows:

- The new regime will cover a wide range of financial instruments used for managing interest rate risk by contracts involving notional principal amounts. It is not intended that the new law will cover financial instruments used for handling risk attaching to equities or commodities (or related indexes).
- The basic approach favoured in the Consultative Document is to tax all payments and receipts as income (so that all payments are relieved as deductions against profits and all receipts are taxed as income). This would remove such payments and receipts from the capital gains tax regime.
- The financial instruments that will be covered by the legislation will include the great majority of swaps and other instruments that involve payments which are determined by reference to the application of an interest rate to a notional principal amount (e.g. caps, collars and floors) and single payment instruments where the payment is determined by applying the interest rate to the notional principal amount (e.g. forward rate agreements and interest rate futures and options).
- As regards the question when payments and receipts are to be recognized for tax purposes, the proposal is that this

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would be determined in accordance with the method used by companies in preparing their audited accounts. For example, where a "mark-to-market" method is used in preparing accounts, this would *always* be followed for tax purposes. The same would be true where the accounts were prepared on an accruals basis (provided the basis is "acceptable", i.e. where the costs of the instrument are allocated to different periods in proportion to the benefits which at the outset might reasonably be expected to accrue).

The proposals contain anti-avoidance rules which would apply to deny tax relief where the payments exceed those that would have been paid between independent parties at arm's length; and to impose a withholding tax on payments (except those made by a UK bank of financial trader) to tax haven-resident recipients.

It will be necessary to wait for the draft legislation to discover whether the consultative process resulted in any major deviations from the proposed regime. However, care will need to be taken that the financial instrument in question falls clearly within the new regime and this will no doubt be one of the key areas for debate. In general, however, the proposals are to be welcomed since they clarify a previously obscure area of law and practice and provide a sound statutory base for these financial instruments.

IV. EQUITY NOTES AND THIN CAPITALIZATION

Many international US tax practitioners will already be aware of the fundamentally different approaches taken by the US tax system from those of the UK and other European tax systems. The US tax system often adopts an approach which is more concerned with the economic substance of a transaction or a structure than that of the UK system where the emphasis is rather more on the transaction's form. Consequently, it has been possible to "arbitrage" between the two tax systems to produce an advantageous result. The best known example of this tax arbitrage was the use of dual resident companies. More recently, a number of groups exploited the difference in US and UK definitions of debt and equity. As a result, some US parents financed their UK subsidiaries by hybrid instruments which were characterized as debt (the interest thereon being deductible) in the UK but which were regarded in the United States as equity ("dividends" thereon carrying foreign tax credits).

In 1992, the UK Revenue introduced legislation to counteract the tax advantages of these hybrid instruments (known as "equity notes"). New Subsections (9) and (11) were inserted into the "distribution" provisions of Section 209 Income and Corporation Taxes Act (ICTA) 1988. The effect of this provision is that interest payments on an equity note held by a 75 percent affiliate or by a "funded company" (i.e. a company put in funds by the issuer or a company associated by the issuer) are treated as non-deductible distributions (i.e. a quasi-dividend). However, this legislation is quite narrowly based, and there still seem to be some opportunities in this area.

In addition to changes made to the distribution legislation, the Inland Revenue also clarified the "thin capitalization" rules which are contained in many of the UK's double tax treaties. The background to this change was a court decision involving equity notes (a decision of the Special Commissioner – the proceedings and decision are private, although the Revenue announced the substance of the decision) which held that Article 11 of the US/UK double tax treaty did not impose a thin capitalization requirement as regards UK subsidiaries of US parents. This ruling took many commentators (and certainly the Inland Revenue) by surprise. The Revenue moved swiftly to close this unintended loophole and introduced Section 52 of the Finance (No. 2) Act 1992.

The concept of thin capitalization in UK law is somewhat complex and involves the interaction of domestic UK law and double tax treaties to which the United Kingdom is a party. Section 209(2)(e)(iv) and (v) ICTA 1988, in very broad terms, treats interest paid by a UK company to a non-resident 75 percent associated company as a distribution (i.e. a quasi-dividend). Article 11(7) of the US/UK double tax treaty (an article typically found in UK treaties) disapplies this treatment. However, the protection of Article 11(7) is itself lost where, in accordance with Article 11(5):

> "... 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...." (emphasis added)

In the Special Commissioners' decision mentioned above, it was held that the words "for whatever reason" were not sufficiently broad to allow a thin capitalization argument to be raised by the UK Revenue. It had previously been believed (and it was certainly the UK Revenue's view when the treaty was negotiated) that this wording was sufficiently broad to enable not merely the rate of interest but also the amount of indebtedness and other factors to be taken into account in determining whether the payer of the interest was thinly capitalized. Accordingly, Section 52 Finance (No 2) Act 1992 (introducing a new Section 808(A) ICTA 1988) provides that a "special relationship" provision in the treaty (such as Article 11(7) of the US/UK treaty) shall be construed as requiring account to be taken of *all* factors, including (a) the question whether the loan would have been made at all in the absence of the relationship; (b) the amount which the loan would have been in the absence of the relationship; and (c) the rate of interest and other terms which would have been agreed in the absence of the relationship.

Moreover, the onus of proof is on the taxpayer to show the amount of interest which would have been paid in the absence of the special relationship. However, the new rules do not apply to "special relationship" provisions which expressly require that regard must be had to the debt on which the interest is paid in determining the amount of interest to be treated as distribution.

V. USE OF LEGISLATIVE HISTORY IN STATUTORY INTERPRETATION

Very recently, the UK legal system took the first tentative steps along a path already familiar in the United States. The

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House of Lords in *Pepper v. Hart*[2] held that where legislation was ambiguous or obscure, or its literal interpretation could lead to an absurdity, a court could refer to proceedings in Parliament, provided that the statements relied on were made by a Minister or other promoter of the legislation and that the statements relied on were clear. *Pepper v. Hart* was in fact a tax appeal, although the decision will apply in every area of English law.

US observers will note that the circumstances in which reference can be made to legislative history are narrower than those in the United States. It should also be understood that the implications of this decision have not yet been fully worked out. In particular, there are a number of important earlier decisions which have followed a strict literal rule of statutory interpretation which must now be regarded as of questionable authority when viewed in the light of relevant legislative history. The decision has also opened up the possibility of law firms and other tax experts briefing Members of Parliament on behalf of their clients to question Ministers on the effect of new statutory provisions during debates on proposed legislation. Any ministerial confirmations or undertakings given in Parliament might be used at a later stage in interpreting the legislation.

VI. UNITARY TAXATION

The UK Government continues to keep a close watch on the Barclays Bank litigation in California concerning the propriety of unitary taxation. The Government has indicated that it will await the outcome of this and associated litigation before deciding whether to invoke Section 812 ICTA 1988. This provision, if brought into effect, would deny the benefit of the tax credit refunds, usually available under the US/UK treaty, where dividends are paid to a company which has or is associated with a company which has a qualifying presence in a unitary tax state.

2. (1992) STC 898.

Hubert Hamaekers Appointed Professor of International Tax Law

The IBFD's Chief Executive, Hubert Hamaekers, has been appointed professor of European and international tax law at the Law Faculty of the University of Nijmegen (Netherlands) from 1 September 1993. The chair was established by the International Bureau of Fiscal Documentation to stimulate teaching and research in the field of international tax in cooperation with universities in Europe and abroad.

Mr Hamaekers received his law degree from the University of Nijmegen and worked at the Ministry of Finance from 1975 to 1985. He assumed the position of Chief Executive of the IBFD in 1985. Mr Hamaekers is also a member of the Permanent Scientific Committee of the International Fiscal Association, a member of the Committee on Fiscal Affairs of the OECD, chairman of the Working Party on Transfer Pricing of the CFA and advisor to the Ministry of Finance of the People's Republic of China. His publications are largely in the field of EC tax law and transfer pricing.

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FRENCH INCOME TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS

Olivier Delattre and Clotilde Fournier

This article looks at some of the most significant tax events which took place during 1992 and the beginning of 1993. The implementation of EC law has already received much attention and will only be briefly discussed. The focus will be on recently enacted legislation and some court decisions affecting corporations, and on the marked evolution in the area of financial instruments.

Olivier Delattre is the head partner at the New York office of Bureau Francis Lefebvre, the Paris-based law firm. Mr Delattre holds a Diplôme d'Études Supérieures de Fiscalité from the Université de Paris. He furthered his studies of international tax law at the Boston University Law School for one year after which he joined the New York law firm, Davis Polk & Wardwell. In 1983, Mr Delattre joined the international tax department at Bureau Francis Lefebvre in Paris, and in 1987, established their New York branch.

Mr Delattre holds membership in the International Bar Association, the French branch of the International Fiscal Association and the American Tax Institute.

Clotilde Fournier, a member of the New York bar, has been a tax associate at the New York office of Bureau Francis Lefebvre since 1991, and was a tax associate at the New York law firm of Davis Polk & Wardwell for two years. Clotilde received a Diplôme d'Études Approfondies from the University of Paris, an LL.M. from the London School of Economics and Political Science and an LL.M. from Cornell University Law School.

Contents

I. Implementation of EC Law
- A. EC directives
- B. Common VAT regime
- C. Transfer pricing

II. Corporate Taxation
- A. Standard corporation tax rate
- B. Parent-subsidiary regime
- C. Stock redemptions and liquidations

III. Financial Instruments
- A. Mutual funds
- B. Tax regime of reimbursement premium
- C. Transfer of assets outside France

IV. Update on France/US tax treaty

I. IMPLEMENTATION OF EC LAW

A. *EC directives*

The beginning of 1992 witnessed the effort, not only in France but also in the other EC member states, to meet the deadlines for implementation of two EC directives.

While no successful attempt has been made, as of yet, to achieve a common EC regime of taxation, and, in all likelihood, this will not be achieved for a long time, two important areas of corporate taxation have attained a greater degree of conformity following the enactment on 23 July 1990 of two EC directives, i.e. the parent-subsidiary directive and the merger directive. The parent-subsidiary directive concerns the taxation of dividend distributions between parent and subsidiary companies located in different member states, which brings a full exemption from withholding tax on qualifying dividend distributions, and the merger directive affects the tax regime applicable to reorganizations, i.e. mergers, transfers of assets and exchanges of stock between companies located in different member states, which generally allows postponing the taxation of capital gains realized on the reorganization.

The degree of uniformity that has been achieved, however, is tempered by the fact that the practical aspects of the implementation of these two directives have been left to each member state. In any event, anticipating implementation of the parent/subsidiary directive, some member states had been competing for some time to provide a more attractive tax regime for holding companies. Such is the case, for example, in Luxembourg with the SOPARFI regime, in Denmark which grants full exemption from tax on both dividend and capital gains and in France with the foreign participation regime which results in a full exemption from tax for the French holding company upon receipt and redistribution of dividends received from its foreign qualifying subsidiaries.[1]

B. *Common VAT regime*

Some uniformity has also been achieved with the creation on 1 January 1993 of a single market for VAT purposes. In effect, with respect to qualifying internal EC transfers of goods, VAT is no longer imposed in the member state of origin but rather in the member state of destination of the transferred goods. This regime applies regardless of the citizenship of the parties and hence, a US corporation that ships goods from its plant in France to the German office of a Japanese corporation falls within the scope of the new rules.

C. *Transfer pricing*

In the area of transfer pricing, a treaty was signed on 23 July 1990 between the 12 member states; it was ratified by France on 8 January 1992. The treaty provides some measure of relief from the risk of double taxation that may result when a

1. In addition, although not fully exempt (unless realized in a qualifying reorganization), capital gains realized by the holding company on its participation can benefit from a reduced rate of taxation (18%) provided the corresponding stock has been held for at least two years before disposition, and the balance of the gain is set aside in a special reserve. Upon redistribution of the balance of the gain, the corporation tax is levied in the amount of the difference between the 33.33% rate that should have been imposed, and the 18% rate.

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member state adjusts the price charged or paid by an affiliated company located in another member state.

In effect, when the price charged by a corporation located in country A to an affiliated corporation located in country B is adjusted by the tax administration of country A, the second corporation is entitled to claim the benefit of a corresponding adjustment from the tax administration of country B. The requested corresponding adjustment can be obtained in one of the following ways: (i) after notification of the adjustment that is envisaged, country B agrees to correspondingly adjust the taxable income of the corporation located therein; (ii) if such an adjustment is denied, an agreement is concluded between the tax administrations of country A and country B within two years of the date the tax administration was informed of the request; and (iii) in the absence of an agreement, an advisory committee is set up to render an opinion. If the tax administrations of the countries involved cannot agree on a method to avoid double taxation, they must comply with the opinion rendered by the advisory committee.

Thus, the treaty does not provide methods to determine an arm's length transfer price, but rather some grounds to obtain relief. However, it may be some time before the treaty will enter into force since it is provided that it will enter into force only when it has been ratified by all member states.

II. CORPORATE TAXATION

The Finance Law for 1993 and the Technical Correction Law for 1992 both contain important measures affecting corporations.

A. *Standard corporation tax rate*

Since the corporation tax was enacted in 1949, the rate has long remained unchanged at 50 percent. Since 1986, however, it has been progressively lowered to its current 33.33 percent for 1993. This new rate is likely to be the last development instigated by the French government in that sense at least for a while. In addition, simultaneously with this rate reduction, the additional tax ("supplément d'impôt") which was created in 1989 to bring the level of corporation tax on distributed income up to 42 percent has been totally eliminated. Accordingly, the rate of the French corporation tax is now one of the lowest in the EC.

This is reinforced by the fact that this single reduced rate does not affect the amount of "avoir fiscal" (a tax credit available upon redistribution of the dividend) which remains equal to 50 percent of the dividend. As a result of these two factors, the portion of the profits entitled to the "avoir fiscal" upon distribution is now entirely free of corporation tax. Moreover, the "précompte mobilier" (an equalization tax levied on amounts that have not borne corporation tax at the standard rate or that are paid out of profits realized more than five years before distribution) also remains unchanged in the amount of 50 percent of the net dividend.

B. *Parent-subsidiary regime*

The parent-subsidiary regime of Sections 145 and 216 of the French Tax Code has also been subject to significant changes. This regime grants exemption from tax on dividends received by French qualifying parent companies, except for the reintegration of a service charge which is fixed at 5 percent of the gross dividend (i.e. the amount distributed plus the "avoir fiscal").

Among these changes, two are of particular interest.[2] The first change concerns the elimination of the service charge. This allows full exemption of the dividend received and hence, tax treatment on a par with the ordinary regime of dividend distribution. Indeed, as we have seen, under the ordinary regime of dividend distribution, the corporation tax paid by the distributing corporation is now completely eliminated.

As an example, we will assume a distribution of 66.66 by a French subsidiary, that is, profits of 100 minus 33.33 corporation tax. If the parent-subsidiary regime applies, the French parent company will receive a net dividend of 66.33 and will not be subject to corporation tax upon receipt.[3] If the ordinary regime applies, the parent company will receive a net dividend of 66.66 with the benefit of 33.33 of "avoir fiscal" and will pay on that grossed-up amount 33.33 of corporation tax. Thus, in both cases, the parent corporation is entitled to a net dividend of 66.33.

Under certain circumstances, however, it will remain more advantageous to elect to apply the parent-subsidiary regime. This will be the case when the corporation receiving the dividend is in a loss situation since the dividend will reduce the amount of its losses and the "avoir fiscal" cannot be used; or in the case of foreign-source dividends since the avoir fiscal is not granted with respect to such dividends and, hence, in the absence of exemption, they are effectively subject to tax in the hands of the French corporate recipient.

The other important modification is the exclusion from the parent-subsidiary regime of all non-voting shares. This will especially affect foreign non-voting stock since foreign stock is not entitled to the "avoir fiscal".

C. *Stock redemptions and liquidations*

The Conseil d'Etat rendered a decision in the context of a redemption of stock that substantially narrows the definition of dividend distribution for purposes of granting the "avoir fiscal".[4]

This decision excludes from the scope of dividend distribution amounts received by one shareholder in (total or partial) redemption of his stock, even if the corporation has retained earnings at the time of redemption and treats such income as capital gain. Consequently, it is now clear that, with respect to the redeeming corporation, the "précompte" can no longer be imposed since the benefit of the "avoir fiscal" is denied. The controversial aspect remains the tax treatment of the redeemed shareholder. Although not expressly stated in the decision, it appears more certain, from the wording of the

2. The other changes are application of the parent-subsidiary regime on an optional basis, and the repeal of most exceptions to the conditions of application of this regime.
3. Upon redistribution, the "précompte" will be due but with the benefit of the "avoir fiscal" for French-source dividends.
4. CE 8 July 1992, No. 88734, "Gardet".

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decision, that the amount received, to the extent of the difference between the redemption amount and the acquisition price or issue price of the redeemed stock, should be subject to the more advantageous tax regime of capital gains; that is, for individuals the reduced tax rate of 18.1 percent and for corporations[5] the reduced tax rate of 18 percent for long-term capital gains.[6]

When the redemption involves a foreign party, the tax consequences should be as follows. Assuming that the redeemed shareholder is a resident of the United States, the qualification of the amount received in redemption as a capital gain results in no tax being levied in France since under Article 12 of the France/US tax treaty (as most tax treaties signed with France), such capital gain (other than capital gain on real property) is taxable only in the United States, the state of residence of the shareholder.

Assuming that the redeeming corporation is a US corporation, the capital gain is taxable only in France. However, this supposes that both states give to such transaction the same qualification under their domestic law. In the event that the United States treats the amount received by the French shareholder as a dividend, the tax treaty does not provide a solution to such conflicting qualification and hence, US withholding tax at the treaty rate would be levied. On the other hand, France may not grant the corresponding tax credit since, on its side, the amount received is a capital gain taxable in France only. Finally, although this case involved a redemption, it could also affect the tax treatment of parties involved in a complete liquidation.

III. FINANCIAL INSTRUMENTS

More than any other area of law, the tax treatment of financial instruments has been remodelled over the past years and at the beginning of 1993 to a point where their financial reality is finally taken into account. Notions that have been in effect under US tax law for some time are being progressively introduced into French tax law.

A. *Mutual funds*

Such is the case of the mark-to-market rule. The Technical Correction Law of 1991 had extended its application to interest-rate and currency swap agreements concluded, under certain conditions, by credit institutions and brokerage firms. The Finance Law for 1993 further extends application of the mark-to-market rule to securities held in mutual funds ("OPCVM", that is, "Organisme de Placement Collectif de Valeurs Mobilières"). More specifically, effective for fiscal years ending on or after 1 November 1992, the mark-to-market rule (i.e. annual taxation) applies to securities held directly or indirectly in French or foreign mutual funds by corporations subject to corporation tax. Thus, securities held indirectly through a foreign person are subject to these new rules. There is indirect participation when the French corporation holds, directly or indirectly, the stock of a foreign person[7] which in turn owns the stock of the mutual fund but only if (i) at least 50 percent of the assets, in terms of value, of the foreign person consists of the securities held in the mutual fund, or (ii) its primary activity is administering these securities for its own account. There is no other indication as to what type of indirect participation can be taken into account for purposes of this test but it is arguable that, since the test is in terms of assets, mere voting stock without financial rights should not be taken into account. Securities held in French or foreign mutual funds that "invest essentially in shares" and "mutual funds at risk" are, under certain conditions, excluded from the scope of the mark-to-market rule.

Under the mark-to-market rule, the liquidation value of the securities held in these mutual funds has to be determined at the close of every fiscal year. The difference between the liquidation value at the beginning of the fiscal year and the liquidation value at the end of the fiscal year is taxed in proportion to the participation of the French corporation at the standard corporation tax rate.[8]

B. *Tax regime of reimbursement premium*

The rule of annual taxation has also been introduced progressively in the tax treatment of reimbursement premium.

The tax regime of the beneficiary of the reimbursement premium has been modified to such extent, over the past years, that the applicable tax treatment depends on the date the debt was issued. The last modification is contained in the Finance Law for 1993 and codified under new Section 238 septies E of the French Tax Code.

Section 238 septies E is effective for debts issued, or for rights arising from the stripping of debt instruments, on or after 1 January 1993. The list of debts concerned by this new rule is over-inclusive.[9] In addition, it applies to every person except individuals, provided that the corresponding debt instrument is not accounted for as a business asset.

Reimbursement premium is generally defined, for purposes of that section, as the difference between the sums or consideration, regardless of their nature, that will be received upon reimbursement and the sums or consideration that are paid at the time of issuance or acquisition of the debt instrument. Excluded interests are more strictly defined and, hence, capitalized interests are now part of the reimbursement premium.

Section 238 septies E applies to reimbursement premium that meets the two following conditions:

5. On the other hand, this decision may not apply in the case of a parent corporation entitled to the parent-subsidiary regime of Sec. 145 of the French Tax Code. Indeed, in a preceding decision involving the redemption of the stock of a French parent company the Conseil d'Etat held that the amount distributed (i.e. the difference between the redemption amount and the acquisition price) remained subject to the parent-subsidiary regime of dividend exemption (CE 18 March 1992, No. 94061, "Péchiney").
6. See *supra* note 1.
7. The term "foreign person" is broadly defined for that purpose since it can be, *inter alia*, a foreign individual with whom the French corporation has deposited funds, a trust or other association. On the other hand, it is not clear whether the term applies to a foreign establishment or a branch.
8. For the first fiscal year ending on or after 1 November 1992, however, it is provided that this difference is to be determined on the basis of the liquidation value as of 1 July 1992, unless the liquidation value after that date has varied in an opposite direction to the difference determined before that date. In this latter case, the difference is determined on the basis of the entire fiscal year.
9. Its scope has been further extended to debt instruments or debt instruments providing for capitalization which are non-negotiable.

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- it must exceed 10 percent of the acquisition price of the debt instrument or of the right; and
- it must relate either to a debt instrument whose average issue price does not exceed 90 percent of its reimbursement value, or to a right arising from the stripping of the debt.[10]

In such case, the holder of the debt instrument or of the right is taxed annually on an accrued fraction of the premium (and on the contractual interest, if any).

The principal interest of this new section is the manner this fraction is determined. Indeed, it is determined by applying to the acquisition price the effective interest rate at the time of acquisition of the debt. For the following years, the acquisition price is then grossed up by the fraction of the premium already taxed and of the interest capitalized on the anniversary date of the debt instrument or of the right. As a result, the present value of the debt instrument is now annually taken into account in the taxable fraction. Thus, the annual taxable amount is not linear but progressively increases over the entire term of the debt.

The 1993 Finance Law sets forth some rules for the deductibility of the reimbursement premium and, thereby, achieves some symmetry between taxation and deductibility. Indeed, under new Section 39-1º ter of the French Tax Code, the deductible amount of the premium is also determined on the basis of an annual fraction computed in the same manner as for the taxation of the holder of the debt instrument.

The definition of reimbursement premium for deductibility purposes is, however, more vague than its counterpart for taxation purposes and may lead to a more extensive application of the rules of Section 39-1º ter.[11] In this sense, Section 39-1º ter does not use the terms "reimbursement premium", presumably to avoid any confusion with the definition of reimbursement premium for purposes of its taxation. The annual amount of the deductible fraction should otherwise be determined in the same manner as described above. Thus, its amount increases progressively over the term of the debt rather than being deductible on a straight-line basis.

C. *Transfer of assets outside France*

The Technical Correction Law for 1992 contains a provision that was part of a failed project to introduce a comprehensive regime of trusts under French domestic law. Under this new provision, French corporations which transfer assets (cash, securities, debts etc.) to a third party outside France, either to be administered for the profit of the French corporation or to undertake an existing or future obligation, are taxed on the resulting investment income.

The provision is not intended to apply, however, to transactions such as loans, service arrangements or contributions of assets.[12] In practice, two financial transactions, defeasance and repackaged TSDI ("Titres Subordonnés à Durée Indéterminée"), seem to be particularly affected by this provision. Indeed, in a defeasance transaction, the corporation transfers some assets to a third party for purposes of assuming the payment of the principal and interests on a debt incurred by the transferring corporation. Repackaged TSDIs involve the issuance of so-called "perpetual bonds" where part of the issuance price is immediately transferred to a foreign tax-exempt vehicle, which repays the principal of the bond at the end of a 15-year period using zero coupons that mature free of tax.

If the transfer satisfies the above criteria, the transferring corporation must include in its taxable income the income derived from the administration or disposition of the transferred assets or of the assets acquired in replacement. The transferring corporation is, however, entitled to deduct the foreign taxes from the French corporation tax provided that these foreign taxes are similar to the French corporation tax. Thus, foreign withholding taxes, if any, imposed on such income are not, in principle, creditable.

The transferring corporation must determine its investment income from such transfers separately. The resulting income is taxed in the same basket as the transferring corporation's other income, however, and thus can be used to offset net operating losses.

Finally, specific recordkeeping obligations and penalties are provided.

These rules are effective for fiscal years starting on or after 1 January 1992, regardless of the date of the transfer. Thus, they may apply to transfers that have already been made.

IV. UPDATE ON THE FRANCE/US TAX TREATY

The last modifications to the France/US income tax treaty and to the estate and gift tax treaty were made in 1988 and 1980, respectively. Since 1988, however, these two treaties have been the centre of renegotiation between the two parties to take account of the 1986 US Tax Reform Act. It now appears that a document should be definitely be adopted sometime in 1993.

With respect to the income tax treaty, it should bring modifications, among others, to the "Limitation on Benefits" provision, and includes within its scope pension funds and real estate mortgage investment conduits ("REMICS"). With respect to the estate and gift tax treaty, a provision allowing the marital deduction to a non-US surviving or donee spouse remains an issue.

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10. If one of these conditions is not satisfied, the reimbursement premium will be taxed fully at maturity.
11. Sec. 39-1º ter provides that "with respect to debts issued on or after 1 January 1993 the fraction, accrued during the fiscal year, of the remuneration which equals the difference between the sums or consideration to be reimbursed, other than interests, and the sums or consideration received upon issuance, when this remuneration exceeds 10% of the sums initially at the disposal of the borrower" can be deducted from the gross income of the borrower.
12. Transfers resulting from insurance contracts or from agency contracts are also excluded.

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NETHERLANDS:

INCOME TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISORS

Paul H. Sleurink

Contents

I. Implementation of the Parent-Subsidiary Directive into Dutch Tax Law
- A. General
- B. Participation exemption
- C. Exemption of dividend withholding tax
- D. Tax planning opportunities

II. Implementation of the Mergers Directive into Dutch Tax Law
- A. Introduction
- B. Current Dutch law
- C. Implementation of the provisions of the mergers directive

III. Proposed Interest and Royalty Directive
- A. General
- B. Corporate income tax on interest and royalties

IV. Proposed Directive on Losses of PEs and Subsidiaries
- A. General
- B. The meaning of the term "enterprise" under Dutch tax law
- C. The taking into account of losses of PEs
- D. The taking into account of losses of subsidiaries

V. Information Note on the Fiscal Climate in the Netherlands
- A. General
- B. Object
- C. Eligible fiscal measures
- D. Continuing international tax policy aspects

VI. The 35 Percent Concession per 1 September 1992
- A. General
- B. Conditions
- C. Decisive circumstances
- D. Special situations
- E. Determination of taxable employment income
- F. Exempt 35 percent compensation
- G. School fees
- H. Pensionable base
- I. 35 percent concession and employee insurance contributions
- J. Resident tax liability or non-resident tax liability?
- K. Employee qualified as a non-resident of the Netherlands has status of non-resident taxpayer
- L. Tax rates

VII. Miscellaneous
- A. Supreme Court ruling on different withholding tax in case of dual resident company
- B. Revision of the internal reorganization exemption regarding Dutch capital duty

I. IMPLEMENTATION OF THE PARENT-SUBSIDIARY DIRECTIVE INTO DUTCH TAX LAW

A. *General*

On 3 October 1991 the bill for the implementation of the parent-subsidiary directive (the "directive") was submitted to the Dutch Parliament. The law was passed in September 1992, almost a year later, the delay of almost a year being due to extensive technical discussions in both Chambers of Parliament. The Under-Secretary of Finance instructed the tax inspectors to apply the proposed legislation between 1 January and 8 September 1992 (being the date of approval by the Senate) in order to comply with the directive as of January 1992. The main characteristics of the implementation of the directive are discussed below.

B. *Participation exemption*

1. Before implementation

In general, four requirements must be met for the exemption to apply to a participation in a non-resident company:

- The participation must amount to at least 5 percent of the nominal paid up capital of the subsidiary company. Under very specific circumstances, a smaller participation may also qualify.
- The shares may not be held as inventory. This requirement is intended to deny application of the participation exemption in situations in which the ownership of shares is motivated not so much by a desire to participate in an enterprise owned by a company, but as a financial services business. This requirement is specifically designed to deny Dutch banks the benefit of the exemption for the profits (the discount and mark-up) which they earn on trading in "cash" companies. The Under-Secretary of Finance has indicated that this requirement

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would apply only if a company does not have assets other than mere liquidities and/or portfolio investments.
- The non-resident company must be subject to a tax imposed, at the federal level, on its profits by any sovereign state in which the company is resident.
- The participation may not be held as a portfolio investment. Generally, this means that the Dutch entity must have a business interest for the investment in the foreign subsidiary. The Under-Secretary of Finance indicated in a 1974 Resolution that shares are not held as a portfolio investment if:
  - the foreign subsidiary is itself not a passive investment company; and
  - the holding company performs an "essential function" to the group as a holding company. This is the case if either the holding company is involved in the management, policy making, etc. of the subsidiary, or if there is a connection between the business activities of the foreign subsidiary and the ultimate parent shareholder.

2. After implementation

The amendments made to the provisions of the participation exemption due to implementation of the parent-subsidiary directive are relatively small. Generally speaking, the existing participation exemption is in line with the directive. The amendments made to the participation exemption as a result of the directive follow.

The non-portfolio investment test has been abolished but only in situations which are directly covered by the directive, i.e. 25 percent or more EC resident subsidiary companies. Moreover, a "portfolio subsidiary" may not be subject to a "special tax regime". Although the directive only addresses distributions of profits, the abolition by the Netherlands of the non-portfolio investment test (in situations covered by the directive) has been extended to capital gains.

In addition to the 5 percent minimum participation requirement a 25 percent voting power test has been introduced in case the participation is less than 5 percent of the share capital of the subsidiary. This extension of the participation exemption applies only to subsidiaries resident in the United Kingdom, Ireland and, temporarily, in Germany. The Dutch treaties with the United Kingdom and Ireland apply the voting rights criterion for the reduced (5 percent) withholding tax rate on dividends. These treaties are seen by the Netherlands as referred to in Article 3, paragraph 2 of the directive. With regards to Germany, application of the voting rights criterion is under discussion because the tax treaty with Germany applies a voting "stock" rather than a voting "rights" criterion.

3. Specific issues

(a) *Anti-abuse provisions in Dutch participation exemption legislation*

In 1990, additional provisions were introduced to the Dutch Corporate Income Tax Act ("CITA") limiting application of the participation exemption in areas where tax strategies had been developed that caused unintended tax advantages for taxpayers. As a result of these provisions, the participation exemption requires the recognition of taxable income upon certain transfers of parent-subsidiary loans with respect to which a parent corporation has previously taken a bad debt deduction. Additionally, the participation exemption does not apply to certain income from an (otherwise qualifying) participation if the enterprise of such participation has previously been conducted in the form of a permanent establishment (PE) and losses of such PE have decreased Dutch taxable income. Finally, the possibility to deduct losses from the liquidation of a participation has been limited under the amended participation exemption, especially if the shareholder's interest in the foreign company is less than 25 percent, the participation is continued by the taxpayer or a party related to it, or a possibility to compensate losses from the enterprise of the participation exists after the liquidation. In situations covered by the directive, these anti-abuse provisions will continue to be applied by the Dutch authorities on the basis of Article 1, paragraph 2 of the directive. This paragraph is also the basis for the continued exclusion from the participation exemption for benefits derived from shares held as "inventory".

A question arises about the "special tax regime test" that has been introduced with respect to EC subsidiaries that do not meet the non-portfolio investment test. According to the legislative history of the act, a "special tax regime" is a regime employing a reduced rate of profit tax and also a regime under which the subsidiary company computes its taxable income using a special, favourable method (e.g. in cost plus systems). The directive requires only that a subsidiary must be subject to tax on its profits as mentioned in the directive, without an option of being exempt. The directive does not seem to allow any further condition of a substantive nature, such as conditions regarding a minimum tax rate or a certain tax regime. The "special tax regime test" therefore seems available for successful challenge.

(b) *Minimum holding period*

Until April 1990, the participation exemption provision required that a parent company should own a participation as of the beginning of its taxable year. This requirement, which was originally intended to prevent certain dividend stripping transactions involving participations, had lost its purpose and was deleted when several other above-mentioned anti-abuse amendments were implemented. Although the directive permits member states to introduce a maximum holding period of two years, the Netherlands has not made use of this possibility to reintroduce a minimum holding period for the participation exemption. For the minimum holding period required for the exemption of dividend withholding tax see below.

(c) *Tax haven and CFC legislation*

The Netherlands does not apply tax haven or CFC legislation.[1] The Ministry of Finance is studying the introduction of

1. However, if a Dutch corporation has an interest of at least 25 percent in a non-resident corporation, the assets of which consist at least for 90 percent of portfolio investments, the Netherlands corporation will be taxed annually, in its proportionate share of the increase in the net asset value of his participation, regardless of whether any profits have been distributed. Obviously, if this foreign subsidiary is a qualifying resident of an EC member state, the participation exemption will, in most cases, exempt this deemed benefit derived from the foreign corporation from the Netherlands corporation tax.

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anti-tax haven legislation in the Netherlands, but it is unlikely that such legislation will be introduced in the foreseeable future.

(d) *Compartmentalization*

Under discussion is the application of the "compartmentalization doctrine" on distributions of profits that fall within the scope of the directive. This doctrine prescribes that benefits derived from a participation be allocated, whenever appropriate, between periods in which the participation exemption did and did not apply, and then be taxed accordingly. Application of this doctrine means that profits realized before 1992 and distributed after this year would not be exempt. The Under-Secretary of Finance has indicated that this doctrine will be applied with respect to capital gains on shares even if, as a result of the implementation of the directive, the participation exemption applies.

Costs relating to a participation, such as financing and management costs, continue to be non-deductible for Dutch corporate tax purposes unless it is demonstrated that these costs are indirectly subservient to the realization of profits taxable in the Netherlands. Currency gains and losses on loans taken up by the parent company to finance the acquisition (or increase of capital) of the participation are fully taxed in the Netherlands.

C. *Exemption of dividend withholding tax*

Under the Dividend Tax Act 1965 ("DTA") all payments of dividends, payments on profit certificates and certain other payments such as interest on participating bonds, are subject to Dutch dividend withholding tax at a rate of 25 percent.

Tax treaties concluded by the Netherlands reduce the 25 percent rate. The Netherlands has tax treaties in force with all EC member states except Portugal. In several Dutch treaties a zero percent rate is applied for corporate shareholdings owning 25 percent or more of the shares of a Dutch company. Such rate is included (under certain conditions) in the treaties with Czechoslovakia, Denmark, Finland, Ireland, Italy, Malaysia, Norway, Poland, Singapore, Sweden, Switzerland and Venezuela. Due to the implementation of the directive a full exemption of dividend withholding tax will also be applied on dividend payments to parent companies resident in EC member states.

Article 4A DTA provides an exemption of dividend withholding tax in directive situations.

Full exemption of dividend withholding tax is granted if the following requirements are met:

- the parent company and the subsidiary company are organized as one of the entities mentioned in the annex to the directive;
- the parent company is resident in a different member state; the criterion is whether, according to the fiscal laws of a member state, the company is resident there; furthermore, the EC parent and the Dutch subsidiary are not considered as having a (dual) residence outside the EC under a tax treaty between a member state and a non-EC country;
- the parent company and the subsidiary company are subject to tax in the respective country of residence without being exempt or having the option of being exempt of a tax on its profits as mentioned in Article 2C of the directive;
- an anti-abuse provision in the tax treaty between the Netherlands and the country of residence of the parent company does not prevent the parent company from claiming a reduction of tax on dividends;
- the parent company has owned shares representing 25 percent or more of the subsidiary's nominal share capital at the time the profits are made available by the subsidiary, for an uninterrupted period of one year. During this one year period, the exemption can nevertheless be applied if the Dutch subsidiary provides the Collector of Taxes with sufficient collateral (e.g. a bank guarantee) for the amount of the tax that would otherwise be due. If, during this one year period, the parent company's interest in the Dutch subsidiary falls below 25 percent, the dividend withholding tax becomes due. The Collector of Taxes can decide whether the security offered by the Dutch subsidiary is sufficient. Costs involved in providing this security to the Collector are for the account of the Dutch subsidiary.

If the parent company is a resident of a member state with which the Netherlands has concluded a tax treaty that contains a voting power test for the reduction of the dividend withholding tax, the criterion for full exemption of DTA is 25 percent or more of the voting power (regardless of whether the shares are owned by the parent company) in the Dutch subsidiary, rather than 25 percent or more of its nominal share capital. The voting power criterion apples in any case to the United Kingdom and Ireland. The Under-Secretary has declared that he is not certain whether the treaties with Germany and the new treaty with Italy (which is not yet in force) qualify in this respect. Pending discussions with both countries, he has agreed that, if the parent company is resident in Germany, either of the criteria may be applied. After the Italy treaty comes into force, this will also be the case with parent companies resident in Italy.

- the Dutch subsidiary notifies the Dutch tax authorities of the payment within one month after the dividend is made available, provides data on the parent company and confirms that the parent company fulfils the above criteria. (While it is not absolutely certain that this notification is mandatory, it is highly recommended to avoid problems.)

If any of these conditions have not been fulfilled, the normal rules in the applicable tax treaty apply.

D. *Tax planning opportunities*

Regarding Dutch parent companies, the most important result of implementing the directive into domestic law is that the participation exemption will be available in specific situations where the shares in an EC subsidiary are held as a portfolio investment as well as in situations where the shareholding is less than 5 percent of the subsidiary's capital, but represents 25 percent or more of the voting rights.

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Additionally, the group may be applying a debt-to-equity ratio in excess of 85/15 at the level of its Dutch holding, which is the maximum ratio stipulated in a participation exemption ruling. As a consequence of the directive, the necessity to obtain advance tax rulings from Dutch tax authorities to ascertain whether the participation exemption will apply will be reduced. However, an advance ruling may continue to be recommended with respect to non-EC participations. Generally, however, the participation exemption will remain unchanged. Existing Dutch provisions go beyond the minimum requirements of the directive, especially in that capital gains are also included in the participation exemption and a 5 percent shareholding (instead of 25 percent) may be sufficient to benefit from this exemption. The Netherlands therefore remains a good location for a holding company for both EC-based and non-EC based groups.

II. IMPLEMENTATION OF THE MERGERS DIRECTIVE INTO DUTCH TAX LAW

A. *Introduction*

The merger directive was implemented in Netherlands tax law by the law of 25 September 1992, with retroactive effect to 1 January 1992.

B. *Pre-directive Dutch law*

The law already provided exemptions for domestic share mergers and transfers of assets and liabilities. In this respect, a distinction should be made between non-entrepreneurial individuals on the one hand, and entrepreneurs/individuals and corporate taxpayers on the other hand.

1. Individual shareholders

Capital gains realized by individuals on shares in a company are in principle not subject to income tax. However, Netherlands resident individuals owning a "substantial interest" in a corporation are taxed on the capital gains that they realize on the alienation of their shares of such company. A substantial interest is present if the taxpayer owns or owned during the five years preceding the alienation, directly or indirectly, alone or together with family members in the first or second degree, at least one-third of the nominal paid up share capital of a company, and alone or together with the spouse, at least 7 percent of the nominal paid up share capital. Specific provisions address situations whereby special classes of shares are created to avoid the application of the substantial interest rules. Also, non-residents owning a substantial interest in a Netherlands resident company are subject to Dutch income tax on any capital gain realized (note, however, that tax treaties often prevent the Netherlands from taxing capital gains on shares in the hands of non-residents).

The 1964 Income Tax Act ("ITA") provides for an exemption if the shares forming part of a substantial interest are alienated in the course of a qualifying share merger.

2. Entrepreneurs and corporate taxpayers

Corporate taxpayers and individuals holding shares as part of their enterprise are, in principle, subject to tax on capital gains realized from the alienation of shares. However, it is possible for these categories of taxpayers to obtain an exemption or a rollover of the capital gain realized in connection with an alienation of shares, either on the basis of the participation exemption (corporate taxpayers) or on the basis of the replacement reserve or rollover provisions. Finally, it is possible under certain conditions to contribute a full enterprise, or an independent part of an enterprise, to a company in exchange for shares free of (corporate) income tax.

C. *Implementation of the provisions of the mergers directive*

1. Exchange of shares

ITA Article 40 provided for a rollover of the capital gain realized by an individual taxpayer who contributes shares that are part of a substantial interest to a Netherlands resident company in exchange for shares of the latter company. As a result of the implementation of the directive, Article 40 is replaced by Article 14B, which provides a new definition of the transactions that qualify as an exchange of shares for tax purposes. In fact, the scope of the current share exchange facility is extended to cover the situations prescribed in the directive. Furthermore, the range of taxpayers that can make use of the exchange of shares facility has been extended. Apart from individual taxpayers, corporate taxpayers (and individual taxpayers for which the shares are allocated to an enterprise) can also request application of the new exchange of share facility.

Article 14B distinguishes between three types of exchanges of shares (hereinafter "share merger"):

(a) the share merger whereby a company of one member state acquires shares in the capital of a company resident in another member state such that it obtains a majority of voting power in the latter company in exchange for shares in its own capital;
(b) a similar share merger involving two companies that are both resident in the Netherlands;
(c) a share merger whereby a Netherlands resident company acquires shares in the capital of a company resident *outside* the EC such that it obtains at least 90 percent of the voting power in the latter company, in exchange for shares.

Only the share merger mentioned under (a) is prescribed by the directive. The directive definition of a qualifying share merger does not include (i) a share merger between two companies resident in the same member state, (ii) nor does it provide for a share merger between a company resident in a member state and a company resident outside the EC. A company resident in a member state that is involved in a share merger as described under (a) above should meet the conditions set forth in Article 3 of the directive regarding the legal form of the company, the "residence for tax purposes" and the "subject to tax" tests. These conditions of the directive have been taken over literally in ITA Article 14B, paragraph 2. In the course of a share merger a cash payment (or a payment in kind) of not more than 10 percent of the nominal value of the shares issued in exchange can be granted. Tax-

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payers may ask the competent tax inspector to confirm, in advance, that a transaction qualifies under the law as a share merger. This request is optional and does not constitute a condition for applicability of the share merger facility.

The Proposal introduces the new voting right criterion prescribed by the directive for the determination of whether a transaction qualifies as a share merger. Preferential and priority shares must be taken into account as ordinary shares for this purpose. (Structural) voting agreements must also be taken into account for the determination of whether or not a company acquired a majority of the voting rights of another company.

One of the conditions that is imposed on the share merger is that the enterprises of the companies involved in the share merger should carry on material enterprises and that these enterprises must be structurally united both financially and economically. The introduction of this condition, which cannot be found in the directive, is defended on the basis of the anti-abuse provision of the directive (Article 11). If this condition is not met (which will be often the case), it is possible to request a dispensation from the tax inspector. According to the Commentary to the Proposal, dispensation can only be refused if the share merger is used for "constructions" that are aimed at tax fraud or tax avoidance. An unfavourable decision of the tax inspector on a request for dispensation can be appealed. Special rules apply for share mergers involving a Netherlands resident company with a "fiscal investment institution status". A "fiscal investment institution", which is not considered to carry on a material enterprise, can under certain circumstances be a party to a qualifying share merger.

Exemptions obtained by individual shareholders in the course of a share merger, whereby the shares of a Netherlands resident company are exchanged for shares in a company resident in another member state, are withdrawn if the individual shareholder emigrates within five years after the share merger took place. An automatic extension of payment of the tax thus payable will be granted for as long as the shareholder does not alienate the shares that he received in exchange. The shareholder's liability for the tax will be discharged if he still owns the shares five years after the share merger. A non-resident shareholder with a substantial interest in a Dutch company cannot make use of the share merger facility if his shares are exchanged in the course of a share merger for shares of a company of another member state. Since the Dutch legislature understands that this denial of the share merger facility is not in conformity with the directive, the tax payable on the capital gain realized is not collected (extension of payment) provided the non-resident shareholder owns the shares that he received in exchange for a period of at least five years after the date of the share merger.

2. Transfer of assets and liabilities (business merger)

Article 14 of the 1969 Corporate Income Tax Act ("CITA") provides for a rollover of the profit realized by a corporate taxpayer from the contribution of an entire enterprise or an independent part of an enterprise to another company in exchange for shares. The directive has caused an amendment of the rules of this provision to facilitate transfer of assets as provided therein.

According to the Commentary to the amendments, the range of taxpayers that can make use of the existing facility of CITA Article 14 is already broad enough to include the situations covered by the directive. Under current law, a Dutch company contributing an enterprise or an independent part of an enterprise to a foreign company may already benefit from the rollover provision so long as the foreign receiving company maintains a Dutch PE to which the assets and liabilities contributed are allocated. Please note that the facility of CITA Article 14 is not limited to contributions made to companies resident in other member states. Contributions to companies resident outside the EC can benefit from the rollover provision as well.

Under CITA Article 14, paragraph 1 profit realized as a result of the transfer of an enterprise or an independent part of an enterprise is tax exempt as long as the claim of the tax authorities on such profit is preserved. If, in the case of assets transferred by a Dutch company to a foreign resident company, all assets transferred cannot be allocated to a Dutch PE, it is possible that the rollover provision will only be applied to the assets and liabilities that are allocated to a Dutch PE. Fiscal reserves and the repayment obligation for investment premiums can also be rolled over.

According to CITA Article 14, the transaction should consist of the contribution of "an enterprise or an independent part of an enterprise" in exchange for shares of the company to which the contribution has been made. According to the legislative history, the meaning of the requirement coincides materially with the phrase "all or one or more branches of activity" used in the directive.

Application of Article 14 is subject to various additional conditions.

3. Contribution of PE

Article 10 of the directive forbids the member state of the transferring company from taxing the profit realized on the contribution of the assets and liabilities that belong to a PE in another member state. However, the member state of the transferring company can reintegrate the PE's losses deducted in the past from that company's worldwide profit.

If a Netherlands resident company contributes a PE resident in another member state to a company resident in the other member state or in a third member state, CITA Article 14 (business merger) does not apply since the occasion of the transfer of the PE presents the last opportunity for the Netherlands to tax the (hidden) reserves of the PE. In the Parliamentary proceedings, the Under-Secretary of Finance noted that in his view the incorporation of a foreign PE of a Netherlands resident company is not covered by Article 10 of the directive. However, he stated that this issue lacks importance since the Netherlands will apply a facility for the avoidance of double taxation to the profits realized on the transfer of the PE to a local company, either on the basis of a tax treaty or on the basis of unilateral rules for the avoidance of double taxation. The exemption requirements set forth in Article 10 of

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the directive are considered fulfilled by this provision for the relief from double taxation. Under certain circumstances, however, the method of calculation of the relief for double taxation will not result in the exemption of all of the profit that is realized on the transfer of the assets and liabilities that belong to the PE. This is especially the case where assets have been transferred from the company's Dutch head office to the foreign PE.

The recapture of PE losses deducted from the worldwide profit of the transferring company permitted under Article 10, paragraph 2 of the directive is not taken up in the amendments. Corporate income tax law already contains a provision that brings about the same material result through a partial denial of the application of the participation exemption to a participation in the company to which the assets and liabilities of a PE have been contributed. The benefits of the participation exemption are withheld in proportion to the amount of PE losses that have been deducted against the worldwide profit of the transferring company in the past.

4. Intra-community legal mergers and divisions

In view of the absence of legislation regarding legal mergers or divisions between companies resident in different member states, the Proposal contains only a framework provision dealing with the tax consequences of such legal mergers and divisions. This provision states that the competent tax authorities can, under certain conditions, exempt the profit realized from an intra-Community legal merger and/or divisions from income and corporate income tax.

5. Anti-abuse provisions

Many of the conditions imposed on the application of the share merger or the transfer of assets facilities are motivated by the general anti-abuse provision of the directive (Article 11, paragraph 1) allowing member states to refuse application of the provisions of the directive if the main goal or one of the main goals of the transaction is tax fraud or tax evasion. These "anti-abuse conditions" can be summarized as follows:

- material enterprise condition;
- denial of share merger facility to emigrating shareholders and non-resident shareholders;
- refusal of business merger facility, if the acquiring company has tax losses, and the transferring and acquiring companies do not apply the same rules regarding the determination of taxable profit;
- three-year holding period for the shares received in exchange for the transfer of assets and liabilities; and
- exclusion of fiscal investment institutions that do not possess a special licence from the directive's tax facilities.

The question of whether or not these provisions exceed the scope of the general anti-abuse provision of the directive remains unanswered. Note, however, that under additional conditions to be imposed by the tax inspector, dispensation can be granted for most of these requirements.

6. Tax planning opportunities

The implementation of the mergers directive into Dutch law will increase the possibilities of groups to reorganize their EC companies free of tax, in order to achieve a more tax efficient group structure. The facilities provided for in the implementing legislation can be used, for example, to create a Dutch (sub)holding company.

III. PROPOSED INTEREST AND ROYALTY DIRECTIVE

A. *General*

The proposed interest and royalty directive does not have a great impact on Dutch taxation because the Netherlands does not impose a withholding tax on interest and royalty payments. Foreign corporations are, however, in a small number of cases liable to Netherlands corporate income tax as non-residents for cross-border interest and royalty payments.

B. *Corporate income tax on interest and royalties*

1. Profit-sharing interest and royalty payments

Non-resident corporations that do not carry on an enterprise and that have a substantial interest in a Dutch company are liable for corporate income tax in the Netherlands if the Dutch company pays interest to this non-resident corporation. A substantial interest is present if the foreign corporation owns or owned during the last five years directly or indirectly at least one-third of the nominal paid up share capital of the Dutch company. In the tax treaties with the United Kingdom, Italy, Ireland, Germany and Denmark the Netherlands is not allowed to levy this tax. In my opinion the scope of the interest and royalty directive should be extended to corporate income taxes in these cases, since the scope of the directive should not be limited to withholding taxes.

2. Payments received by a non-EC PE

If a non-EC PE receives interest payments between EC member state companies, these payments should fall within the scope of the directive if these payments are normally taxed in the non-EC-country. Since the Netherlands does not levy a withholding tax on interest and royalty payments, such a scope would not have an impact on Dutch taxation.

IV. PROPOSED DIRECTIVE ON LOSSES OF PES AND SUBSIDIARIES

A. *General*

If the "Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their PEs and subsidiaries situated in other member states" (hereinafter "directive") is adopted, the Netherlands will have to make some major changes in its domestic legislation in order to allow losses of foreign subsidiaries to be taken into account in accordance with the provisions of the directive. With respect to PEs, it can be expected that the Netherlands will select the "method of deducting losses and reincorporating subsequent profits" set forth in Article 7 of the directive (hereinafter "reincorporation method"). In that case, the directive will have relatively little impact on Dutch tax law.

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B. *The meaning of the term "enterprise" under Dutch tax law*

It appears that an individual or corporate taxpayer must carry on an enterprise in order to fall within the provisions of the directive. The term "enterprise" is not defined in the directive. It can therefore be expected that the Netherlands will take the position that the term "enterprise" as used in the directive must be interpreted according to Dutch tax law. The term "enterprise" is not defined in Dutch statutes or regulations. Consequently, it is left to the Dutch courts to define the term. A general definition which can be derived from case law reads as follows: "An organization of capital and labour aimed at participating in the social production process with the purpose of generating profits." Furthermore, there should be a reasonable expectation that profits will arise. Independent professional services normally constitute an enterprise. Passive investment activities do not constitute an enterprise. Such activities may be defined as activities of a passive nature performed with respect to portfolio investments with the purpose of obtaining revenue or gain which can be expected not to exceed the return on normally managed portfolio investments.

C. *The taking into account of losses of PEs*

As mentioned above, it can be expected that the Netherlands will choose the reincorporation method if the directive is adopted. This method is to a large extent similar to the method of (proportional) tax exemption (hereinafter "exemption method") applied in the Netherlands with respect to the results of foreign PEs. The exemption method is applied on the basis of the tax treaties concluded by the Netherlands, or its domestic arrangement for the avoidance of double taxation. The Netherlands has concluded tax treaties with all countries of the EC except Portugal. Pursuant to the exemption method, the results (positive or negative) of foreign PEs form part of the worldwide income of a resident taxpayer. If the activities carried on through foreign PEs result in profits, a reduction of the Dutch taxation which relates to the profits of such PEs is granted (hereinafter "foreign profits"). However, it is stipulated that foreign losses reduce the amount of foreign profits to be exempted in the eight years following the year in which the foreign loss became deductible. It can be argued that this eight-year period is in conflict with the "incorporation rule" contained in Article 7(1)(b) of the directive pursuant to which foreign profits are to be included in the taxable results of the head office to the extent of losses previously (without limitation) deducted. The above-mentioned eight-year period is in line with domestic arrangements for the carry-over of losses. The Commission has "linked" the adoption of the directive to its 1984 proposal pursuant to which a loss can be offset against the profits of the three preceding years and/or against subsequent profits (without limitation). This is in the interest of Dutch taxpayers. The 1984 proposal improves the position of Dutch taxpayers, whereas an unlimited incorporation period on the basis of the directive will have a negative impact on the position of Dutch taxpayers.

The meaning of the term "PE" in the different tax treaties concluded by the Netherlands and in domestic tax law is normally in line with the meaning of this term in the 1977 OECD model treaty. The explanatory memorandum to the directive mentions that the definition of a "PE" in the directive is modelled on that of Article 5 of the OECD model treaty. However, no provisions are included in the directive with respect to permanent representatives, construction projects, the maintenance of a fixed place for the purpose of carrying on preparatory or auxiliary activities, etc. The exact meaning of the term "PE" in the context of the directive is therefore unclear.

The profits of a PE are determined in accordance with the rules of Dutch law unless a treaty provides otherwise. It seems inconceivable that the Netherlands would accept the rule contained in Article 7(2) of the directive pursuant to which the losses and subsequent profits of PEs must be determined "in accordance with the rules of law of the member state in which the PE is situated".

If a resident taxpayer has several PEs through which both profits and losses are derived, the effect of the exemption method will depend on whether the "per country" or "overall" method is applied. In the first case, foreign losses are deducted from taxable income, regardless of any other foreign income. In the second case, foreign losses are first compensated with exempt foreign profits. An effective tax deduction is only allowed to the extent foreign losses exceed foreign profits. Pursuant to tax treaties concluded with EC countries, the per country method should be applied with respect to Italy (1957 treaty), Denmark, Germany, Luxembourg, Ireland, Belgium, Spain and France. The tax treaties with Italy (1990 treaty), the United Kingdom and Greece provide for the overall method. Pursuant to domestic tax law, the overall method should be applied to Greece. It follows from the above that from a Dutch perspective it is very important that the directive explicitly state that the results of PEs must be determined on a per country basis.

Dutch tax law contains no provisions regarding "automatic reincorporation" as described in Article 8 of the directive. If these provisions are written into domestic tax law, they would have a substantial negative impact on the position of Dutch taxpayers.

Losses of foreign enterprises are normally allocated to the individual or legal entity carrying on the relevant enterprise. This is not the case if an entity is regarded as tax transparent (e.g. certain partnerships), or if a fiscal unity is formed for corporate income tax purposes (pursuant to CITA Article 15, a fiscal unity can be formed between a Dutch parent company and its Dutch subsidiary). After the formation of a fiscal unity, all assets and liabilities (including those attributable to a PE) and all profits and losses (including those derived through a PE) are directly allocated to the parent company. A fiscal unity can only be formed between corporate taxpayers incorporated under Dutch law.

It can be expected that the Netherlands will not change the allocation rules set forth above if the directive is adopted.

D. *The taking into account of losses of subsidiaries*

Under Dutch tax law, an individual or corporate entity cannot directly take into account any losses incurred by a company

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in which it has a shareholding of 75 percent or more. In some instances, however, a structural decrease in value of a subsidiary can lead to a revaluation of the shareholding which is tax deductible. For corporate income tax purposes, however, such revaluations can normally not be taken into account by virtue of the participation exemption rules. Pursuant to these rules, income or capital gains derived from qualifying participations are not taken into account when determining the taxable profit of a Dutch parent company. As an exception to these participation exemption rules, losses arising in connection with the liquidation of a subsidiary are tax deductible if certain (strict) conditions are fulfilled.

An exception to the general rule that losses of foreign subsidiaries cannot be taken into account by a Dutch parent company applies if a fiscal unity is formed between a Dutch parent company and its 100 percent Dutch subsidiary which is effectively managed from a foreign country. Under the fiscal unity regime, all assets and liabilities and all profits and losses of such a dual resident subsidiary are allocated directly to its Dutch parent company. As mentioned above, a fiscal unity can only be formed between corporate taxpayers incorporated under Dutch law. The above tax treatment can therefore only apply if the foreign subsidiary is incorporated under Dutch law.

1. Impact of the directive on Dutch tax law

The Netherlands would have to make some major changes to its domestic legislation in order to allow losses of foreign subsidiaries to be taken into account in accordance with the provisions of the directive. The proposed "one way" offset of losses will, however, not be very advantageous for the Dutch business community. In comparison with countries such as, e.g. Germany and France, the consumer market in the Netherlands is relatively small. Consequently, the taxable base of a Dutch parent company may not be sufficient to absorb foreign losses.

2. Alternatives

From a Dutch tax point of view, it would be best to have a European consolidation system. Such a system would, however, require far-reaching harmonization which for the moment is not likely to occur. An alternative might be a system in which losses are treated as transferable assets (the UK system). Another alternative may be a variant to the UK system whereby, pursuant to an international pooling arrangement, losses made within a European group are allocated to profitable companies within the group (in proportion to the profits made).[2]

V. INFORMATION NOTE ON THE FISCAL CLIMATE IN THE NETHERLANDS

A. *General*

On 6 October 1992, the Dutch Under-Secretary of Finance sent an information note to Parliament on the fiscal climate for enterprises in the Netherlands. The purpose of this note was to contribute to the present discussion on the possibilities of attracting foreign investment to the Netherlands and on the fiscal changes that could take place following this discussion. The following summarizes the note.

B. *Object*

The Netherlands has traditionally taken a leading position in establishing itself as a residence country. Current international developments require that the Netherlands should focus on lasting investments in respect of its international tax policy. Short-term fiscal measures do not fit into this policy. Measures have to be taken to increase the fiscal attractiveness of the Netherlands as a residence country. The object of eligible fiscal measures is to attract real investments that bring long-term employment and increase welfare, while maintaining the established stable fiscal climate. The Under-Secretary expects to present concrete changes in the near future – possibly this year.

C. *Eligible fiscal measures*

The Under-Secretary of Finance announced the following eligible fiscal measures.

1. Fiscal incentives to stimulate economically weak areas in the Netherlands

The purpose of this measure is to increase the rate of return on investments in these areas, which makes them more attractive for investors. Considered changes in these specific areas include accelerated depreciation allowances and a lower (or even a zero) corporate income tax rate.

One of the Under-Secretary's remarks is that it is doubtful whether such fiscal incentives are useful in improving the Dutch fiscal climate. Temporary fiscal accommodation will generally only attract enterprises seeking a fiscal profit, leaving when a more profitable situation occurs somewhere else. Further investigation on this point will follow.

2. Fiscal allowance provisions on the transfer of goodwill and know-how to a PE in the Netherlands

Such provision does exist for the transfer of these intangibles by a foreign parent to a Dutch subsidiary. There are no provisions for the transfer by a foreign head office to its PE in the Netherlands. At first glance, such a provision will increase depreciation allowances and as a consequence a lower corporate income tax will result, but there are some considerable disadvantages. Therefore, the Under-Secretary will not consider such measures as important business partners, such as the United States, Japan and the United Kingdom, use the credit method to grant relief for the profit of a PE. The unilateral implementation of an additional depreciation possibility will only shift the tax burden (instead of reducing it) from the Netherlands to the country where the head office is established.

3. Specific accelerated depreciation on fixed assets

The effect that such depreciation on certain specific investment categories or on fixed assets with a short life has on

[2] See "Loss compensation within the European Community", *Intertax* (October 1990).

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employment and investment will be examined. Specifically, such an incentive is considered for short life assets, such as fixed assets with a useful life of less than five years (e.g. computers, software and intangible assets).

4. *Change in the fiscal treatment of currency translation results*

The question has been raised whether the possibility should be created for a foreign parent with a Dutch subsidiary to calculate the result of the subsidiary in a functional currency. Another question is whether exchange results realized on loans the interest of which is not deductible should be excluded from corporation tax. In the current situation, the positive exchange results on these loans are included, whereas the exchange results on the participation itself are exempted.

5. The scope of the EC parent-subsidiary directive will be extended

A broader application of the parent-subsidiary directive will be aimed for in negotiating tax treaties. The scope of two criteria, i.e. the legal form of the company (NV/BV) and the 25 percent criterion, will be studied. Further, legislation to lower the threshold percentage of participation in order to expand the waiver of withholding tax (on the basis of reciprocity) might be proposed.

6. Extension of fiscal compensation of losses and introduction of unlimited carry-forward of losses

Even though the Netherlands already has a broad system of compensation of losses, the extension of loss carry-forward could be examined, possibly an indefinite carry-forward. However, a "trade" in losses should not be the result of the change. The possibility of transferring losses within a group which does not form a fiscal unity is also being examined.

7. Implementation of the per-country method for losses of a foreign PE

The present policy is aimed at using the overall method in tax treaties. Because the per-country method, i.e. no set-off of profits and losses from PEs from different countries, could be more profitable due to a resulting higher exemption credit, a change in policy could be considered.

8. A provision to take into account non-creditable withholding tax on participation dividends

Under the participation exemption, Dutch corporations are exempt from Dutch corporate income with respect to dividends received and capital gains (including currency exchange gains) realized on the alienation of a qualifying shareholding. The exemption applies not only to domestic but also to foreign subsidiaries. In the latter situation, foreign dividend withholding tax cannot be credited against Dutch corporate income tax. This is considered an undesirable burden, especially if one would add the fact that the Netherlands imposes a withholding tax on further distribution of such income.

The Under-Secretary wants to examine whether this problem could be reduced by allowing the taxpayer to (partly) credit the foreign-source tax against the Dutch dividend withholding tax.

9. A permanent office for potential foreign investors will be added to the Dutch Revenue Department

Because an entrepreneur requires the cooperation of the Revenue Department in setting up his business, it is important that the Department is well organized and properly functioning. Measures will be taken to ensure that the advance ruling team of the Large Enterprise Department of the Rotterdam Tax District Office will be able to deal faster with advance ruling requests, specifically in situations that deal with real Dutch economic interests.

10. In the announced proposals on the 35 percent resolution, the deemed foreign tax liability, awaiting further determination, will be maintained

This means that foreign-source income from net wealth of temporarily resident foreign employees will not be subject to Dutch income tax. A regulation is being studied which will take into consideration only those items that are being transferred to the Netherlands (remittance base).

D. *Continuing international tax policy aspects*

The Dutch capital duty (1 percent) can be a heavy burden in setting up new corporations, but abolition is not being considered for budgetary reasons. On the part of the corporate income tax rate and tax base, the Netherlands runs a fairly middle course compared to the surrounding countries. In view of the future common EC tax policy, no significant changes are being considered. The "classical system", which causes profits to be subject to double taxation, once at the corporate level and once at the shareholder level when distributed, will remain unchanged.

Dutch tax treaty policy is aimed at reducing the withholding tax on dividends to zero percent in case of a qualifying shareholding. The reason for this strong position relates to the above-mentioned participation exemption system, which currently prescribes a disallowance for crediting the foreign dividend withholding tax. The Under-Secretary wants to maintain this position in treaty negotiations, but agrees not to be too rigid on this point.

The current method used in the Netherlands to avoid international double taxation is the exemption method. The exemption method remains basically unchanged, although certain elements of this method may be sharpened (see above).

VI. THE 35 PERCENT CONCESSION PER 1 SEPTEMBER 1992

A. *General*

The 35 percent concession is a tax facility for non-Dutch employees temporarily employed in the Netherlands, based

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on the directive of the State Secretary of Finance dated 4 June 1992. The facility allows an employer to provide the employee with a non-taxable compensation for special expenses with which the non-Dutch employee is deemed to incur in connection with his employment in the Netherlands.

B. *Conditions*

The 35 percent compensation facility is applicable in respect of employees coming to the Netherlands as of 1 September 1992 or those employees who qualify for the facility under the transitional regulations of the directive of 4 June 1992.

The concession is only available for employees.

The employment must be a real employment (no "deemed" employment such as employment through an employment agency). In addition, artists, sportsmen, members of a supervisory board, etc. are excluded.

The employee must come from outside the Netherlands, although an employee having Dutch nationality qualifies if he lived outside the Netherlands for more than eight years (see below).

The employee must reside or sojourn in the Netherlands and work in this country.

The employee must stay in the Netherlands on a temporary basis. "Temporary" is not defined, so in principle the period of sojourn in the Netherlands could exceed 96 months.

There must be a (Netherlands-established) withholding entity (company deducting from the salary and contributing wage withholding tax and national insurance contributions on a monthly basis on behalf of the employee.) If there is no withholding entity, the non-Dutch employer should be appointed as such.

The non-Dutch employee should be assigned or recruited by the Dutch employer because he has a specific expertise which is not available or is scarcely available on the Dutch labour market. In this respect, education, experience, qualification of the function and the net remuneration also play an important role.

The 35 percent concession can only be applied after the Revenue has, at the request of both employer and employee, granted approval. If a withholding entity must be appointed, the request for the 35 percent concession must be filed within four months after the start of the employment in the Netherlands.

The tax-free compensation (maximum 35 percent) of the basis for computation mentioned in paragraph 3.5 of the directive of 4 June 1992 must be granted separately (in the employment agreement or in an appendix thereto), and paid together with the salary. The Revenue attaches great importance to the simultaneous payment of both the salary and the 35 percent compensation!

In principle, the 35 percent concession is available for a period of 96 months from the start of the employment in the Netherlands. However, before the expiration of 48 months, an interim review must be initiated by both employer and employee.

The Dutch employer must demonstrate that the non-Dutch employee has to extend his stay in the Netherlands as a consequence of the permanent shortage of specific expertise on the Dutch labour market.

The period of 96 months is reduced by periods of earlier sojourn or employment in the Netherlands. However, if the date of departure from the Netherlands at the time is eight years or more before the start of the new employment in the Netherlands, the 96 month period will not be reduced.

The 35 percent concession is not available when the 35 percent deduction in accordance with the "Wet faciliteit voor de zeevaart" (facility for seafaring employees) applies. However, the "Nedeco-regeling" (35 percent deduction for expatriates assigned to specific areas of the world) is available (only for those employees under the 35 percent concession having the status of a resident taxpayer).

If the non-resident employee benefiting from the 35 percent concession starts to work for a new employer in the Netherlands, he can again qualify for the 35 percent concession (if, of course, the further requirements are satisfied) for the remaining months of the maximum period of 48 or 96 months. Both the new employer and the employee have to file a request in this respect.

C. *Decisive circumstances*

The circumstances at the start of the employment in the Netherlands are decisive with respect to the question whether the employee qualifies for the 35 percent concession. If the employee would satisfy the conditions at a later point in time, the circumstances at that later point in time will be decisive. In that situation, the period of 96 months will be reduced by the months during which the employee has already been in the Netherlands.

D. *Special situations*

If the benefits of the 4 June 1992 directive would be more beneficial, employees benefiting from the 35 percent concession under earlier directives may at any time choose that facility for the remaining months of the 96 months if all prerequisites of the 4 June 1992 directive are satisfied.

When the maximum period of 60 months under earlier directives has expired, employees benefiting from the 35 percent concession under such directives may apply for the benefits under the 4 June 1992 directive (for a period of 36 months). Where the maximum 60-month period has expired before 1 September 1992, employees who have benefited from the 35 percent concession under earlier directives but who are still in the Netherlands, may again apply for the 35 percent concession under the 4 June 1992 directive for the remaining months of the maximum 96-month period, counted as from the date of arrival in the Netherlands.

Employees who did not qualify for the 35 percent concession under earlier directives because the conditions of those direc-

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tives were not satisfied may apply for the 35 percent concession as of 1 September 1992 for the remaining months of the maximum period if the conditions of the 4 June 1992 directive are fulfilled.

In all of the above situations, the conditions of the 4 June 1992 directive must be satisfied. The circumstances at the time of arrival in the Netherlands are decisive. It is not yet clear how "temporary" will be interpreted in these situations.

E. *Determination of taxable employment income*

Taxable employment income is determined in accordance with the legal rules in the Wage Tax Act 1964. In addition to the tax-free 35 percent compensation, the employer can also provide other tax-free allowances, and the employee can deduct in his income tax return certain professional expenses.

F. *Exempt 35 percent compensation*

The non-taxable 35 percent compensation is determined, taking into account the basis for calculation set forth in paragraphs 3-5 of the directive. If the employee claims in his income tax return a deduction for the avoidance of double taxation in respect of employment income earned outside the Netherlands, a tax-free 35 percent compensation is not permitted in respect of this foreign income.

Under all circumstances, the exempt 35 percent compensation must be paid together with the salary. Monthly salary statements have to demonstrate this payment. Until the tax authorities have granted approval of the concession, the full compensation must be taxed. A recalculation can be made when the concession is granted.

G. *School fees*

In addition to the non-taxable 35 percent compensation, the employer can reimburse school fees for children at international schools for primary and secondary education, both in and outside the Netherlands, without any tax consequences. In this respect, school fees are the amounts for education (not for boarding) and transport invoiced by the school.

Contrary to earlier directives, if the employer does not reimburse the school fees it is not possible for the employee to deduct the expenses in his income tax return.

H. *Pensionable base*

It is not presently clear whether the split between salary and exempt 35 percent compensation would have negative consequences for the pensionable base.

I. *35 percent concession and employee insurance contributions*

For the time being, most of the industrial boards do not accept that the 35 percent concession is applied in respect of the salary on which the employee insurance contributions (ZW, WW, WAO, ZFW) are calculated. This item is still under discussion. If the 35 percent concession would be applied in this respect, it could have an impact on the level of possible benefits.

J. *Resident tax liability or non-resident tax liability?*

The directive of 4 June 1992 provides that an employee who, on the basis of circumstances, is regarded as a (tax) resident of the Netherlands, is qualified as a resident taxpayer. In such a case, the employee's tax liability is unlimited, i.e. he is liable for Dutch tax on his worldwide income and worldwide net wealth. Income other than income from employment is subject to tax in the Netherlands. However, the employee may also deduct certain expenses (e.g. alimony paid to an ex-spouse or the negative income from non-Dutch real estate, interest paid on loans, contributions to Dutch charities, etc.).

K. *Employee qualified as a non-resident of the Netherlands has status of non-resident taxpayer*

The directive of 28 August 1992, a supplement to the 4 June directive, provides that when filing the request for the 35 percent concession an employee who is tax resident in the Netherlands may request to be qualified as a deemed non-resident taxpayer for a period of 48 months. This implies that the employee's tax liability would be limited. In general, only the employment income earned in the Netherlands and (positive or negative) income from Dutch real estate will be taken into account.

A non-Dutch employee who is qualified as a deemed non-resident taxpayer is nevertheless regarded as a resident taxpayer in respect of the following:

- for purposes of determining the personal allowance (tax group): the employee is entitled to the basic personal allowance and additional allowances;
- for purposes of allocating non-personal income: such income is allocated to the partner having the highest personally earned employment income, unless, if this would be more beneficial, the employee requests allocation as a non-resident taxpayer (the same allocation rules apply for net wealth tax purposes); and
- for purposes of determining taxable employment income (income earned outside the Netherlands is also subject to Dutch taxation).

When choosing the tax status (resident or non-resident taxpayer) the personal circumstances of the employee are decisive. Also, the choice made when filing the 35 percent concession request is final for the first 48 months. After 48 months, the circumstances determine whether during the last 48 months the employee was a resident or non-resident taxpayer.

A resident employee who wishes to be qualified as a deemed non-resident taxpayer cannot apply for the "90 percent concession", a concession providing certain facilities to non-resident taxpayers; such concession is in principle only available to resident taxpayers. A "real" non-resident taxpayer can invoke this 90 percent concession, and he can split off from his Dutch taxable income the salary earned in respect of activities performed outside the Netherlands on the basis of the number of days he worked outside the Netherlands. Such

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a "salary split" is not available for (statutory) managing directors of a Dutch company.

An employee benefiting per 1 September 1992 from the 35 percent concession under earlier directives may, if he prefers the new 35 percent regulations, request to continue his status as a deemed non-resident taxpayer. The same applies for an employee who has his "old" 35 percent concession extended after expiration of the 60 month period.

L. *Tax rates*

In principle the general personal allowances, tax brackets and tax rates apply in respect of taxpayers benefiting from the 35 percent concession. However, there is a special rule for taxpayers who are exempt from Dutch social security. In general, 13 percent tax and 25.55 percent national insurance contributions are levied on the first tax bracket (Dfl. 42,966 in 1992). In view of the fact that the national insurance contributions are not due, the employee would have to pay 13 percent tax. However, the latter only applies to residents of the Netherlands. The "real" non-resident taxpayers have to pay 25 percent tax on the first bracket.

VII. MISCELLANEOUS

A. *Supreme Court ruling on different withholding tax in case of dual resident company*

On 2 September 1992, the Dutch Supreme Court issued an important ruling regarding the applicability of Dutch withholding tax in case of distributions of a dual resident company (hereinafter referred to as "DRC").

The corporation, incorporated under the laws of the Netherlands, was effectively managed and controlled in Ireland. The corporation ("BV") made a dividend payment to its sole US corporate shareholder, without any withholding, whereupon the Dutch tax inspector issued a Dutch dividend tax assessment at the rate of five percent based on Article VII, paragraph 1 of the Dutch-US tax treaty. The Revenue based this assessment on Article 1, paragraph 3 of the 1965 Dividend Tax Act, whereunder all corporations incorporated under the laws of the Netherlands are deemed to be subject to 25 percent dividend withholding tax, subject to relief under a tax treaty.

One of the key issues in the case was whether Article 8, paragraph 9 of the Dutch-Irish tax treaty, which is substantially similar to Article 10, paragraph 5 of the 1963 OECD model convention, would prevent the Netherlands from levying a withholding tax since BV is considered a resident of Ireland for purposes of the Dutch-Irish treaty.

The Lower Court at the Hague did not apply Article 8, paragraph 9 of the Dutch-Irish treaty holding that this provision only covered cases where an Irish company derives profit or income from the Netherlands. In the case at issue, BV carried on no activities at all in the Netherlands and it did not receive any Dutch source income. The Supreme Court, however, overruled this decision, relying heavily on the OECD Commentary to Article 10, paragraph 5 of the 1963 OECD model convention. The Supreme Court concluded that regardless of whether the DRC was deriving any Dutch profits and/or income, Article 8, paragraph 9 of the Dutch-Irish tax treaty denied the Netherlands the right to levy a withholding tax on a distribution of profits by the DRC to its US shareholder. The Court focused on the final words of this paragraph, "even if the dividends or the undistributed profits consist wholly or partly on income arising in such other State [i.e. the Netherlands]."

Based on this Supreme Court ruling, shareholders may start to seek avoidance of Dutch dividend withholding tax by transferring the effective management of a Dutch corporation to a country that has a tax treaty with the Netherlands that contains a provision similar to Article 10, paragraph 5 of the 1963 or 1979 OECD model convention. In the Supreme Court case, BV had never conducted business in the Netherlands. It is not inconceivable that if a Dutch company has been conducting business in the Netherlands and has accumulated retained earnings during that period, a distribution immediately upon transfer of the effective management to a third country will be challenged under abuse of law.

It is likely that this Supreme Court decision may also urge the Dutch government to introduce an exit tax provision in the Dutch Dividends Tax Act under which a Dutch corporation would become liable to dividend tax on all retained earnings at the time plus any possible unrealized gains.

B. *Revision of the internal reorganization exemption regarding Dutch capital duty*

The Netherlands is one of the remaining EC member states that levies a non-recurring 1 percent capital duty on any capital contribution to a Dutch corporation regardless of the form and nature of the contribution. This capital duty is generally considered a substantial constraint for structuring, e.g., a Dutch holding corporation. However, in many cases multinational groups could reduce the effective capital duty burden substantially by relying on the merger exemption and/or internal reorganization exemption. The merger exemption in general terms applies when a Dutch corporation receives at least 75 percent of the stock of another corporation resident in an EC member state, regardless of the residency of the contributing corporation.

The internal reorganization exemption was applied, for example, in the case where an EC resident corporation contributed to a Dutch corporation 100 percent of the stock of another corporation whereby it was irrelevant whether the transferred corporation was resident in an EC member state. The exemption was applied since the Dutch Supreme Court ruled in 1981 that a 100 percent subsidiary corporation could be considered an "independent part of an enterprise", the expression used by the Netherlands to implement the "branch of activities" as referred to in Article 7, paragraph 1, subparagraph b of the EC directive of 7 July 1969.

[continued on page 406]

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GERMANY:
ADMINISTRATIVE AND LEGISLATIVE DEVELOPMENTS OF INTEREST TO US TAX ADVISERS

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Contents

I. Inbound Investment
- A Implementation of the parent-subsidiary directive
- B. Implementation of the mergers directive; effect on tax-neutral rearrangements of participations within a European group
- C. Fiscal unity: legislative changes in reaction to Civil Court decision
- D. Administrative Circular on tax-neutral split-ups and spin-offs; effect on tax-neutral rearrangements of participations in general
- E. Introduction of a withholding tax on interest; effect on non-resident payees; effect on non-resident issuers of debt with German paying agents
- F. Proposals for thin capitalization rules
- G. Investment grants and accelerated depreciation for investment in the new *Länder*; new proposals for enhanced provisions
- H. Relaxation of bank secrecy rules on German branches of European financial institutions; possible effects on taxation
- I. Dividend strategies with German stock around ex-dividend date

II. Outbound Investment
- A. Tightening of German CFC rules; effect on passive non-controlling investments by German residents abroad
- B. Tightening of German rules on deductibility of foreign losses from domestic profits

III. Trends in German Tax Legislation
- A. Proposals for relief from personal and corporate income tax
- B. Re-introduction of a solidarity surcharge; effect on non-residents

I. INBOUND INVESTMENT

A. *Implementation of the parent-subsidiary directive*

Since 1 January 1992 dividends distributed by a German resident corporation to a qualified EC parent company have been subject to withholding at a rate of 5 percent of the gross dividend. Effective 1 July 1996 dividends distributed by a German resident corporation to a qualified EC parent company will not be subject to German withholding tax.

Both rules apply also to the refund of corporate income tax which the German distributing company has to pay upon distribution of pre-1977 profits (so-called EK 03) and of profits from foreign sources exempt from German tax under a tax treaty, such as foreign source income from a permanent establishment (PE), from the letting and leasing or the alienation of foreign-situs real (immovable) property, or direct investment dividends (so-called EK 01).

A *qualified EC parent* is a company that is listed in Article 2 of the parent-subsidiary directive; has neither statutory seat nor place of effective management in Germany; and can show that it has held a qualified interest in the German distributing company continuously over the 12-month period preceding the distribution.

A *qualified interest* is defined as a
- 25 percent or more interest in the stated capital of the German company; or
- 10 percent or more interest in the stated capital of the German company if
  - the parent's residence country exempts from its tax dividends received by the parent company from the German distributing company; or
  - the residence country gives a credit for the German withholding tax; and
  - exempts from its withholding tax dividends paid by a resident affiliate to the German parent; and
  - each of these requirements is met provided there is a 10 percent or more interest in the other company ("reciprocity requirement").

The lower rates apply, on application, at source so that the refund procedure is no longer required. Up-front relief is also granted if the lower withholding rate applies on the basis of a tax treaty (i.e. also *vis-à-vis* parent companies outside the EC holding a 10 percent or more interest in the German distributing company).

It is currently unclear whether the zero percent withholding rate applicable *vis-à-vis* EC parent companies after 30 June 1996 will also be extended to important non-EC trading partners of Germany such as the United States. A complete waiver of the German withholding tax would require reciprocal measures by the treaty partner unless the German split-rate system is substantially altered by then (discussed in III). This requirement should not come as a surprise to the US treaty negotiators as similar negotiating positions have been known to exist on the part of the Mexican and USSR negotiators. Also, until early 1987 the US delegation's position *vis-à-vis* Germany was that Germany should waive its withholding tax completely to compensate US parents for the fact that the German corporate income tax is not generally refunded to non-resident shareholders.

B. *Implementation of the mergers directive; effect on tax-neutral rearrangements of participations within a European group*

Effective 1 January 1992 contributions in exchange for new shares issued by the receiving company qualify for rollover relief also in the cross-border EC context.

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1. Share-for-share exchanges

Tax neutrality of a share-for-share exchange no longer requires a 100 percent shareholding. Majority voting rights of the receiving company on the basis of existing and transferred shares are now sufficient.

Payment of "boot" by the receiving company to the transferor is admissible if the "boot" does not exceed 10 percent of the nominal value of the transferred shares.

The tax-neutrality is lost if the receiving company disposes of the transferred shares within seven years of the exchange unless the shares are contributed, without basis step-up, in a further share-for-share exchange with another EC company.

2. Business-for-share exchanges

The transfer must involve an entire business or an independent business division viable on its own if separated from the remaining business ("*Teilbetrieb*"; stand-alone business division).

Business-for-share contributions are now tax-favoured not only if the transfer is made by a German resident to another German resident but also if:

- a German resident corporation contributes a business or a stand-alone business division to a German PE of an EC corporation in exchange for new shares of such corporation; or
- a non-resident EC corporation contributes its German PE to a German resident or a non-resident EC corporation; or
- a German resident corporation contributes its non-German EC PE to another corporation.

The tax neutrality is lost if the non-resident EC company disposes of the shares received in exchange for the contribution of the German PE within seven years of the transfer unless the shares are contributed without basis step-up to another EC company.

C. *Fiscal unity: legislative changes in reaction to civil court decision*

German corporate income tax law does not provide for the filing of consolidated returns. Instead the notion of *Organschaft* has the effect of group relief. This "fiscal unity" concept requires financial, economic and organizational integration of a subordinated corporation into a dominating business enterprise and the conclusion of a profit and loss absorption agreement. In practice fiscal unity is normally brought about by the conclusion of a profit and loss absorption agreement between the dominant business enterprise and the subordinated corporation; and a domination agreement between the two parties.

The highest German civil court (BGH) ruled that a valid profit and loss absorption agreement between a dominant business enterprise and a limited liability company (GmbH) requires that

- the agreement be entered into the commercial register of the subordinated entity corporation;
- the shareholders of the dominant business enterprise consent to the agreement by a 75 percent majority of votes cast. If the dominant entity is a stock corporation (AG), a general shareholders' meeting is necessary. The shareholders' resolution need not be notarized;
- the shareholders of the subordinated corporation consent to the agreement. It remains unclear whether a qualified majority is also required here. The shareholders' resolution must be notarized.

The Corporate Income Tax Act used to provide that the profit and loss absorption agreement had to become effective by the end of the first year for which fiscal unity was to apply. The formal requirements established by the BGH normally make it impossible to complete all elements necessary within such time frame. Accordingly, the tax rules were relaxed effective for the assessment period 1991, so that the profit and loss absorption agreement need only become effective by the end of the subordinated entity's fiscal year which follows the fiscal year for which fiscal unity is first to apply.

D. *Administrative Circular on tax-neutral split-ups and spin-offs; effect on tax-neutral rearrangements of participations in general*

1. General

As opposed to mergers and certain types of reorganizations, German statutory law does not currently contain any provisions that specifically address the split-up or the spin-off of a business division from a corporation. This is true both for commercial and fiscal law purposes. In connection with the implementation of the EC directive on the taxation of cross-border mergers the German government has begun work on draft legislation that would create the tools, under commercial law, required to provide for tax-neutral split-ups and spin-offs both in the domestic and the international context. However, this draft legislation has not been finalized. It therefore remains unclear whether a formal proposal of the relevant fiscal legislation can be expected soon.

In the interim, the German Ministry of Finance (BMF) on 9 January 1992 issued a Circular (comparable to Treasury Regulations in the United States, except for their non-binding character on taxpayers and courts) that summarizes the criteria for split-ups and spin-offs.[1]

The Circular does not improve the situation under commercial law. A split-up or spin-off cannot be achieved in one unified act whereby the new corporation assumes the juridical position of the corporation being reorganized. Instead a series of individual, but interdependent steps is still required until the commercial law has been amended as envisaged. The Circular does, however, summarize the criteria that will allow the taxpayer to treat the entire arrangement as a tax-neutral reorganization for (corporate) income and capital gains tax purposes. As the Circular is relatively new, the tax administrations of the *Länder* have agreed that taxpayers wishing to

1. The BMF is basically a policy-making body on the level of the Federal Government (much like the US Treasury Department) that coordinates, but does not interfere directly with, the application and practical implementation of the tax laws by the Federal States (*Länder*).

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avail themselves of the tax neutrality should come in for an advance ruling. Any substantial departure from the standards of the Circular will first have to be discussed between the *Länder* officials and is bound to slow down the ruling process.

The Circular does not provide for the tax neutrality of split-ups and spin-offs for transfer tax purposes. After the elimination of capital transfer and stock exchange turnover taxes the taxpayers involved therefore remain exposed to some level of real property transfer tax.

2. Highlights of Circular

The Circular describes the individual steps involved in a split-up/spin-off, i.e.:

- the business-for-share contribution by the distributing corporation to a newly established subsidiary ("NewCo") of the distributing corporation; this step is tax-neutral under existing law;
- the transfer of the NewCo shares to the shareholders of the distributing corporation; under existing law this step amounts to a taxable dividend-in-kind unless it is accompanied by the next step;
- the surrender of shares which the receiving shareholders have in the distributing corporation; under existing law this step generally amounts to a taxable exchange unless certain like-kind criteria are met which the tax courts have developed in their jurisprudence.

The Circular allows these individual steps to be treated as one unified tax-neutral measure if the reorganization has a valid business purpose, i.e. serves to continue the existing entrepreneurial activities in a new juridical form.

3. Particular points

The contribution by the distributing corporation to NewCo must involve an entire business, a separate, independently viable business division (stand-alone business division) or 100 percent of the shares in another corporation. The transfer of a stand-alone business division generally requires the transfer of land and buildings essential for the operation of the transferred or business division.

The transfer must be at book value.

Both the distributing and the controlled corporation must be German residents; the shareholders of the distributing corporation can be non-residents.

NewCo must be an entity newly established for purposes of the reorganization; it cannot be a pre-existing entity.

The shares in the distributing corporation and in NewCo must not be sold outside the group within the five years following the reorganization.

The existing group of shareholders must not be changed; however, identity in shareholdings *vis-à-vis* an individual corporation before and after the reorganization is not required.

Unrealized gain as represented by the transferred business and by the shares in the distributing corporation must remain subject to German taxability after the reorganization to the same extent as it was before.

Workers' co-determination rights must not be negatively affected by the reorganization (e.g. the spun-off entity must still have 2,000 employed personnel if the distributing corporation was above that threshold for parity representation in its supervisory board).

It appears that the tax administration is currently entertaining a rather narrow interpretation of these principles. They are obviously concerned that too generous a treatment would result in the demerger of large groups in preparation of a tax-efficient sale of the constituent parts in such a way that the German fisc does not participate in gain accrued prior to the spin-off. This approach can cause difficulties, e.g. in situations involving a Section 355 IRC spin-off where the shares in NewCo are to be distributed to group entities not forming part of the group of direct shareholders of the German corporation being split-up. Such reorganizations should therefore be planned with great care, particularly in cases involving the spin-off of a worldwide business.

E. *Introduction of a withholding tax on interest; effect on non-resident payees; effect on non-resident issuers of debt with German paying agents*

Non-resident bondholders are generally not affected by the new 30 percent interest withholding tax if they derive foreign or German-source interest income from debt securities held in a custodial account with a German or non-German bank.

Non-resident "coupon clippers" are affected by the interest withholding tax at a rate of 35 percent if they present their interest coupons for cash payment to a German disbursing entity, i.e. a financial institution resident in Germany; a German branch of a foreign financial institution; or to the obligor itself, for payment outside a custodial account. An exemption under a tax treaty can only be invoked through the refund procedure.

Non-residents are further affected if their foreign or German-source interest income, payable by a German disbursing entity, is effectively connected with a German PE or German immovable property. In that case tax is withheld at a rate of 30 percent and credited against the tax on the net income of the PE or from the letting and leasing of the immovable property.

It should be noted that the paying agent within the terms of an agency contract between the issuer of debt and a financial institution is not necessarily identical with the disbursing entity. Generally, only the "retail bank" holding the debt security in custody on behalf of the ultimate investor pays out the interest and has to withhold tax thereon if the investor is a German resident. The paying agent does not generally assume the function of "retail bank", but pays interest on behalf of the debt issuer to those financial institutions that present interest coupons or the debt obligation itself on behalf of their customers upon maturity.

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F. *Proposals for thin capitalization rules*[2]

The German Parliament is currently considering a bill for the introduction of thin capitalization rules after a 1987 Ministry of Finance Circular providing for a 9:1 debt/equity ratio (where debt includes third-party and shareholder loans) was invalidated by a February 1992 BFH decision and subsequently withdrawn by the MoF. The bill amounts to a re-introduction of similar proposals that were thoroughly rejected by the business community in committee hearings in 1988.

The present version of the bill (as of 21 June 1993) would recharacterize as constructive dividend distributions any consideration payable by a German resident corporation to a shareholder not entitled to the corporate imputation credit holding a 25 percent or more interest in the stated capital of the corporation, where such consideration pertains to

- any debt instrument providing for consideration in terms other than a fixed percentage of the loan principal (such as profit participating rights or loans or other "hybrid instruments") where the loan capital extended by the shareholder exceeds 50 percent of that portion of the corporation's equity that corresponds to the shareholder's interest in the corporation's stated capital (1:2 debt/equity ratio);
- any other indebtedness, where the loan exceeds a debt/equity ratio of 3:1, *unless* an unrelated party would have extended such loan capital at the same terms and conditions or the loan serves to finance transactions usual in the banking sector.

The same rules apply if a person related to the shareholder extends the loan and such person is not entitled to the corporate imputation credit or if a third party provides the loan financing, where such third party has recourse to the shareholder or to a person related to the shareholder.

A special safe haven debt/equity ratio of 9:1 would apply to German holding companies with respect to non-hybrid debt instruments. However, the German entities controlled by the holding company would not be covered by a special safe haven. As a consequence a holding company structure could not be used to increase the volume of acceptable shareholder loan financing of share acquisitions beyond the 9:1 ratio.

The likelihood of passage of this bill is difficult to judge. The business community has apparently softened its critical stance of 1988 as the thin capitalization rules as now introduced come in a package with lower corporate and personal income tax rates (see below at III). Several State Governments have criticized the bill's lower rate so that the entire package will go into the Bundestag/Bundesrat Joint Conference Committee. It is unclear whether the Committee will be able to reconcile the difference in opinion prior to the summer break.

G. *Investment grants and accelerated depreciation for investment in the new Länder; new proposals for enhanced provisions*

Existing law provides for a number of measures designed to stimulate investment in the five new *Länder*:

- investment grants (between 8 and 12 percent of the investment);
- accelerated depreciation (up to 50 percent over the first five years of the investment) through 1994;
- non-collection of trade tax on capital and net worth tax through 1994.

Effective 1 January 1993 investment grants were enhanced/modified:

- the 31 December 1992 deadline, by which investments had to be initiated, was cancelled;
- the 31 December 1994 deadline, by which the investments had to be completed, was extended by two years to 31 December 1996, except that the new deadlines do not apply to marketing (wholesale, retail) enterprises; financial institutions, insurance companies; gas and electricity utilities;
- 8 percent grant for investments initiated prior to 1 July 1994, 5 percent thereafter;
- 20 percent grant for manufacturing enterprises and craftsmen resident in the five new Länder on the day the Berlin Wall came down (9 November 89) for investments up to DM 1 million, 8 percent (5 percent) for the excess amount;

In addition, the following has been proposed:

- extension of the 50 percent depreciation by two years (through 1996);
- extension of non-collection of trade tax on capital and net worth tax by one year (through 1995).

H. *Relaxation of bank supervisory rules on German branches of European financial institutions;*[3] *possible effects on taxation*

Prior German bank supervisory law required the German branch of a foreign financial institution to show equity ("allotted") capital the amount of which depended, *inter alia*, on the lending volume of the branch. For tax purposes, the branch was not allowed to deduct interest payable to the head office on such allotted capital.

Effective 1 January 1993, under the "European Passport" approach, German branches of financial institutions resident in another EC country are not required to show allotted capital but have to show "sufficient liquidity". Due to the European Passport approach a number of financial institutions have begun to reorganize their German affiliates by transferring their business to a new German branch of the parent's head office.

Such reorganization may result in lower costs of funding and the ability to rely on the home bank's credit standing in the market. The German bank supervisory authorities having jurisdiction over the branch have to accept the banking licence issued in the head office's home country and can only request certain filings to be submitted by the branch.

A number of new tax issues arise as a consequence of these legislative changes of bank supervisory law:

2. Corporate Income Tax Act, Sec. 8a.
3. Banking Act, Sec. 53b.

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- Will the tax authorities accept that the German branch does not have to show allotted capital or will they require a notional amount for tax purposes?
- Can the branch be supplied with tax-favoured loan financing by the head office or by sister corporations or sister branches through straight or participating loans, silent partnerships or other hybrid instruments?
- Can a tax-neutral transfer of existing businesses to the new "European Passport" branch be achieved? This problem is of particular importance for bank subsidiaries that have been in existence for an extended period of time and are, therefore, likely to have accrued considerable goodwill that would need to be recognized in an arm's length transfer of its business.

It should be noted in this context that the "European Passport" concept can be extended by the government to financial institutions resident in a non-EC country. Section 53c Banking Act authorizes the Ministry of Finance to pass administrative regulations to this effect, provided that

- the home country of the foreign financial institution treats local branches of German financial institutions on a reciprocal basis;
- the other country supervises its resident financial institutions pursuant to internationally recognized principles;
- the other country extends national treatment to local branches of German financial institutions; and
- the other country's bank supervisory authorities are prepared satisfactorily to cooperate with the German competent authorities and such cooperation is safeguarded by bilateral agreement.

The Ministry of Finance has not, as of this writing, extended the European Passport approach to another non-EC country.

I. *Dividend strategies with German stock around ex-dividend date*

Due to the German corporate tax regime (imputation credit) and the unwillingness of the German legislature to permit a corporate tax refund to non-resident shareholders by treaty, stock of a German corporation is worth more in the hands of a resident taxable entity on dividend day than in the hands of a non-resident or a domestic tax-exempt entity. The imputation credit mechanism has led to a substantial volume of trade into Germany with respect to stock in German corporations around ex-dividend day designed to make the imputation credit available, at least economically, to non-resident shareholders. Surprisingly little administrative guidance exists on the acceptability of such "dividend strategies". A 1978 ruling denies the tax credit to the interim holder of stock that purchased stock from a non-resident shortly before ex-dividend day, collected the dividend, claimed the withholding and imputation credits, and agreed to sell the stock back at the quoted price soon thereafter. The ruling relies on abuse of legal form considerations.

A tax court decision of 1982 indicates that even a repurchase arrangement is acceptable and results in the attribution of the income derived from a security to its interim holder as the beneficial owner of the income. The decision dealt with debt instrument generating tax-exempt interest, not dividends.

The entire issue is sensitive as the use by non-residents of the imputation credit runs counter to a core element of the German corporate tax imputation system. The stock exchange supervisory authorities in Frankfurt have begun to investigate stock brokers apparently involved in holding stock as principal under short-term round-trip transactions. The volume of the most aggressive transactions is reported to have dropped significantly since these investigations were initiated. However, the investigators' findings have been kept confidential so far. The stock exchange supervisory authorities might well share the material on their findings with the tax authorities, particularly if criminal sanctions are called for.

The tax package currently before Parliament contains changes to Section 50c Income Tax Act. Pursuant to this provision a resident purchaser of stock in a German corporation cannot recognize a tax loss if he acquired the stock from a person not entitled to the corporate imputation credit, where the loss reflects a reduction in the stock's value attributable to the distribution of profits. A tax deduction for such loss is barred for ten years beginning in the year of the acquisition, and extends to losses from the disposition of the stock or extraordinary write-offs under a mark-to-market approach. Section 50c contains an exception for stock acquired on the exchange through a financial institution. The draft bill would modify the exchange-trading exception so that it only applies if it is not apparent to the purchaser of the stock that the seller is not entitled to the corporate imputation credit. The provision will most likely undergo further modifications when the bill is marked up in the Conference Committee.

II. OUTBOUND INVESTMENT

A. *Tightening of German CFC rules; effect on passive non-controlling investments by German residents abroad*[4]

Under previous law the controlling investment by German residents in a passive offshore company subject to an effective tax rate below 30 percent resulted in the imputation of the offshore company's passive income to the German resident shareholder (elimination of deferral). The imputed amount was treated like a dividend also for purposes of an applicable tax treaty. In the case of an investment by a German corporation the participation exemption under a tax treaty applied unless the treaty contained an activity clause.

Effective 1 January 1992 these rules were broadened with respect to certain types of passive income retained by the offshore company:

- passive investment-type income is now imputed to a shareholder that has a 10 percent or more interest in the offshore company even if such company is not German-controlled;

4. International Tax Act, Secs. 7(6), 10(6).

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- the participation exemption under a tax treaty is denied to the extent the imputed amount consists of passive investment-type income;
- passive investment-type income is also imputed if it is effectively connected with a PE which the German investor maintains in the low-taxing jurisdiction even if the income would otherwise be exempt under an applicable tax treaty;
- the rules described above take precedence over those provisions governing the treatment of investment in offshore mutual funds.

B. *Tightening of German rules on deductibility of foreign losses from domestic profits*[5]

Effective 1 January 1992 losses resulting, *inter alia*, from a write-down to lower market value of a participation in a foreign corporation; and the sale of a share in, or the reduction of the capital of, a foreign corporation can only be set off against current or future income from the same type of operation or participation, unless the foreign corporation is engaged in an active trade or business involving the manufacture or marketing of goods (except arms), the production or extraction of minerals or the rendering of commercial services.

III. TRENDS IN GERMAN TAX LEGISLATION

A. *Proposals for relief from personal and corporate income tax*[6]

A draft bill currently being considered by the *Bundestag* and *Bundesrat* would:

- lower the corporate income tax rates on retained profits from 50 to 44 percent; on distributed profits from 36 to 30 percent; on the profits of a German branch of a foreign corporation from 46 to 41 percent;
- mitigate the current "recapture" of corporate income tax in case foreign treaty-exempt income is distributed to a shareholder. This would enhance the tax situation of German holding companies and their shareholders;
- extend the dividend participation exemption under tax treaties to capital gains from the disposition of shares in a foreign subsidiary or affiliate;
- lower the *top personal income tax* rate on income from industrial or commercial activities from 53 to 44 percent in order to compensate for trade tax on income without eliminating this tax altogether (requiring an entirely new system of revenue sharing) and without an across-the-board lowering of the top personal income tax rate on all categories of income;
- defer the income tax liability for small and medium size businesses by allowing additions to a tax-deductible reserve in anticipation of future investment in depreciable property (maximum 45 percent of the anticipated production or acquisition cost of the asset). The reserve has to be dissolved, and the resulting amount taken into income, as soon as the asset is acquired and depreciation has begun, but at the latest at the end of the second year following the formation of the reserve. If a higher amount is reserved than actually invested the amount taken into income upon the dissolution of the reserve is increased by 6 percent to compensate for the tax deferral;
- extend certain tax benefits for investment in the new *Länder*.

These tax benefits would be partly offset by base-broadening measures in order to keep the entire package practically revenue-neutral. Such base broadening measures would include:

- new rules on thin capitalization (as discussed above at I.F.);
- deceleration of declining-base depreciation (30 to 25 percent for movable property; 10 to 7 percent for immovable business property);
- extension of the useful life of automobiles used in a trade or business from four to five years.

B. *Re-introduction of a solidarity surcharge; effect on non-residents*

There appears to be agreement between the major political parties that, effective 1 January 1995, the "solidarity surcharge" to personal and corporate income tax will be re-introduced on a "temporary basis" to contribute to the cost of German unification. No decisions have been taken as to when the surcharge would cease to apply. A similar surcharge was in effect in 1991 and 1992 at a rate of 3.75 percent of the personal or corporate income tax assessed during these years. The new solidarity surcharge would be imposed at a rate of 7.5 percent of the assessed income tax, bringing the effective marginal top income tax rate to 56.975 percent (as it relates to non-business income) and to 47.3 percent as it relates to business income (assuming that the current plans for lower rates are implemented). The rate on retained corporate profits would also increase to an effective 47.3 percent whereas the rate on distributed corporate profits would be 32.25 percent.

The old solidarity surcharge was treated as a covered income tax under tax treaties so that non-resident persons entitled to treaty benefits obtained relief to the extent the imposition of the surcharge resulted in a tax exceeding that permitted under the applicable treaty.

5. Income Tax Act, Sec. 2a.
6. Draft Investment Location Protection Act.

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CANADA:

TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS

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His books include The Foreign Affiliate System: Canadian Taxation after 1982 – a Structured Overview, published by CCH Canadian Limited in 1983; Taxation in Canada – Implications for Foreign Investment (in co-authorship with Bruno Ducharme), published by Kluwer in 1985; and U.S. Tax Reform – the Canadian Perspective (in co-authorship with Gary J. Gartner), published by CCH Canadian Limited in 1987.

This paper, prepared for presentation on 5 March 1993, reflected, in its original version distributed to participants at the meeting, Canadian developments to 22 February 1993. This version has been updated to reflect only a few - but significant - developments between 22 February and 19 May, the date this version was finalized.

Contents

I. Introduction and overview
- A. Scope
- B. Background context: similarities and differences between Canadian and US tax systems

II. Current Developments Affecting Outbound US/Inbound Canadian Transactions and Events
- A. US-based multinationals operating in Canada
- B. Other US outbound/Canada inbound business and investment matters
- C. US transfers and moves to Canada

III. Current Developments Affecting Inbound US/Outbound Canadian Transactions and Events
- A. Overview
- B. Canadian-based multinationals
- C. Other Canadian outbound/US inbound business and investment matters
- D. Canadian movement to the United States

IV. Conclusion

I. INTRODUCTION AND OVERVIEW

A. *Scope*

Recent developments in Canadian tax law which may be of interest to US tax advisers are both of very recent vintage - e.g. the 21 December 1992 release by the Department of Finance of 235 pages of proposed "technical" amendments to the Income Tax Act[1] which include, however, many substantive changes - and those arising over the last year or two. I will address the topic from the perspective, sequentially, of matters which are of interest in the US outbound-Canada inbound context (e.g. US-based multinationals doing business in Canada) and, then, in the US inbound-Canada outbound context. My comments will, in part, seek to place in a workable perspective the Canadian response to certain recent US developments as well as certain other US developments affecting cross-border Canada-US tax practice.

B. *Background context: similarities and differences between Canadian and US tax systems*

Some if not all of you know that there is much similarity between the structure or scheme of the Canadian and US tax systems, particularly as a result of changes over the last ten or 15 years which have drawn the systems much closer together, although in certain respects significant differences remain. The following is a brief summary of the main areas of similarities and differences.[2]

1. Jurisdiction to tax

Both countries tax worldwide income of its residents[3] and tax only certain domestic source income of non-residents. However, Canada, unlike the United States, in accord with the general international norm, does not tax Canadian citizens who are not resident in Canada.

1. S.C. 1970-71-72, ch. 63 as amended ("the Act"). Draft Income Tax Amendments, Draft Regulations and Technical Notes, issued under Department of Finance Release No. 92-098 on 21 December 1992 ("the December 21/92 Proposals").
2. For an earlier comparison, see Nathan Boidman and Gary J. Gartner, "The Canadian and U.S. Tax Systems - Similarities and Differences", *Tax Management International Journal*, Vol. 15 No. 12 (December 1986), at 482.
3. This paper focuses on Canadian federal income tax law. However, each of the ten provinces - as well as the Yukon and Northwest Territories - also levy

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Although both countries treat as residents corporations formed within their jurisdictions, Canada also may tax, as a resident, a foreign incorporated company whose central mind and management is exercised in Canada (along the lines of the United Kingdom).

Canada retains the pre-1985 US "facts and circumstances" approach to determining the residence of individuals and does not deem as a resident a non-Canadian who has been granted a Canadian permanent visa. However, like the United States, a physical presence test applies in that a person who is ordinarily not a resident of Canada but physically present for 183 days or more in the year is deemed a resident for the entire year.[4]

2. Base broadening – rate reductions

Both countries in the second half of the 1980s adopted a basic income base broadening and tax rate reduction format, although the recent reversal of both factors in both countries has been more pronounced in the United States than in Canada (particularly on the tax rate side with the Clinton Administration proposals operating to further widen the gap in this area).[5] Note also that in general terms Canadian individual tax rates remain higher than those in the United States (taking into account the effect of local, i.e. provincial or state, taxation) with the highest marginal (combined federal and provincial) Canadian income tax rates for individuals ranging between some 47 to 52 percent as compared to the highest effective integrated US federal, state and even city tax rates which (except for New York City) would be, even after the Clinton proposals, somewhat lower. On the corporate side, it will be seen below, that Canadian tax rates are often but not always higher than those in the United States.

3. Capital gains

Both countries tax capital gains as well as ordinary income. However, in Canada the approach is to tax, at ordinary rates, three-quarters of a capital gain (or gain from disposing of so-called "eligible capital property", which is a distinct category of indefinite life of intangible assets such as goodwill), while the United States of course now taxes 100 percent of such gains, although in the case of individuals at differentiated tax rates.

Moreover, Canada taxes non-residents on capital gains realized from a wider class of Canadian-based property than does the United States in the case of foreign investors. For example, subject to treaty exemption, a non-resident is subject to Canadian tax on the sale of stock of a Canadian corporation, unless the stock is publicly traded and the seller owns less than 25 percent of the stock.[6]

4. Corporate liquidations

With the abolition of "General Utilities" in the 1986 Tax Reform Act both countries tax corporate liquidations and similar transactions at both the corporate and shareholder level and, generally, do not permit a tax-free step-up in inside basis upon the acquisition of corporations. However, under Canadian law a limited tax-free step-up is available with respect to inside basis of non-depreciable capital property. For example, in the case of an acquisition of a Canadian corporation (through a Canadian corporate acquisition vehicle), a post-acquisition liquidation of the target would result in a tax-free step-up in basis of underlying subsidiaries or other non-depreciable capital property such as land.[7]

5. Treatment of dividends

Both countries tax dividend or other shareholder distributions. In the cross-border context, under the 1980 Canada-US income tax convention ("the 1980 Convention") there is a 10 percent tax on dividends paid by a Canadian or US subsidiary to a US or Canadian parent company and a 15 percent withholding tax on dividends paid to Canadian or US shareholders who are either individuals or corporations not owning 10 percent or more of the voting stock of the payer Canadian or US corporation.

However, in the domestic context, under current law, while the United States still has the classical double tax system, offering no integration between corporate and shareholder level tax (subject of course to the recent Treasury proposals to radically change same), Canada provides a total or partial integration (depending upon circumstances) in respect of dividends paid by Canadian corporations to Canadian individual shareholders, although at this time there are no UK-ACT-type cross-border rebates or refunds available to US shareholders receiving dividends from Canadian corporations.

6. Basic scheme of taxation of foreign investors

Both countries tax, subject to treaty protection, a foreign person's income effectively connected to a domestic trade or business (in Canada referred to as income from carrying on business in Canada) and in the case of a foreign person's domestic

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income tax on individuals (who are resident therein on the last day of the year or before terminating Canadian residency) and corporations (which carry on business therein through permanent establishments). Except in the case of Quebec (for both individuals and corporations) and Alberta and Ontario (for corporations) provincial tax law is administered, on behalf of the provinces, by the federal Department of National Revenue ("Revenue Canada"). In general the federal and provincial income tax law is quite similar and reference is made in the text below to the integrated effects of the two - particularly in respect of effective rates of taxation.

4. For details of the comparative position between the two countries in this respect see Nathan Boidman, L. Frank Chopin and Alan W. Granwell, "Tax Effects for Canadians of the New US Code and Treaty Residency Rules", *Tax Management International Journal*, Vol. 14 No. 5 (May 1985), at 143 (Part I) and Vol. 14 No. 6 (June 1985), at 183 (Part II) [and published in booklet ("The New US Residency Rules for Canadians") form by *CCH Canadian* in December 1985]. See also Nathan Boidman and Gary J. Gartner, "Effect of US Residency Rules on Canadians - The Proposed Regulations and Other Recent Developments", *Tax Management International Journal*, Vol. 16 No. 11 (November 1987), at 475 and Nathan Boidman, "A Canadian Perspective on the US Residency Regulations", *Tax Management International Journal*, Vol. 21 No. 7 (August 1992), at 442.

5. For a discussion of February 1992 proposals in Canada which would somewhat reverse the broadening of the corporate income base and also reduce certain corporate tax rates see Nathan Boidman, "Canadian Budget (Including Treaty Update)", *Tax Management International Journal*, Vol. 21 No. 4 (April 1992), at 199.

6. The proposed "10% stock" rule in HR 5270 would have drawn the two systems closer.

7. See Secs. 88(1)(c) and (d) *et seq.* of the Act and compare to IRC Secs. 336-338.

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source non-effectively connected income there is often a straight flat withholding tax on the gross income payment.

The statutory Canadian withholding rate, under Part XIII of the Act (Sections 212-218), in respect of specified types of non-effectively connected income[8] (i.e. dividends, rents, royalties, interest, etc.) is 25 percent while the US rate is of course 30 percent. Both countries permit net income elections in respect of non-effectively connected real property rental income.[9]

Both countries may extend the latter rules for non-effectively connected income to payments made by one foreign person to another through re-sourcing mechanisms.

7. Branch profits tax

In 1986 the United States adopted a long standing Canadian approach by implementing a branch profits tax on foreign corporations engaged in a domestic trade or business (in lieu of, in the US context, seeking to tax dividend distributions made by such foreign corporations, an approach never adopted by Canada). However, the Canadian statutory rate of branch tax is 25 percent, compared to that of 30 percent in the United States.

8. Earning stripping

Both countries are concerned with "earning stripping" through either transfer pricing (as discussed separately below) or through related party cross-border interest charges. However, the mechanism and approach are quite different in the two countries. In Canada, Section 18(4) of the Act provides a relatively straightforward prohibition (not simply deferral) against deductibility of interest paid by Canadian corporations to related non-residents to the extent of interest on related non-resident party debt which exceeds three times the shareholder equity of the corporation attributable to such non-residents. Contrast this to the aggregate effects of earning stripping rules of IRC Section 163(j) – to be extended by the Clinton Administration – and the possibility of recharacterization of the debt as equity under IRC Section 385.

9. Death taxes

Both countries levy tax at death but in radically different forms. The United States retains the traditional and conventional estate tax approach which Canada abolished at the federal level in 1972 (with the provinces following suit over the succeeding decade and a half – although the province of Ontario is now threatening to reintroduce succession duties). Since 1 January 1972 Canadian death tax takes the form of an income tax on unrealized appreciation in most types of property which are deemed to be sold upon death. This is an approach which has been discussed in recent years in US government circles (in addition to conventional estate taxes).

The significant difference in the two approaches (i.e. in one case estate tax is levied and in the other case a deemed income tax) leads to potential for severe double taxation where a Canadian individual dies owning US property or vice versa in the converse situation. As discussed below, this issue is under consideration in ongoing treaty renegotiations, between the two countries.

10. Corporate reorganizations

Both countries provide for tax-free corporate reorganizations in a variety of circumstances, particularly where no cross-border movement or entity is involved and, conversely, substantially restrict the applicability of non-recognition (in Canadian parlance, rollover) rules in the cross-border context.

The US approach from the technical standpoint is to provide generally for non-recognition transactions and then impose the cross-border restrictions through the specific provisions of IRC Section 367. The Canadian approach is to build the territorial limitation into the specific non-recognition rules so that, for example, a tax-free transfer of property to a corporation in exchange for stock (governed in the United States under IRC Section 351) is permitted under the comparable provision of Canadian law (Section 85 of the Act) only where the transferee corporation is a "Canadian corporation", which except in very narrow circumstances (as discussed further below) means one that has been, inter alia, formed in Canada.

In the cross-border context Canadian law never allows a tax-free transfer to a foreign corporation except where the property transferred constitutes shares of a foreign affiliate, that is a corporation in which a Canadian has a direct or indirect interest of at least 10 percent, and the transferee is (also) a foreign affiliate (after the transfer) pursuant to Section 85.1(3) of the Act.

11. Taxation of foreign operations

Perhaps the most basic or fundamental difference between the tax systems of the two countries arises in the international area where the US taxes repatriation of foreign subsidiary profits (subject to the available foreign tax credit relief) and severely restricts the movement of assets between the various controlled foreign corporations (leaving aside certain same country situations). Canada, on the other hand, under the foreign affiliate-exempt surplus/foreign affiliate property income rules, not only does not tax repatriation of profit from foreign subsidiaries operating in countries with which Canada has treaty relations but excludes from the Canadian counterpart of Subpart F (foreign accrual property income) inter-foreign affiliate transactions such as the payment of interest from a Canadian-owned US operating subsidiary to an offshore captive finance subsidiary of the Canadian group.[10]

12. Treaty override

Another basic difference and (potentially festering point of issue between the two countries) is the approach to treaty

8. More precisely Part XIII tax applies (to specified categories of payments) unless *both* the item is effectively connected to a business *and* the business is carried on through a *permanent establishment*, as defined in Part IV of the Income Tax Regulations made pursuant to the Act, whereas under US rules the mainstream net income approach applies where such items are effectively connected to a US trade or business whether or not a "permanent establishment" is involved. See Sec. 214(13) of the Act and Sec. 805 of the Income Tax Regulations made thereunder.

9. See Sec. 216 of the Act.

10. For a discussion of various relevant aspects of these rules see, *inter alia*, Nathan Boidman, (Canadian-American Tax Issues: Cross-Border Commen-

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override by domestic legislation. Unlike the United States (e.g. IRC Section 7852(d)) the Canadian statutory enactment which accompanies the implementation of each income tax treaty between Canada and another country specifically provides for override of domestic law by treaty provisions. The resulting basic difference in the manner of application and role of treaties between Canada and the United States frustrates Canadians and, more importantly, creates uncertainty for Canadians seeking treaty relief from US taxation.

However, Canada's hands in this area are not totally lily-white. For example, a pending technical amendment tabled in December 1991 (not to be confused with the December 21/92 Proposals) would extend to the terms "annuity" and "pension" the manner in which the Income Tax Conventions Interpretation Act[11] seeks to incorporate Canadian domestic definitions of terms for treaty purposes.[12]

13. Anti-avoidance law

While the United States adopted case-made law principles respecting business purpose, substance over form, step-transactions and the like, earlier and in a more comprehensive fashion than Canada, in 1988 Canada caught up somewhat by enacting a "General Anti Avoidance Rule" (GAAR) under Section 245 of the Act. GAAR allows Revenue Canada to recharacterize the effects of a transaction where one of the main purposes thereof is to achieve a tax benefit unless the transaction does not constitute a "misuse" of a particular provision of the Act or an "abuse" of the Act read as a whole. It has yet to be tested before the Canadian courts.

The enactment, however, clearly has inhibited the somewhat aggressive style which once characterized planning and structuring from the taxation standpoint, although during the late 1970s and 1980s Canadian courts had already served notice that transactions devoid of economic effect or substance would be ignored, notwithstanding that legal niceties or formalistic modalities appeared to comply with the requirements of the statutory rules.

14. Partnership and entity characterization

Neither country taxes a partnership as a separate taxpayer, but Canada does not have the US notion of recharacterizing unincorporated entities as corporations. This difference can cause a multitude of difficulties or uncertainties for cross-border joint business or investment undertakings.

There are of course many other similarities and differences between the two systems, but the foregoing review should provide some useful context in which to consider the following discussion of current developments.

II. CURRENT DEVELOPMENTS AFFECTING OUTBOUND US/INBOUND CANADIAN TRANSACTIONS AND EVENTS

A. *US-based multinationals operating in Canada*

1. Overview – basic excess foreign tax issue

US-based multinationals generally carry on business in Canada through Canadian-formed subsidiaries where, from the overall tax perspective, the predominant theme of US based multinational groups prevails, namely, stratagems for reducing foreign (Canadian) taxes in order to avoid excess foreign tax credit positions from the US perspective. In general terms such issue may arise by reason of:

(a) tax rate arbitrage factors,
(b) the particular effects of the 1986 legislated US parent company interest allocation rules to foreign source income under IRC Section 902 et al., or
(c) excess foreign tax credit positions *vis-à-vis* other controlled foreign corporations.

The first factor, tax rate arbitrage, is not in fact conclusive. Overall Canadian taxes do not always exceed those of the United States relevant to the US-based multinational, with the result that it is not always preferable that there be maximized a shift of Canadian subsidiary profits to the US parent. This is so even under the current Canada-US treaty which taxes dividend distributions from a Canadian subsidiary to a US parent at 10 percent (see discussion below respecting the probable advent of a reduced 5 percent dividend tax rate.)

Aggregate Canadian federal and provincial rates of tax on the undistributed profits of a Canadian subsidiary range from a low of 30 to 32 percent for manufacturing profits allocable to the province of Quebec to a high of some 45 to 46 percent on non-manufacturing profits allocable to most other provinces.[13] Given the 10 percent tax on dividend distributions by Canadian subsidiaries under the combined provisions of Section 212 of the Act and Article X of the 1980 Convention, the overall Canadian taxes on distributed profits is increased by some 6-7 percent and ranges from some 37-39 percent to some 51-52 percent.

If a US company has an effective US rate of tax (having regard to both federal and state taxes) which is less than the applicable Canadian taxes within the above noted range (which as discussed below may in fact be reduced by a rene-

tary), "Select Issues in Financing Cross-Border Business Activities", *Tax Notes International*, Vol. 3 No. 3 (March 1991), at 270 (Part I); Vol. 3 No. 4 (April 1991), at 397 (Part II). For a discussion of foreign affiliate rules see Nathan Boidman, "Canadian Tax Proposals - Cross-Border Effects - Part III", *Tax Management International Journal*, Vol. 19 No. 12 (December 1990), at 540. See also Nathan Boidman, "The Foreign Affiliate System: Canadian Taxation after 1982 - A Structured Overview", *CCH Canadian Limited*, 1983 and Nathan Boidman, "Canada's Taxation of Foreign Affiliates - 1982 Revisions", *Tax Management International Journal*, (4 April 1983), at 18 (Part I), (5 May 1983), at 17 (Part II), (8 August 1983), at 14 (Part III) and Vol. 13 No. 2(February 1984), at 48 (Part IV).

11. See Nathan Boidman, "Canada: New Legislation Respecting Treaty Interpretation", 10 *Intertax* (October 1983), at 383.

12. See Nathan Boidman, "Proposed 1991 Technical Amendments -Cross-Border Effects", *Tax Management International Journal*, Vol. 21 No. 3 (March 1992), at 159, 162.

13. In general terms a Canadian corporation pays a corporate tax of 28% (together with a small amount of surtax) to the federal government on income earned in and allocable to a province. There is a reduced rate of 23% (being reduced to 21% over 1993-94) on manufacturing profits. The provinces impose (a non-deductible) corporate income tax (on, generally, the same income base as taxable for federal purposes) at rates generally ranging from 14 to 15%. The province of Quebec has a rate of only 8.9% on business profits, while a few provinces have rates as high as 17%. Thus a company with manufacturing profits taxable in the province of Quebec pays an aggregate federal and Quebec corporate rate of tax of some 32% (reducing to 30% by 1994) while corporations earning non-manufacturing business profits in the highest taxed provinces may pay tax at aggregate rates as high as 45-46%.

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gotiated treaty), it would obviously be desirable from a pure tax rate arbitrage standpoint to focus on stratagems designed to shift profit from the Canadian subsidiary to the US parent. (Obviously the Clinton Administration proposals to increase the federal corporate tax rate to 36 percent on taxable income in excess of $ 10 million will decrease circumstances where US taxes are less than those in Canada.)

The second factor noted, the 1986 enacted IRC Section 904 allocation of US parent company interest to foreign source income, has of course substantially eroded effective utilization of foreign (Canadian) tax credits and results in substantial double tax (even though one could argue that there really is no double tax because the purpose of the IRC rule is to merely compensate the US fisc for the fact that the interest allocable to the Canadian dividend has previously served to reduce US domestic taxable income) – overall comprising a problem with which US corporate tax planners have struggled since 1986. A possible solution to this problem is to have loans taken directly by a Canadian subsidiary.

2. Impact of recent developments on basic excess foreign tax credit issuue

Are there any recent developments in Canadian tax law which would help solve or otherwise ameliorate the foregoing basic issues for US-based multinationals operating in Canada?

(a) *Profit shifting and Canadian transfer pricing law*

In principle profit shifts from a Canadian subsidiary to a US parent through transfer pricing arrangements as a means of solving an excess foreign tax credit issue are subject to the same constraints as would arise under US law in converse circumstances. As a capital importing country, the Canadian government has generally been concerned with intercompany charges made by foreign based multinationals to Canadian subsidiaries. Indeed it is somewhat ironic, given the concerns which have arisen in US government circles in recent years respecting earning stripping through inbound transfers by foreign-based multinationals to US foreign-owned subsidiaries, that it has generally been US-based multinationals which are the transferors in the intercompany transactions which concern Revenue Canada.

As in the United States, Canadian companies are required to maintain an arm's length standard in transactions with other members of a multinational group. However, there are no detailed statutory rules and little case law respecting the nature of an arm's length standard. Section 69 of the Act requires a price that "would have been reasonable in the circumstances had ... (the parties) ... been dealing at arm's length". Revenue Canada has published a non-binding "Information Circular" (IC-87-2) which reflects an approach patterned on the pre-January 1993 regulations under IRC Section 482 and the OECD transfer pricing guidelines (based themselves on the latter US rules).[14]

Although the Canadian government has yet to respond to the January 1993 US Proposed and Temporary IRC Section 482 Regulations, there is nothing in recent Canadian developments, aside from the role which advance rulings may play - as discussed below - which facilitates profit shifting through transfer pricing arrangements. Indeed, in order that there be effective compliance with intercompany pricing rules, recent developments, patterned on US precedents, have tightened audit and enforcement procedures.

Section 152(4)(b) of the Act has been amended to extend the normal three or four year period for reassessment (after the date of the original notice of assessment) to seven years (six years in the case of corporations not controlled by non-residents) where:

> "There is reason, as a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm's length, to assess or reassess the taxpayer's tax for any relevant taxation year."

Section 231.6, patterned on certain US law, was enacted to require a Canadian company involved in international transactions to produce "foreign-based information or documents", upon demand by Revenue Canada. Failure to comply with a request (the efficacy of which can at the election of the taxpayer be revised by a judge) will result in the following sanction:

> "... any court having jurisdiction in a civil proceeding relating to the administration or enforcement of this Act shall, upon motion of the Minister, prohibit the introduction by that person of any foreign-based information or document covered by that notice."

Section 233.1 was added, in order to increase reporting by Canadian corporations of intercompany transactions as follows:

> "Any corporation that, at any time in a taxation year, was resident in Canada or carried on business in Canada shall, in respect of each non-resident person with whom he was not dealing at arm's length at any time in the year, file with the Minister, within six months from the end of the year, an annual information return for the year in prescribed form and containing prescribed information in respect of transactions with that person."

14. For a full discussion see, *inter alia*, Nathan Boidman, "Transfer Pricing in Canada", 1989, Chapter in *The Tax Treatment of Transfer Pricing* (looseleaf service published by The International Bureau of Fiscal Documentation, Amsterdam); Nathan Boidman, "Related Party Transactions: Canada's New Administrative Guidelines Compared to IRS Section 482 and OECD Guidelines", *Tax Management International Journal*, Vol. 16 No. 11 (November 1987), at 447; Nathan Boidman, "Update on Transfer Pricing: *Indalex v. The Queen*", *Tax Management International Journal*, Vol. 17 No. 4 (April 1988), at 156; Nathan Boidman, "Intercompany Pricing - Irving Oil Case", *Tax Management International Journal*, Vol. 17 No. 6 (June 1988), at 251; Nathan Boidman, "The Section 482 White Paper and Canada-US Transactions", *Tax Management International Journal*, Vol. 18 No. 3 (March 1989), at 138; Nathan Boidman, "Revenue Canada Issues New Intercompany Pricing Reporting Form", *Tax Management International Journal*, Vol. 18 No. 5 (May 1989), at 230; Nathan Boidman, "Canadian Perspective on IRS Proposal for Intercompany Rulings", *Tax Management International Journal*, Vol. 19 No. 8 (August 1990), at 355; Nathan Boidman, "Canada-US Intercompany Pricing Update", *Tax Management International Journal*, Vol. 20 No. 4 (April 1991), at 176; Nathan Boidman, "US Transfer Pricing Proposals Will Affect Canadians", *Tax Management International Journal*, Vol. 21 No. 5 (May 1992), at 275; Nathan Boidman and Gary J. Gartner, "More Tempests in the US-Canada (Tax) Tea Pot", *Tax Management International Journal*, Vol. 21 No. 9 (September 1992), at 485; and Nathan Boidman, "Canadian Perspective on 1993 US Transfer Pricing Proposals", *Tax Management International Journal*, Vol. 22 No. 4 (April 1993), at 201.

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This form, T-106, which is patterned on US Form 5472 required in similar circumstances by the Internal Revenue Service, has been in force for some three years.[15]

The basic arm's length principle applies to the transfer of goods, rendering of services or outright transfer or licensing of intangibles. Revenue Canada had resolutely rejected the theory of the super royalty rule, at least as explained by the White Paper, in particular being concerned that super royalty legislation would provide a handy rationale for US licensors to overcharge Canadian licensees. Revenue Canada seemingly was also not enamoured with the January 1992 proposed regulations, particularly the comparable profit method, but as noted earlier its reaction to the watered down January 1993 Section 482 regulations is not yet known.

With respect to intercompany charges for services, Revenue Canada has indicated, without any particular statutory or case made law authority, that a mark-up or profit margin may not be appropriate or warranted but has acknowledged the effect of the 1980 Convention, which came into force in 1985, that US companies are not subject to a statutory rule (ironically originally enacted in 1963 in response to perceived excessive charges by US-based multinationals for services rendered to Canadian subsidiaries) imposing a 25 percent withholding tax on payments to related non-residents for administrative or management fees (even though rendered from outside of Canada) to the extent or in respect of that portion of such fee which exceeds the cost of the service so provided.[16]

Perhaps the only positive note on the transfer pricing scene for US-based multinationals is the announcement in November of last year that Revenue Canada, after a two year test period, will be adopting a generic advance ruling system for transfer pricing arrangements, presumably patterned on the US advance pricing agreement procedure. Two test cases apparently have just been completed and the ruling procedures are to be issued shortly.[17]

In summary it would appear that Canadian transfer pricing law cannot be considered to provide a handy mechanism for US-based multinationals to resolve foreign excess tax credit issues, although the advent of advance rulings may in some circumstances be of substantial benefit to a US group operating in Canada through Canadian subsidiaries.[18]

(b) *Financing arrangements*

How can financing arrangements help ameliorate the basic excess foreign tax credit issue? And do recent Canadian developments affect such stratagems? The answer to the first question may be affirmative but, except with respect to the interrelated effects of a renegotiated treaty, the answer to the second question would seem to be negative.

If a US company has an effective US rate of tax lower than the lower end of the Canadian range, it would seem desirable to structure investment in a Canadian subsidiary through interest- bearing debt. In this respect the following comparative Canada-US points may be noted:

Unlike the US approach, under Canadian tax law "a loan is a loan". Investment made in a Canadian corporation by way of loan, recognized as such under applicable corporate or commercial law, would be treated as such for Canadian tax purposes. There is of course no tax on repaying debt.

Further, even if the debt were recharacterizable as stock, under Canadian law the full amount of stock investment ordinarily may be repaid without tax even though the corporation may have undistributed profits on hand.[19] In other words, there is no comparable Canadian notion to the US rule that payment in respect of stock may be treated as a taxable dividend to the extent of underlying undistributed income ("earnings and profits"). As a result, the absence of deemed dividend treatment on the retirement of stock investment (provided the amount paid does not exceed the amount originally invested in the stock) provides much flexibility, from the Canadian standpoint, to a US company, having regard to the eventual repatriation of the investment, in deciding whether to invest in debt or shares of the Canadian subsidiary. In either case, the investment may be retired without Canadian tax.

It was noted earlier that, unlike the more complex and uncertain "thin capitalization" effects of IRC Sections 385 and 163(j), in Canada there is a clear, relatively well understood and relatively non-onerous statutory thin capitalization rule governing interest-bearing debt financings received from non-resident shareholders. Under Section 18(4) et seq. of the Act, interest paid on loans to foreign shareholders is fully deductible except to the extent of interest relating to that portion of loans received from 25 percent or greater foreign shareholders which exceeds three times the equity of the corporation attributable to such shareholders (measured by reference to paid-in capital and retained earnings). Accordingly, for example, in the case of an initial $ 10 million funding of a newly formed Canadian subsidiary, $ 7.5 million could be injected by way of fully deductible interest bearing debt and $ 2.5 million by way of capital stock investment.[20]

In some situations it might be overall preferable for the US parent company to fund the Canadian company with debt bearing no interest or below-market interest. This might arise, for example, where the Canadian subsidiary is in a loss position. Canadian tax law would accommodate such strategy and, in particular, would not impute interest (income or

15. For a discussion see Boidman, *supra* note 14 (*TMIJ*, Vol. 18 No. 5).
16. See Nathan Boidman, "Revenue Canada Acknowledges 1980 Convention Exemption for Management Fees - IT-468R", *Tax Management International Journal*, Vol. 19 No. 3 (March 1990), at 133.
17. For a full discussion of this matter from the Canadian perspective see Nathan Boidman, "The Effect of the APA and other US Transfer-Pricing Initiatives in Canada and Other Countries", *The Tax Executive*, Vol. 44 No. 4 (July-August 1992), at 254.
18. For a discussion of certain other recent developments respecting subordinate transfer pricing law themes or factors see Nathan Boidman "Developments in Transfer Pricing", *Butterworths -Canadian Current Tax*, Vol. 2 No. 35 (November 1992). For example, in *Crestbrook Forest Industries Ltd. v. The Queen*, 92 DTC 6187 (F.C.A.), the Federal Court rejected an attempt by Revenue Canada to utilize information respecting comparables, voluntarily divulged to it in a government sponsored study of pricing in the pulp and paper industry. See also note 67 *infra* respecting *Crestbrook*.
19. See, inter alia, Secs. 84 and 89(1)(c) of the Act.
20. For December 1991 proposed amendments to the Sec. 18(4) thin capitalization, see Nathan Boidman, *supra* note 12, at 159-160.

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expense) for either party to the transaction.[21] Although as discussed earlier the Canadian "equivalent" of IRC Section 482, Section 69 of the Act, requires that amounts charged by a foreign related person to a Canadian company not exceed an arm's length amount, these rules do not require that a Canadian company pay an adequate amount to a foreign related party for goods or services.

Where a US parent makes an interest-bearing loan to a Canadian subsidiary, and incurs a 15 percent Canadian withholding tax on the interest payments under Article XI of the 1980 Convention, interest expense incurred by the US parent may serve to reduce credit, under IRC Section 901, in respect of the Canadian withholding tax.

As already noted, the interrelationship between interest deductions and foreign tax credits under the IRC becomes even more complex where dividends are received on stock investment, as a result of the 1986 tax reform amendments requiring a portion of the US parent company's interest expense, otherwise deductible against US domestic income, be allocated to and deducted from the foreign source (Canadian subsidiary) grossed-up dividend for purposes of applying the basic IRC Section 902 foreign tax credit limitation.

One possible solution to the latter problem, particularly where there is to be direct borrowing to fund the investment in the Canadian subsidiary, is to have the loan taken directly by the Canadian subsidiary. The income derived from the borrowed funds by the Canadian subsidiary would service the debt and thus reduce Canadian taxable income on a dollar-per-dollar basis. Such income would not flow through or to the hands of the US parent. However, where the US parent must guarantee such loans, there are a number of points to be considered:

(a) Is it possible, under the principles of *Plantation Patterns*,[22] that a loan guaranteed by the US parent would be considered to have been made to the US parent which has invested in stock of the Canadian subsidiary, so that interest payments by the Canadian subsidiary are treated as distributions to the US parent in respect of stock, with the result of not avoiding the problem at all?

(b) A guaranteed loan ostensibly has the benefit of avoiding the Canadian three-to-one debt-to-equity thin capitalization restrictions under Section 18(4) of the Act, described above. However, it should be noted that where such guarantee is collateralized by a deposit with the lender (or perhaps related entity), it may run afoul the "back-to-back" rule of Section 18(6) so as to result in the third party loan being treated as a shareholder loan for purposes of the thin capitalization rules.

(c) A collateralized loan may also give rise to Canadian withholding tax issues. There is no Canadian withholding tax on interest paid to an unrelated non-resident lender on a loan in respect of which no more than 25 percent of the principal of which is required to be repaid during the first five years of the loan,[23] or paid on foreign currency deposits with Canadian banks. However, there is concern that certain collateralized guaranteed (back-to-back) loans to Canadian operating subsidiaries result in unintended application of this exemption and avoidance of Canadian tax on interest effectively paid to related non-residents. Thus, for example, a number of years ago the Canadian government extracted an agreement from the Canadian Bankers Association that its members would not enter into back-to-back loan arrangements of this type. It is somewhat ironic that such concerns (and the latter anti-avoidance arrangement) could serve to obstruct a loan arrangement put in place by a US parent in order to avoid the harsh results of US tax law.

(d) Neither the thin capitalization nor the withholding tax concerns arise where the guaranteed loan is not collateralized or is collateralized with third party security.

(e) If the US parent charges a loan guarantee fee to its Canadian subsidiary, such amount is deemed under Section 214(15) of the Act to be interest subject to Canadian withholding tax. Such taxation would be permitted, at 15 percent, under Article XI(4) of the 1980 Convention which defines interest as meaning, *inter alia*, "... income assimilated to income from money lent under the taxation laws of the Contracting State in which the income arises". Would a foreign tax credit arise in respect of such Canadian withholding tax? From the US standpoint, a guarantee is viewed as a service, the income from which has a source at the place of residence of the guarantor?[24] However, under Article XXIV(3) of the 1980 Convention, items of income which Canada is permitted to tax under the terms of the treaty are supposed to be resourced in Canada for foreign tax credit purposes. Is there any reason why the IRS would not agree with such treatment? Finally recent audit experience is that Revenue Canada treats a guarantee as a service and would accept a reasonable arm's length charge under the Section 69 transfer pricing rules.

The foregoing only touches on some of the issues for direct finaning of US-owned Canadian subsidiaries.[25]

The US-controlled foreign corporation - Subpart F rules seem to generally eliminate overall benefits for US-based multinationals to finance Canadian operations through captive finance vehicles. For example, it would not ordinarily be advantageous to flow interest from a Canadian operating subsidiary to a third country captive finance company (as would be the case where a Canadian based multinational uses a third country captive finance company to finance a Canadian owned US subsidiary).[26]

However, US groups can benefit from financing Canadian subsidiaries through Canadian corporations qualified as a "non-resident-owned investment corporation" (NRO) under

21. Query, however, whether such loan would attract interest imputation for the US parent under IRC Secs. 482 or 7872.
22. *Plantation Patterns, Inc. v. Commissioner*, T.C. Memo 1970-182, aff'd 462 F.2d 712 (5th Cir. 1972), cert. denied 409 U.S. 1076.
23. Sec. 212(1)(b)(vii) of the Act.
24. See *Bank of America v. Commissioner*, 680 F.2d 142 (Ct.Cl. 1982).
25. For a good discussion of certain issues see Kenneth J. Snider, "Canadian Interest Withholding Rules: The US Lender Perspective", *Tax Management International Journal*, Vol. 21 No. 10 (October 1992), at 564. See also note 67.
26. See *supra* note 10 and related text.

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Section 133 of the Act. A NRO is a corporation all of the shares of which are owned by non-residents and which derive income exclusively from certain passive activities such as investment in interest bearing securities.[27] The NRO pays a fully refundable 25 percent tax on its income, with Canadian withholding tax being exigible on dividends paid by the NRO to its non-resident shareholders as the same time that the NRO receives refund of the interim 25 percent tax on the income it has received.

There have been structures put in place where, depending upon a US taxpayer's specific foreign tax credit position under IRC Section 902 et seq., financing US-owned Canadian subsidiaries through NROs has proven beneficial.

There are two key factors from the US standpoint in respect of such arrangements. First, under the "same country" exception, interest paid by a Canadian operating company to the NRO would not be subject to attribution under Subpart F.[28] Second, there are circumstances where excess foreign tax credits, arising from Canadian or other foreign operations, or current or cumulative underlying foreign (i.e. Canadian) tax relevant to dividend payments, may serve, depending upon the particulars of the overall arrangement, to eliminate any net US tax on dividends paid by the NRO out of its interest income, notwithstanding that the net Canadian taxes paid in respect of the income realized in such fashion is restricted to the 10 percent withholding tax on dividends paid by the NRO.[29] In other words, in some circumstances the reduction of Canadian source taxation through the NRO interest payment arrangement is not offset by an increase in overall US taxes.

The only current development which may improve the latter arrangements for US-based multinationals is the ongoing renegotiation of the 1980 Convention and the likelihood that tax on cross-border interests will be reduced at least to 10 percent (from the current 15 percent) and that tax on cross-border intercorporate dividends would be reduced from 10 to 5 percent.

The reduction in the treaty interest withholding rate would improve the results of direct cross-border US parent-Canadian subsidiary loans as discussed above, to the extent that the current 15 percent withholding tax results in excess foreign tax credits. (With respect to this first point, it has been suggested that such a reduced dividend tax rate could be coupled with a change announced in the December 21/92 proposals, which would refund to foreign shareholders the deemed dividend tax payable on loans made by Canadian corporations to foreign shareholders where such loans are repaid, to withdraw funds from a Canadian subsidiary in advance implementation of the proposed treaty reduction in dividend withholding tax rates).[30]

The reduction in dividend rates could improve matters in two different ways. First, having due regard to the foregoing discussion respecting tax rate arbitrage, there could result, at least in certain cases, an effective overall Canadian corporate (profit) level and shareholder (dividend) level rate of tax which is less than the US (federal and state) tax applicable to the US-based multinational. Second, having regard to the NRO arrangement described, deductible interest charges can be effectively converted into payments taxable from the Canadian standpoint as dividends at a rate of 5 percent. The latter effect, however, will not arise if the approach as seen in the Protocol signed between Canada and the Netherlands on 4 March 1993 obtains in a new Canada-US treaty. In particular, the Protocol does reduce the withholding tax on dividends paid by Canadian subsidiaries to Dutch parent corporations from 10 to 5 percent (over a five year phase-in period commencing in 1993). It also reduces withholding tax on interest, under Article XI, from 15 to 10 percent. However, it specifically maintains a 10 percent tax on dividends paid by NROs to Dutch parent corporations and, to the extent such rules are incorporated in a new Canada-US income tax convention, interest payments pursuant to the NRO arrangement described above will continue to be effectively taxed, as at present, at 10 percent.

The prognosis for a 5 percent treaty rate on dividends was considerably enhanced by an announcement 25 February 1992 by the Canadian Department of Finance in its 1992 annual budget which, without mentioning the Canada-US treaty specifically, stated that there would be a basic change in Canada's tax treaty posture with respect to withholding taxes on dividends. The government would drop its long entrenched position of not granting withholding tax rates which are less than 10 percent and, instead, would negotiate a 5 percent withholding rate on intercorporate dividend flows. This development was not surprising given the strong US business lobby on US treaty negotiators to negotiate a reduction in the current 10 percent withholding rate.[31] As noted above, this new policy has been implemented for the first time in the 4 March Canada-Netherlands Protocol.

2. Note respecting relevance of third country treaties

Finally it should be noted that the proposed change of Canadian treaty policy on intercorporate dividends, changes in

27. Beyond the scope of this paper are concerns that intercompany loans by an NRO constitute the business of lending, thus invalidating the NRO status, unless circuitous procedures are employed. In this respect, however, see a recent Revenue Canada ruling (Advance Tax Ruling ATR-43, Utilization of a Non-Resident-Owned Investment Corporation As A Holding Corporation, 17 February 1992), which seemed to downgrade this concern or at least clearly accepts the circuitous procedure.

28. See IRC Sec. 954(c)(3) and (d)(3).

29. It is obviously an advantage that the net effect of the NRO arrangement from the Canadian standpoint is to reduce tax on interest payments to 10 from 15%. See below, however, the anti-avoidance approach reflected in the 4 March 1993 Protocol to the Canada-Netherlands income tax convention respecting the interrelationship between tax on dividends under Art. X and tax on interest under Art. XI. The same may well appear in the new treaty between Canada and the United States and consider the effects thereof on NRO arrangements, discussed below.

30. See Allan Lanthier, "Technical Bill Hits International Planning", *Canadian Tax Highlights*, (Canadian Tax Foundation), Vol. 1 No. 2 (16 February 1993), at 16.

31. For a full discussion of this matter, see Boidman, *supra* note 5. Reference may also be had to that article for a discussion of as yet unimplemented proposals to increase the rate at which manufacturing equipment may be depreciated (from 25 to 30% on a declining balance basis) and the change already noted in the reduced rate of tax on manufacturing and processing profit from (federal) 23 to 21% (before surtaxes) which will be phased in over a two year period commencing 1 January 1993. (Reference to that article and the earlier discussion respecting Quebec corporate rates of tax on business profits should take into account that subsequent to the publication thereof the Quebec rate of roughly 6% was raised to 8-9%.)

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European taxation under the EC intercorporate dividend directives and the current treaty between Canada and Luxembourg would, in certain select situations, make it advantageous for a US-based multinational to consider using excess profits of a Canadian subsidiary to directly fund third country (say European) expansion and investment.[32]

B. *Other US outbound/Canada inbound business and investment matters*

1. Overview

Unlike the preceding discussion there is no predominant theme respecting the interrelationship between current Canadian developments and other US business or investment activities in Canada. A number of situations, however, may be of interest and useful to at least note briefly.

2. Cross-border software licensing

US companies which develop and sell standard application software directly to Canadian customers are generally treated as licensors (of software) - notwithstanding the single transaction, lump sum price nature of such arrangements - and under the combined provisions of Section 212(1)(d) of the Act and Article XII of the 1980 Convention subject to a 10 percent (withholding) tax on the gross sale price. This notwithstanding that both the Canadian Act and the 1980 Convention contain an exemption for non-resident licensors of computer software provided that the arrangement conveys to the licensee a right to reproduce and not simply a right to use. (This is based on computer software being subject to copyright protection as a literary work and thus eligible for the relevant Act and treaty exemption for payments for the right to reproduce a literary work subject to copyright protection.)

The latter exemption does not apply to the sale of prepackaged software given the usual prohibition against reproduction where the arrangement normally conveys simply a right to use (normally in perpetuity) but with restricted covenants respecting disclosure or reassignment.

Some US companies have sought the assistance of the IRS in dealing with this problem. In particular there was an item in the *BNA Daily Tax Report* last fall to the effect that certain US software companies believe that if the IRS would issue a ruling generally treating comparable inbound software transactions as the sale of property and not a licence, that Revenue Canada would be persuaded to adopt a similar position respecting inbound sales to Canadians by US companies.[33] This observer has noted (see note 32) that it is unlikely that Revenue Canada has the authority to modify the relevant interpretation and that a remedy would require either legislation or a change in the terms of the 1980 Convention. (See also note 60.)

The prognosis for relief for US licensors brightened considerably in March and April. In the 4 March Protocol to the Canada-Netherlands income tax convention referred to above there was instituted an exemption, under Article XII, from cross-border withholding tax on royalties paid for the use of computer software. This somewhat unexpected development was explained by the federal government in its 26 April Budget when it announced that, in order to increase Canadian industry's access to foreign technology, it was prepared through bilateral treaty negotiations to exempt both royalties paid for the use of computer software and royalties for patented information and know-how. In particular, the Department of Finance stated in the Budget Release:

> "New technology is being rapidly developed and integrated into production and distribution systems. It is important for Canadian businesses to acquire new technologies in order to maintain their ability to compete in the global marketplace. An issue identified in the December 1992 Economic and Fiscal Statement was whether the tax system is impeding the ability of Canadian firms to access these new technologies." (pps. 76-77 of Budget Speech)
>
> "The government also affirms its commitment to negotiate, on a bilateral basis, exemptions from withholding taxes for payments made for the use of computer software. Canada recently concluded a protocol to the Canada-Netherlands Income Tax Convention which provides for such an exemption." (p.78 of Budget Speech)

3. Cross-border divisive reorganization curtailed

Residents of the United States are generally exempt from Canadian tax on the sale of shares of a wholly owned Canadian subsidiary provided that the value of its shares are not principally derived from Canadian real estate or resource properties, pursuant to Article XIII(4) of the 1980 Convention notwithstanding that under domestic law such a disposition would be subject to Canadian tax. Conversely, the sale of shares of a Canadian real estate company or other corporation the value of the shares of which are principally derived from underlying real estate would be subject to Canadian tax pursuant to Article XIII(3) of the Convention.

In light of the foregoing rules and certain Canadian law respecting tax-free divisions of corporations into two or more successor corporations through "butterfly" reorganizations - entailing a combination of statutory and administrative made rules - a US owned Canadian corporation the assets of which do not principally comprise real estate (say an operating company with real estate assets used in carrying on same) can, under current law, be reorganized in such a fashion that appreciated real estate owned by the corporation can be sold without Canadian tax.

This could be accomplished as follows:

(a) The US shareholder of the Canadian corporation (Canco I) would establish a second Canadian corporation (Canco II) and transfer, on a taxable but treaty protected basis, a portion of the shares of Canco I representing the underlying value of real estate to be spun off, taking back shares in Canco II equal to the value of the portion of the transferred Canco I stock.

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32. For a discussion see Nathan Boidman, "Canadian Treaty Developments - In the US Context", *Tax Management International Journal*, Vol. 20 No. 9 (September 1991), at 410.

33. For a full discussion of this matter (and the BNA report) see Nathan Boidman and Gary J. Gartner, "More Confusion Over Cross-Border Software Taxation", *Tax Management International Journal*, Vol. 21 No. 11 (November 1992), at 633.

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(b) The US shareholder would take full basis for Canadian tax purposes in the stock issued by Canco II, notwithstanding that the sale is exempted from Canadian tax under Article XIII(4).
(c) Canco I would then transfer the target appreciated real estate to Canco II under a deferred tax (rollover, non-recognition) transaction under Section 85(1) of the Act - comparable to IRC Section 351 - in exchange for preferred stock issued by Canco II.
(d) The intercorporate shareholdings (common stock of Canco I held by Canco II and the preferred stock of Canco II held by Canco I) would be unwound on a tax-free basis through redemptions relying, in part, on Section 112 of the Act which normally exempts from Canadian tax Canadian inter-corporate dividends.

At the end of the series of transactions the US shareholder would own all of the stock of each of Canco I and Canco II, Canco I would remain with the non-real estate assets and Canco II would own the real estate assets. The US shareholder would have a full basis in the stock of Canco II and he could then proceed to sell it to a third party notwithstanding that it is principally a real estate company.

This type of arrangement would be curtailed pursuant to the December 21/92 Proposals.[34] In particular, Section 55(3.1) would be added to the Act and have the effect of recharacterizing as a taxable capital gain the otherwise tax-free intercorporate dividend arising upon the unwinding of the cross shareholding created in the course of the butterfly transaction. The proposed change would have an immediate effective date (that is on 21 December 1992) although there would be grandfathered transactions occurring "... pursuant to a written agreement entered into on or before the announcement date (21 December 1992)".

Update

Perhaps it is not surprising that on 4 May the Department of Finance announced a broader rule to "... curtail a tax avoidance technique commonly referred to as the 'cross-border purchase butterfly'".[35] The Release goes on to state:

> "The cross-border purchase butterfly consists of a series of transactions designed to avoid tax on arm's-length sales of assets by Canadian corporations. The mechanism allows a capital gain at the corporate level to be deferred until the assets are ultimately disposed of by the purchaser in a subsequent taxable transaction. As well, the proceeds of sale are in effect received at the shareholder rather than the corporate level. Thus, the technique effectively converts a corporate distribution that would otherwise be subject to withholding tax into a capital gain which, in many cases, is sheltered from Canadian tax by a treaty exemption."
>
> The proposed amendment would eliminate the tax advantages of structuring a corporate asset sale as a purchase butterfly in cross-border situations.

Thus, the 4 May announcement effectively extends to any divisive reorganization and subsequent sale of part of the assets of a corporation the constraints outlined above (under the December 21/92 Proposals) even where the assets being spun off are not primarily Canadian real estate or resource properties. In other words, it will no longer be possible for a foreign-owned Canadian corporation to be sold only in part on a tax-deferred basis.

4. Cross-border mergers and acquisitions – generally

It was noted earlier that tax-effective acquisition of Canadian corporations may be assisted by the limited tax-free step-up in inside basis rule under Sections 88(1)(c) and (d) of the Act as well as by the various rules for financing Canadian subsidiaries also described earlier [which, in principle, can provide the basis (to the extent that a Canadian acquisition corporation is utilized) to repatriate without any Canadian tax the amount invested to acquire the Canadian company].

However, it was also noted that, except in the case of Canadian- based multinationals reorganizing their holdings in foreign affiliates, rollover (non-recognition) treatment is not generally accorded to cross-border corporate reorganizations. This makes it very difficult to combine on a tax-efficient basis Canadian and US operations or form a single-entity joint venture between Americans and Canadians.

For example, a Canadian cannot exchange on a tax-free basis stock of a Canadian corporation for stock of a US acquisition corporation (without resorting to certain types of step transactions which presumably would attract the attention of the GAAR referred to above). Similarly non-Canadian assets of a Canadian target cannot generally be spun off on a tax-free basis to a US acquirer.

If anything, the December 21/92 Proposals further tightened the net by extending the rules under Sections 88.1 and 219.1 of the Act (which, as described elsewhere, create taxable gain or income at both the corporate and shareholder level where a Canadian formed company is continued by export continuance rules out of Canada) to termination of Canadian residence by foreign incorporated companies which have been resident in Canada based on the central mind and management test.[36] Moreover, in the case of cross-border mergers all predecessor corporations will adopt the same residency status as the amalgamated corporation, under proposed Section

34. See *supra* note 1.
35. See Department of Finance Release 93-029, "Notice of Ways and Means Motion Tabled Relating to Cross-Border Purchase Butterfly Transactions".
36. One effect of the foregoing change respecting departing corporations is the (inadvertent?) termination of an interesting though illusive tax minimization arrangement. Under present law, a foreign incorporated company resident in Canada continuously since 17 June 1971 is deemed under Sec. 89(1)(a) to be a "Canadian corporation" for purposes of the Act and thus eligible to participate in tax-free reorganizations. At the same time under current law, as discussed further below, the termination of residence of such a corporation would not trigger the disposition-of-all-asset rule of Sec. 88.1 - referred to above -the corporation not having been formed in Canada (under the limited departure tax rules of Sec. 48 which are restricted under current law in general terms to non-Canadian capital property, also as discussed below). As a result of the latter factors, a taxpayer could transfer shares of a private Canadian corporation to such a "17 June 1991" corporation on a tax-free basis under Sec. 85(1) of the Act, which could then terminate Canadian residence without a departure tax (given that its assets consist of shares of a private Canadian corporation). If new residency were established in a country which has a treaty with Canada which provides capital gains exemption (generally in a non-real estate context), a tax-free sale of the Canadian shares could then be carried out, all in a fashion which would clearly constitute an unintended result (although technically sound and subject only to perhaps the Sec. 245 GAAR). However, the December 21/92 Proposals would terminate such stratagem in that the departing 17 June 1971 corporation would be deemed to dispose of all assets and not just Canadian capital property.

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128.2, which could have consequential adverse effects pursuant to the proposed deemed arrival or departure rules under Section 128.1.

In summary, although certain innovative approaches to cross-border mergers and acquisitions have been developed in niche situations in recent years,[37] it remains that it is very difficult to either merge a Canadian corporation or Canadian business assets in a cross-border joint venture or acquisition structure or spin-off Canadian assets to a non-Canadian entity in the course of a Canadian business acquisition.

5. Sale of Canadian real estate acquired before 1972

US persons who sell Canadian real estate are generally subject to full Canadian taxation on gains derived therefrom, including recapture of depreciation as ordinary income. Such taxation, arising under the combined provisions of Sections 2, 13, 38-55 and 115 of the Income Tax Act, is basically unfettered by the terms of the 1980 Convention.

However, the former (1942) Convention generally exempted US persons from Canadian tax on gains derived from the sale of Canadian real estate provided same are not associated with a permanent establishment in Canada under, inter alia, Article VIII of the 1942 Convention. To provide transitional relief for cross-border real estate investors who acquired property prior to the signature of the 1980 Convention (26 September 1980), Article XIII(9) of the 1980 Convention excludes from taxation a portion of gain realized on a post-effective date (generally for these purposes after 1985, given the one-year extension of the 1942 exemption beyond the 1 January 1985 effective date) disposition of real estate acquired before 26 September 1980.

The excluded portion is, generally, the greater of the amount determined by utilizing a valuation of the property on 31 December 1984 or by applying a formula which takes into account the holding period of the property before 1985 or after 1984. Under this formula a person who has acquired Canadian real estate say in 1950 and sold it in 1990 could pro-rate overall gain between (1) the period 1950 to the end of 1984 (as being exempt), and (2) the period 1985-1990 (as being taxable).

The pro-ration rule came into dispute in a 1992 decision involving the sale by a US person of Canadian real estate acquired in 1952 by reason of a Canadian domestic rule which accompanied the introduction of capital gains tax, generally, in Canada in June 1972. Under the domestic (transitional) rule a taxpayer received a cost base equal to the value of the property on December 31, 1971 so that a post-1971 sale of such pre-1972 property would give rise to gain measured by reference to the excess of sale proceeds over the deemed cost base established on 31 December 1971.

In the *Estate of the Late Isaac Kaplan and Her Majesty The Queen*,[38] Revenue Canada took the position that in applying the interrelated effects of the domestic transitional rule and that under Article XIII(9), the gain to be determined was based on the 31 December 1971 value of the property and the period for proration for the purpose of Article XIII(9) commenced only on 1 January 1972. Under such interpretation the overall taxable gain for the US taxpayer would exceed that arising if the Canadian transitional rule were ignored and there was taken into account the original acquisition date by the US taxpayer and his original cost. The Tax Court of Canada rejected Revenue Canada's approach to the application of Article XIII(9) and held that it should be applied without reference to the effects of the Canadian transitional rule.[39]

6. Corporate tax on capital

Aside from the corporate profits tax (and tax on dividend distributions), US investors or other owners of shares of Canadian corporations should be aware, generally, of tax on capital, normally imposed only under provincial taxing statutes but also on certain "large" corporations under the federal Act (and, in part, serving as a minimum tax). This "nuisance" tax can be quite costly and, for example, in the province of Quebec is equal to roughly one-half a percent of a corporation's capital (generally capital stock, retained earnings and long term debt). Under the federal Act it applies at a rate of one-fifth of 1 percent (with exemption for the first $ 10 million of capital).[40] (See also note 58.)

7. Canadian treaty exemption for third country corporations based in the United States

One would normally think that only corporations formed in the United States would qualify as residents of the United States for purposes of the 1980 Convention. However, a somewhat surprising decision of the Federal Court Trial Division in *Crown Forest Industries Ltd. v. The Queen*,[41] decided that a Bahamian formed shipping company having its central management and place of business in the United States qualified as a treaty resident of the United States notwithstanding that the corporation was also exempt from US tax by reason of IRC Section 883 respecting international shipping income.[42]

It may be noted that, paradoxically, in the case of individuals, Revenue Canada seems to take the point of view that a US citizen who is not "resident" in the United States in the "ordinary" sense is not entitled to treaty benefits from Canada notwithstanding general liability to US tax under the IRC.[43]

37. For a very comprehensive discussion of the topic which is well beyond the scope of this paper, see D. Kevin Dolan, Allan R. Lanthier, David W. Smith and James J. Tobin, "Cross-Border Corporate Reorganizations", *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Canadian Tax Foundation, at 17:1.
38. Tax Court of Canada 92-1380 (IT) 19 November 1992.
39. For a full discussion of this decision see Nathan Boidman, "Canadian Court Interprets Treaty Transitional Rule (Art. XIII(9))", *Tax Management International Journal*, Vol. 22 No. 2 (February 1993), at 87, which includes reference to the Income Tax Conventions Interpretation Act, referred to earlier.
40. For a discussion of proposed changes to the federal large corporation capital tax (and implications for US groups), see Peter E. Salvatori, "Cross-Border Implications of Proposed Capital Tax Changes", *Tax Management International Journal*, Vol. 21 No. 7 (July 1992), at 389.
41. 92 DTC 6305.
42. For a full discussion, see Nathan Boidman, "Non-US Corporation Held US Resident for Canada-US Treaty", *Tax Management International Journal*, Vol. 21 No. 6 (June 1992), at 345.
43. For a discussion see Michael Cadesky and Sonja Chong, "A New Twist to the Tie-Breaker Rule on Dual Residency", *Tax Management International Journal*, Vol. 21 No. 1 (January 1992), at 35.

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8. Interest deductibility

In order for interest to be deductible for Canadian tax purposes the specific provisions of Section 20(1)(c) of the Act must be met which, in general terms, require that the funds borrowed be utilized to earn income from investments or carrying on of a business. Canadian taxpayers, which obviously could include Canadian corporations owned by US persons, have had a multitude of disputes with Revenue Canada over the interpretation of this simply worded statutory provision where there is not a direct relationship between the borrowing of funds and the use thereof to earn income from a business or property.

For example, can a corporation deduct interest on funds used to pay a dividend or to redeem or otherwise reduce capital stock?

A Supreme Court decision in 1986, *The Queen v. Bronfman Trust*,[44] brought the pre-existing issues to a head in deciding that a trust could not deduct interest on funds borrowed to make a capital distribution (rejecting the taxpayer's claim that the borrowings were intended to preserve the income earning capacity of the assets retained and not used for the distribution). This brought into question certain Revenue Canada administrative tolerances respecting the deductibility of interest on funds not used directly to finance income earning activities.

As a result of the uncertainty stemming from *Bronfman*, the Department of Finance, commencing in the middle of 1987 and continuing through to December of 1991, has issued a series of draft proposals for amendment of the interest deductibility rules, where, as already noted, the focus is on conventional transactions which, however, do not entail direct use of the borrowed funds to earn income. It is now more than six years since the *Bronfman* decision, and legislation has yet to be finalized to clarify this obviously critical aspect of Canadian tax law. Therefore, US practitioners with clients having Canadian activities which require reference to interest deductibility under Canadian tax law are well advised to monitor this issue.[45]

9. Canadian surplus stripping rules in the international context

As noted earlier, a US shareholder of a Canadian corporation is generally exempt from Canadian tax on the sale of shares therein under Article XIII(4). However, distributions made by a Canadian corporation to a US shareholder in respect of stock (by way of redemption or reduction of capital stock or paid-up capital) are treated as dividends to the extent payment exceeds the relevant paid-up capital of the shares on which the redemption or other distribution is made. This rule (under Section 84 of the Act) applies regardless of the basis in the stock.

In order to protect the integrity of the foregoing deemed dividend rule and having due regard to both the aforementioned Article XIII(4) treaty exemption and the general rule under Canadian tax law that inter-Canadian corporate dividends are tax-free, there is an anti-surplus stripping rule contained in Section 212.1 which prevents a US person from selling shares of a Canadian corporation to a related Canadian corporation and receiving proceeds (other than shares of the transferee corporation) on a tax-free basis. Section 212.1 would treat any non-share consideration as a deemed dividend to the extent such would have arisen had there been a direct redemption or distribution by the transferred Canadian corporation.

In 1991 rules were tabled to extend the circumstances in which Section 212.1 would apply and, for example, could arise in a situation where a person other than the US shareholder or a person related thereto controls the target Canadian corporation.[46]

10. Incorporating a Canadian branch

Where a US corporation carries on business directly in Canada through a branch and seeks to transfer the business to a Canadian subsidiary, the combined effect of the rollover rules under the Act and/or the provisions of the 1980 Convention would generally provide for non-recognition treatment on such branch incorporation.

However, the transfer of Canadian real estate in the course of such branch incorporation would normally not qualify for non-recognition treatment (for example under Section 85 of the Act). The latter defect however has been cured by the enactment of Sections 85(1.1)(h) and 85(1.2) of the Act in 1991.[47]

11. Ambit of relief under Article XIII(8)

As noted earlier a US person who transfers Canadian real estate or shares of a Canadian corporation the principal value of which are derived from Canadian real estate is not afforded any treaty protection from tax otherwise arising under the Act. However, such gains (or others which may be taxed under Article XIII of the Convention) may be afforded deferral treatment under a discretion granted Revenue Canada by Article XIII(8) of the 1980 Convention.[48]

Canadian tax authorities felt compelled to mirror Article XIII(8) in a statutory provision, Section 115.1 of the Act. However, neither the treaty nor the statutory rule (as pro-

44. 87 DTC 5059.
45. For a discussion of the particular effect of the interest deductibility rules respecting financing of US subsidiaries by Canadian-based multinationals, see Nathan Boidman, "Cross-Border Effect of Interest Deduction Proposals", *Tax Management International Journal*, Vol. 21 No. 3 (March 1992), at 157, and discussion below. See also note 67.
46. For a full discussion see Boidman, *supra* note 12, at 160.
47. For a discussion see Nathan Boidman, "Canadian Tax Proposals - Cross-Border Effects", *Tax Management International Journal*, Vol.19 No. 9 (September 1990), at 397, 399.
48. Article XIII(8) reads as follows:
"Where a resident of a Contracting State alienates property in the course of a corporate organization, reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that State, if requested to do so by the person who acquires the property, the competent authority of the other Contracting State may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect so such property for the purpose of taxation in that other State until such time and in such manner as may be stipulated in the agreement."

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posed to be amended in December 1991)[49] indicate the circumstances in which Revenue Canada will exercise such discretion.

What has become clear from applications to and discussions with Revenue Canada is that relief will not be provided under Article XIII(8) where a US person seeks to transfer Canadian property otherwise subject to tax under Article XIII to a US corporation under US IRC Section 351. Revenue Canada is of the view that the ambit of the provision does not include transfers to corporations, even if upon incorporation of same, and it is interesting to note that this position apparently underlies a similar position adopted by the IRS in applying to Canadians the provisions of Article XIII(8).

12. Cross-border aircraft leasing

As a result of an amendment to Section 212(1)(d) of the Act, adopted in 1992, US or other foreign lessors of aircraft to Canadian users are exempt from Canadian tax otherwise arising on rents or royalties paid to non-residents (which would, in the absence of such statutory exemption, be 10 percent in the case of payments to a US lessor under Article XII of the 1980 Convention).

This exemption has eliminated a host of convoluted arrangements previously utilized by Canadian lessors to avoid the effects of Canadian withholding taxes on international transactions.[50]

13. Canadian court takes very broad view of permanent establishment

In 1990 the Tax Court of Canada decided that a US person who regularly exhibited and ran a small shop at an annual two week fair in Vancouver had a permanent establishment within the meaning of the 1980 Convention. This finding comprised a very broad view of that fundamental treaty concept and US observers should take note of this case.[51]

C. *US transfers and moves to Canada*

1. Planning for high net worth individuals

US practitioners may deal with executive transfers to Canada or moves of high net worth US individuals or families to Canada (with or without renunciation of US citizenship). The latter may be tax motivated having regard to the effects of two interrelated Canadian tax rules:

- as noted at the outset, Canada does not impose a conventional estate, succession or inheritance tax; and
- since the introduction of the capital gains tax in Canada in 1972, there has been a step-up in cost base for incoming residents in respect of capital property the effect of which is to exclude from taxation the pre-arrival appreciation in capital property realized upon a post-arrival disposition thereof, pursuant to the present terms of Section 48 of the Act.[52]

It is obvious that, leaving aside the effects of certain anti-avoidance provisions under the IRC respecting expatriating US citizens who retain certain US-based property, the aggregate effect of the foregoing regime of Canadian taxation can, in appropriate circumstances, substantially reduce the overall taxation, particularly at death, of high net worth US taxpayers.[53] The scope of such potential saving would be increased by the December 21/92 Proposals.

In particular, as noted, under current law the step-up in cost base applies only to capital property (which, generally, is not based in Canada). The proposals would replace Section 48 by Section 128.1 and extend the step-up rule to all property, not just capital property (other than Canadian capital assets or assets used in carrying on a Canadian business) owned at the time of arrival. Thus, under these proposals, an incoming US person would be protected from Canadian tax on disposing of inventory or other non-capital property (say non-Canadian undeveloped real estate which normally does not qualify as capital property)[54] to the extent of pre-arrival appreciation realized on a post-arrival disposition. This new rule could also provide a step-up in cost base for intangible property of a business directly carried on by an incoming resident such as, for example, going concern commercial goodwill.

2. Consequential effects on incoming corporations

It should also be noted that the December 21/92 Proposals would change the rules respecting the assumption of Canadian residency by foreign formed corporations. Although such status would not generally arise in the case of a US formed corporation, having due regard to the interrelated effects of the 1980 Convention and Section 250(5) of the Act, it could in the case of a third country corporation, say, owned by an incoming individual.

The proposed (December 21/92) rules applicable to an incoming corporation would include a grind-down (in certain circumstances) in corporate paid-up capital for Canadian tax purposes, which as noted earlier (in the discussion of Section 212.1) comprises the measure of the amounts which may be distributed by a Canadian resident corporation without Canadian tax.

3. Part-year rule

A second change for an incoming (or departing) individual arises under the part-year residency rules of Section 114.

49. See Nathan Boidman, *supra* note 12, at 161.
50. For a full discussion see Nathan Boidman, "Proposed Exemption for US and Other Foreign Aircraft Lessors", *Tax Management International Journal*, Vol. 21 No. 2 (February 1992), at 88.
51. For a full discussion see Nathan Boidman, "Fowler - Permanent Establishment under the Canada-U.S. Treaty", *Tax Management International Journal*, Vol. 20 No. 1 (January 1991), at 38.
52. This rule can of course also mean that, in the case of depreciated property, liability to Canadian tax would arise on any recovery realized after arrival of the portion of the cost of property not matched by the fair market value at the time of arrival.
53. For alien residents of the United States who terminate US residency and take up residency in Canada similar considerations arise, although query, in that context, the effects of a departure-like tax under the passive foreign investment corporation rules (or any successors thereto).
54. As opposed to the US approach respecting the distinction between capital property and non-capital property with respect to real estate, under Canadian case law principles all non-personal-use undeveloped land is generally subject to a rebuttable presumption that it has been acquired for purposes of resale (unless an intent to develop can be substantially demonstrated) and thus is not treated as capital property; this is so even in the absence of a systematic business of dealing with and selling undeveloped land.

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Under present law a person who commences Canadian residency status also commences liability to Canadian tax on worldwide income thereafter unless at some point earlier in the same calendar year before residency commenced the individual was employed or carried on business in Canada, in which case during such period liability to Canadian tax on worldwide income enures.[55]

Section 114 is to be amended so that liability to Canadian tax on worldwide income would commence only after commencement of residency, notwithstanding pre-arrival employment in Canada or carrying on business in Canada.

4. Canadian treatment of IRAs

A change originally tabled in 1990 respecting cross-border retirement plans may be advantageous to residents of Canada who formerly worked in the United States or moved from the United States to Canada. These rules interrelate IRA accounts pursuant to IRC Section 408 and the Canadian rules respecting taxation of benefits derived from retirement or pension arrangements, under Section 56(1)(a)(i)(C.1) of the Act, and place certain restrictions on the extent of Canadian taxation of such plans and also permit tax-free transfers from such plans to Canadian registered plans.[56]

III. CURRENT DEVELOPMENTS AFFECTING INBOUND US/OUTBOUND CANADIAN TRANSACTIONS AND EVENTS

A. *Overview*

In general terms current tax developments respecting Canadian business or investment in the United States stem primarily from the United States and not Canada. This is seen across the spectrum, from (1) the effects of US transfer pricing law on inbound transactions between a Canadian parent and its US subsidiary (including, but not limited to, one-way initiatives such as the HR 5270 proposals respecting inbound transfers)[57] or other corporate/business orientated matters such as recent changes to branch profits tax regulations, the effects on Canadian based multinationals of anti-avoidance initiatives respecting captive finance arrangements (ranging from the conduit theory rulings to IRC Section 163(j) or the renegotiation of the Netherlands-US income tax convention), to (2) matters largely affecting private investment or individuals such as changes to the US estate tax rules and rates, finalization of IRC Section 7701(b) residency rules or the proposed changes respecting the effects of attribution rules for interests in foreign corporations which can substantially impact on Canadian families and Canadian holding companies with family members who have moved to the United States.

The scope of this paper does not include a review of such (or other) US developments affecting Canada-US transactions (whether in the outbound or inbound context); however, it will be seen in the commentary below that certain US changes have or can give rise to consequential or corollary Canadian changes in certain areas. However, as just indicated, recent Canadian tax changes affecting Canadian outbound-US inbound transactions are relatively limited in number and scope.

B. *Canadian-based multinationals operating in the United States*

1. Basic tax strategies under attack?

(a) *Overview*

As referred to earlier Canadian-based multinationals operating in the United States are generally exempt from tax on both undistributed and distributed profits of US subsidiaries. Furthermore, Canadian foreign affiliate-exempt surplus-foreign accrual property income rules (loosely comparable to the US controlled foreign corporation-Subpart F rules) provide much flexibility - not seen under their US counterparts - for shifting of profit between foreign affiliates in the group without creating exposure to Canadian tax. Thus, for example, interest earned by a Dutch or other captive finance affiliate of a Canadian-based multinational from loans made to a US operating subsidiary are not attributable to the Canadian parent and, to the extent that the captive affiliate is a resident in a country with which Canada has a treaty (such as the Netherlands), such interest income may be flowed back to (or repatriated by) the Canadian parent without Canadian tax.

These rules together with exemption from withholding under the current Netherlands-US tax treaty for interest paid by a US borrower to an affiliate Dutch lender have been (subject to the usual concerns arising under the US conduit theory rulings and the constraints imposed by IRC Section 163(j)) the cornerstone of many Canada-Netherlands-US group finance arrangements.

Moreover, in the foregoing context, under current Canadian law interest expense incurred by a Canadian parent to fund a Dutch finance company may be deducted against Canadian source profits of a Canadian parent, thus giving rise to "double dip" finance arrangements.

(b) *Changes in the wind?*

The current status of such arrangements has, however, not only been brought into question by US initiatives (those referred to above and others such as the possibility of a generic anti-treaty shopping IRC rule, such as that proposed in HR 5270) but, as well, in Canada. In particular, stemming from an aborted attempt to legislate interest deductibility limitations in 1981, relative to such arrangements, there has been ongoing concern that the Department of Finance will, one day, change the interest deductibility rules to prohibit the Canadian leg of the double dip finance arrangement just noted.

As recently as November of last year the relevant Canadian rules and their effects for Canadian based multinationals

55. This same effect can arise for a departing resident.
56. For a discussion see Nathan Boidman, "Canadian Tax Proposals - Cross-Border Effects - Part I", *Tax Management International Journal*, Vol. 19 No. 9 (September 1990), at 397.
57. See Nathan Boidman and Gary J. Gartner, *supra* note 14.

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were given rather negative, high profile scrutiny in the annual report of the Auditor General of Canada to the House of Commons, where under the heading "Department of Finance Tax Arrangements for Foreign Affiliates Are Costing Canada Hundreds of Millions of Dollars in Lost Tax Revenues" there was substantial negative commentary on the manner in which Canadian multinationals utilize the foreign affiliate rules to minimize both Canadian and foreign taxes.[58]

The Auditor General's report led to hearings by the Public Accounts Committee of the House of Commons. On 23 April the Committee tabled a report in the House of Commons recommending immediate legislation to terminate aspects of these rules which the Committee claims is costing the government hundreds of millions of dollars in lost revenue.

2. Funding US subsidiaries with interest-free loans?

With respect to cross-border financing by Canadian based multinationals, the one recent development of interest arises out of the interest deduction proposals referred to earlier.

There are limited circumstances where it would be overall advantageous for a Canadian parent to capitalize a US subsidiary with non-interest bearing debt. Leaving aside the potential issues which may arise on the US side pursuant to IRC Sections 385 or 482,[59] such an arrangement could, inter alia, facilitate tax-free repatriation from the US perspective of short or medium term parent-provided financing for the US subsidiary.

However, if the Canadian parent has borrowed to fund an interest-free loan to a US subsidiary, can the interest thereon be deducted in computing the Canadian parent's Canadian source taxable income? At this point the conventional wisdom would appear, based both on case law and the proposed 21 December 1991 interest deductibility rules, to be negative; however, the matter is not totally clear having regard to certain conflicting Canadian case law.[60] On balance, given both the Canadian and US issues and uncertainties, it would generally appear inadvisable for a Canadian-based multinational to finance a US subsidiary through interest-free debt, particularly where the Canadian company has borrowed to fund such advances.

3. Loan guarantee fees?

It was noted earlier that a reasonable loan guarantee fee paid by a Canadian subsidiary to a US parent is treated as a proper deductible expense for Canadian purposes. The converse of that issue has arisen recently with Revenue Canada, under transfer pricing rules, for Canadian-based multinationals which do not charge fees for guaranteeing loans of US or other foreign subsidiaries. At present it appears that reassessments have not been issued and the underlying issue is whether a guarantee constitutes a service for Section 69 of the Act.

4. Tax rate arbitrage and transfer pricing

The earlier discussion respecting the impact of Canada's transfer pricing rules on US-based multinationals operating in Canada should also be considered in relation to Canadian-based multinationals operating in the United States. There is, however, a conceptual difference in the way in which the transfer price rules may operate in the latter context as opposed to the former notwithstanding that the rules are, in principle, equally applicable in respect of inbound or outbound transactions.

A review of the tax rate arbitrage factors dealt with above in the context of Canadian-based multinationals operating in the United States (and factoring in the effects of US withholding taxes on dividend distributions by a US subsidiary to a Canadian parent) would indicate that, as in the case of tax arbitrage favouring the movement of profit from a Canadian subsidiary to a US parent, it may similarly favour a movement or shift of profit from a US subsidiary to a Canadian parent, particularly one which carries on manufacturing activities (or operates in the province of Quebec). In such context both Revenue Canada and the taxpayer would have interests in common, namely to see transfer pricing rules operate to shift the maximum amount of profit from a US subsidiary to a Canadian parent.

One question is the effect on such strategy of the forthcoming adoption by Canada of an advance transfer pricing ruling procedure in the context of the various US developments respecting transfer pricing matters.

It is also worth noting in this context that Canada-US transfer pricing disputes have usually involved Revenue Canada inspired adjustments respecting inbound and not outbound transactions, basically never go to court and generally have been worked out either through private negotiations or through Canada-US competent authority procedure with a not inconsiderable degree of success by Revenue Canada in defending all or part of its proposed adjustments. Query however how successful "the Canadian side" will be in the likely increase of competent authority procedures stemming from IRS initiated adjustments respecting Canada outbound-US inbound transactions? The next few years should produce some interesting experiences and data in this area.

5. Canada-US-Mexico transactions

Finally, it may be noted that the establishment of tax treaty relations between Canada and Mexico in 1992 will, in general terms, ease the tax planning and structuring for Canadian based multinationals operating in both the United States and Mexico given that from the Canadian perspective profits generated in either country by subsidiaries established in either or both will be eligible for tax-free repatriation to Canada, under the foreign affiliate-exempt surplus rules.[61]

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58. See Report of the Auditor General of Canada to the House of Commons, Minister of Supply and Services, Canada 1992, Ottawa, 24 November 1992, Chapter 2 ("Other Audit Observations"). For a brief commentary see Nathan Boidman, "Recent Developments in Canada", *Tax Management International Journal*, Vol. 22 No. 2 (February 1993), at 91, 92. Since that report the House of Commons Finance Committee has been holding public hearings respecting the report. Whether legislative changes will ensue is not of course known at this time.
59. For a discussion see Boidman, *supra* note 10.
60. For a full discussion see Boidman, *supra* note 45.
61. See Boidman, *supra* note 32.

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C. *Other Canadian outbound/US inbound business and investment matters*

1. Limited liability companies

As already noted it is US developments which largely affect Canadian investment in the United States. This is particularly so with respect to private investment or niche situations. Perhaps the only Canadian development in this area of real interest to US practitioners comprises the possible Canadian response to the advent in the United States of the limited liability company.

What are the effects for Canadians carrying on business and investing in the United States of the limited liability company (LLC) legislation in certain states (e.g. Alaska, Colorado, Delaware, Florida, Kansas, Texas, Utah, Virginia and several others) and the IRS ruling position treating LLCs as flow-through partnerships?[62]

An LLC can, inter alia, resolve the problem of how Canadian and US residents can joint venture through one US formed corporate-like entity without creating double taxation for the US party (given that flow-through "S" treatment does not apply in the case of a corporation with non-US resident/citizen shareholders).

From the Canadian standpoint, it was generally thought than an LLC would be treated as a corporation thus bringing into play (having due regard to certain administrative positions of Revenue Canada respecting the treatment of membership interests as classes of stock) the Canadian foreign affiliate-exempt surplus rules. However, apparently as a result of certain concerns respecting inappropriate foreign tax credits or deductions in respect of an interest in an LLC which is treated as a partnership for US tax purposes, Revenue Canada, in a "Round Table" discussion at the Annual Conference of the Canadian Tax Foundation held in Toronto in November 1992, announced that it was now studying (presumably in conjunction with the Department of Finance) the overall question of characterization and treatment for Canadian tax purposes of Canadian interests in LLCs.

2. Terminating Canadian corporate residence

Another recent development of perhaps more limited interest is the December 21/92 Proposal which would terminate Canadian residency status in the case of a Canadian formed corporation which "continues" - under export/import corporate continuance procedures from Canadian corporate jurisdiction into say one of the US states which has "import continuance" rules.

Heretofore, as noted above, even though such a corporation would be taxable, upon such export continuance from Canada, on unrealized appreciation in assets, under Section 88.1 of the Act (now to be replaced by Section 128.1) and, at a 25 percent rate, on the excess of the fair value of its assets over its debts and corporate paid-up capital, under Section 219.1 of the Act, it would, because of its original incorporation in Canada and the rules of Subsection 250(4) of the Act, remain a resident of Canada for Canadian tax purposes.

The December 21/92 Proposals would terminate such ongoing residence by adding Section 250(5.1) which will deem a corporation to be incorporated in the jurisdiction into which it has been continued. Thus, an exported corporation will be deemed incorporated in its new jurisdiction and thus not incorporated in Canada for purposes of the deemed residency rule under Section 250(4), and provided residency based on central mind and management in Canada is also terminated, such corporations will no longer be resident in Canada.

3. Cross-border death tax issues

It was noted at the outset that the combined result of the radical increase of US estate tax rates in 1988 and the separate system under Canadian law for imposing tax at death (on deemed dispositions of appreciated property) creates a potential for substantial double tax for Canadian individuals who directly own US property. This arises because Canada does not view US estate tax as a creditable income tax for purposes of determining the net Canadian income tax payable where a Canadian individual incurs a deemed disposition tax at death with respect to appreciated US property, in respect of which US estate tax also arises.

This issue attracted the attention of Canadian observers after the US estate tax rate increases in 1988 and led to the commencement of treaty negotiations in 1990 with a view to there being developed a treaty-based relief.

Given the tax jurisdiction normally accorded the country of source, it would seem reasonable that it would be Canada which would provide the relief and solution by ceding jurisdiction through a mechanism of treating US estate taxes as a creditable income tax for Canadian purposes.

Early on in the negotiations the Canadian treaty negotiators signalled that such relief would be provided in the new treaty and, as well, that the conclusion of negotiations would be without much delay. That was in 1990. It is now some three years later and the parties are still talking and nothing has been concluded.[63] In the interim individuals must consider a variety of other means of dealing with the potential exposure (including the double tax element) to US estate taxes.[64]

4. Proposed anti-avoidance rule: foreign partnership

The December 21/92 Proposals would terminate an opportunity to create basically artificial losses through investment in a partnership operating outside of Canada.

Partnerships are not taxpayers under Canadian law but rather a resident of Canada who is a member of a partnership,

62. See, for example Rev. Rul. 88-76, 1998-2 C.B. 360, and PLR 8937010.
63. For a discussion of the negotiations see Nathan Boidman and Gary J. Gartner, "Canada and U.S. Announce Treaty Negotiations", *Tax Management International Review*, Vol. 19 No. 2 (February 1990), at 89; Nathan Boidman, "Canadian Treaty Developments - In the U.S. Context", *Tax Management International Journal*, Vol. 20 No. 9 (September 1991), at 410; Gary J. Gartner, "Canada-United States Treaty Renegotiations Postponed", *Tax Management International Journal*, Vol. 21 No. 2 (February 1992), at 91; Nathan Boidman, "Canadian Budget (Including Treaty Update)", *Tax Management International Journal*, Vol. 21 No. 4 (April 1992), at 199.
64. For a full discussion see Nathan Boidman, (Canadian-American Tax Issues: Cross-Border Commentary), "Taxation at Death: Current Issues and Developments, Part I", *Tax Notes International*, Vol. 2 No. 6 (June 1990), at 578; Vol. 2 No. 7 (July 1990), at 702 (Part II); Vol. 2 No. 8, August 1990 (Part III).

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regardless of place of formation or operation, is subject to Canadian tax in respect of an aliquot share of partnership income while a non-resident of Canada is liable to Canadian tax in respect of an aliquot share of partnership income derived from carrying on business in Canada. In all such cases income for tax purposes is computed as though the partnership were a separate taxpayer and, thus, at the "level" of the partnership.[65]

As a consequence and in such context, a partnership determines basis in property and notwithstanding the absence of any specific elaborated rules on point, it appears that a partnership can only have one set of basis numbers for Canadian tax purposes (in contrast to the US approach which can allow for inside basis step-up in respect of certain incoming partners) and that such tax numbers commence being calculated only when there is either a Canadian resident partner in the partnership or a partnership that carries on business in Canada, where, even if there are only non-resident partners, filings are required under Canadian tax law.

In such latter context, therefore, it is the conventional wisdom that in the first year in which there is a requirement to report income of a partnership for Canadian tax purposes, determinations may be made at the level of the partnership by reference, generally, to, inter alia, original or historical acquisition costs of property, notwithstanding the present values thereof or the cost at which a person has acquired an interest in the partnership. This can present the following tax planning opportunity:

> Assume that in 1990 a partnership was formed by non-Canadians to acquire real property in the United States at a cost of $ 10 million. Assume further that by 1993 the partnership property has depreciated in value to $ 2 million and there is a first acquisition of interest in the partnership by a resident of Canada on 1 January 1993. Assume that the Canadian acquires 50 percent of the interest in the partnership at a cost of $ 1 million (reflecting 50 percent of the underlying value of the partnership's property). If the partnership then proceeds to sell the property for $ 2 million, an $ 8 million loss would be determined from a Canadian perspective having due regard to the historical cost of $ 10 million, notwithstanding the amount paid by the incoming Canadian partner for the interest.

To eliminate the relatively artificial loss which would be realized in the foregoing example, the December 21/92 Proposals would add Subsection 96(8) to read as follows:

> "For the purposes of this Act, where at any time a person resident in Canada becomes a member of a partnership and immediately before that time, no member of the partnership was subject to tax under this Part in respect of the income of the partnership, the cost or capital cost of each property that is inventory or capital property at that time of the partnership will be deemed to be equal to the lesser of,
> (a) its fair market value at that time, and
> (b) its cost or capital cost otherwise determined."

It is not clear why the rule does not also apply to cost factors relevant to goodwill and other like "eligible capital property" amortizable pursuant to the rules of Sections 14 and 20(1)(b) of the Act. However, it is not surprising that the rule does not work both ways and permit a step-up in underlying basis where the relevant value is greater than original cost.

The bottom line is that new Section 96(8) of the Act terminates an interesting tax planning opportunity for Canadians to effectively manufacture writeoffs for Canadian tax purposes through US or other foreign partnerships with depreciated property.

D. *Canadian movement to the United States*

US practitioners deal with Canadians who move to the United States either temporarily or permanently and spend substantial time there in personal or business capacities. Aside from the ubiquitous US issues (including those arising under IRC Section 7701(b)) there are a variety of Canadian considerations upon terminating Canadian residency. The December 21/92 Proposals affect certain of these considerations, already alluded to in the earlier discussion respecting incoming Canadian residents.

In general terms under present law (Section 48) a Canadian who terminates Canadian residency is deemed to dispose of all foreign and certain Canadian capital property at fair market value and must pay tax on his final tax return as though such property had been sold at the date of departure. An election can be made to defer such tax but security must be posted and there is potential exposure to Canadian tax upon post-departure appreciation in the property so elected.

It is now proposed to extend the applicability of the deemed departure tax to all property and not just capital property (other than certain Canadian-based property which would be subject to Canadian tax if disposed of by a non-resident). The main effect of this change would seem to pick up and tax under the departure rule foreign real estate not held as capital property and inventory and goodwill (and other "eligible capital property", as explained in note 57) of businesses carried on directly by Canadians outside of Canada. It will also trigger "depreciation recapture" respecting foreign rental real estate. Furthermore, departure tax in respect of the class of property added to the rule will not be deferrable by an election and lodging of security, such option being restricted to capital property.[66]

As noted earlier, a second change for a departing individual arises under the part year residency rules of Section 114, which will no longer operate to tax worldwide income of a person who terminates Canadian residency with respect to a period thereafter but in the same calendar year during which such individual was employed or carried on business in Canada.

65. See Sec. 96(1) of the Act.
66. An anomalous result appears to be that a departing resident will be deemed to dispose of goodwill (and other intangible capital property of an indefinite life, collectively treated as "eligible capital property" pursuant to Sec. 14 of the Act) of a Canadian based business and not have a right to elect out even though there would be continuing jurisdiction to tax same as a non-resident. This likely is an oversight in the drafting.

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IV. CONCLUSION

The foregoing should provide a representative view of those aspects of both the Canadian tax system and recent developments which may be relevant to or affect situations encountered by US tax advisers. However, it does not purport to cover all recent developments and no attempt has been made to deal with specialized industries such as the resource or financial services sectors.[67]

67. See for example Nathan Boidman, "Canada-U.S. Treaty Interpretation - *Utah Mines Ltd. v. The Queen*", *Tax Management International Journal*, Vol. 20 No. 8 (August 1991), at 368 (dealing with non-deductibility of Crown royalties); Nathan Boidman, "Court Interprets Canada's Foreign Income Rules", *Tax Management International Journal*, Vol. 20 No. 3 (March 1991), at 134, and the related decision in *Canada Trustco Mortgage Company v. M.N.R.*, 91 DTC 1312 (T.C.C.), respecting the foreign accrual property income rules; proposed changes to the securities lending rules under Sec. 260 of the Act, issued on 23 December 1992 (Department of Finance Release No. 92-101); administrative issues with Revenue Canada respecting the creditability of Code Sec. 884(1)(f)(B) excess interest tax as a foreign tax; a delay until 1994 of federal proposals, in the 1991 federal budget, to disallow deductibility of provincial tax on capital (discussed earlier) and certain medical health insurance premium levies (Department of Finance Release 92-97, 18 December 1992); a decision respecting the taxability, under withholding, of late payment charges made by a Canadian importer to a foreign seller (*Wenger's Ltd. et al. v. M.N.R.*, 92 DTC 2132, T.C.C.); recent changes to Sec. 19.1 of the Act dealing with restrictions on deductibility by Canadians of advertising on cross-border media aimed at the Canadian market; the effect on the cross-border software sales issues discussed earlier of the September 1992 changes to the OECD 1977 Model Treaty (see Fred C. de Hossen, "Taxation of Cross-Border Software Payments", *Intertax* (December 1992), at 682); draft anti-avoidance legislation requiring accrual-based treatment of certain prepaid interest financing arrangements arising in the 1989-91 period; changes to various complex anti-avoidance type rules respecting after-tax (preferred share) financings; Canadian implications of the requirements for the use of Qualified Domestic Trusts by Canadians to defer U.S. estate tax; Canadian jurisprudence taking a very broad view of the facts and circumstances test for residency of individuals (e.g. *M. Glow v. The Queen*, 92 DTC 6467, F.C.T.D.); liberalization of rules respecting foreign investments by Canadians registered pension funds and similar tax-assisted arrangements; case-law respecting information demands by Revenue Canada in the international context, such as *Crestbrook Forest Industries Ltd. v. The Queen*, 92 DTC 6412 (F.C.T.D.) - reversed by the Federal Court of Appeal in an 12 April 1993 judgment (A-891-92) - and *Roseland Farms Ltd. v. The Queen*, 92 DTC 6365 (F.C.A.) and in the treaty exchange of information context, *Montreal Aluminium Processing Ltd. et al. v. A.G. of Canada et al.*, 92 DTC 6567 (F.C.A.), and restrictive Canadian court interpretation of interrelationship of treaties and domestic law where former Canadians exercise Canadian stock option plans as in *Hale, J. v. The Queen*, 92 DTC 6473 (F.C.A.). As well no reference has been made to taxation for activities in the Yukon or Northwest Territories, where the taxes therein replace those imposed by the provinces.

[continued from page 382]

In 1990 in a case where the 100 percent subsidiary corporation had been newly incorporated and only held liquidities, the Dutch Supreme Court posed a question to the EC Court of Justice whether, in this case, a 100 percent subsidiary corporation could be considered a separate "branch of activities". On 13 December 1991 the EC Court of Justice ruled that, *in general*, a 100 percent subsidiary could not be considered a separate "branch of activities" and therefore contribution thereof did not qualify for the internal reorganization exemption.

This ruling caused substantial uncertainty in the Netherlands since it would considerably increase the up-front cost of setting up a Dutch holding corporation; while it would still be possible to contribute EC resident subsidiaries under a merger exemption it would become virtually impossible to avoid capital duty on the transfer of 100 percent subsidiaries that are not resident in an EC member state.

On 6 January 1993 the Dutch Under-Secretary of Finance issued a regulation that stated notwithstanding the ruling of the EC Court of Justice the contribution of a 100 percent shareholding in a corporation may continue to be considered a contribution of an "independent part of an enterprise", i.e. a separate "branch of activities", provided both of the following conditions are fulfilled:

- the contributing corporation should itself carry on an active business; and
- the 100 percent shareholding that is contributed has to represent an organization of labour and capital that may be considered to form an independent enterprise.

Since the second condition in particular may in many cases not be very clear, it may be advisable to approach the Dutch Revenue before relying on this exemption to seek confirmation that the exemption is indeed available.

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MEXICO:

TAX DEVELOPMENTS OF INTEREST TO US TAX ADVISERS

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I. INTRODUCTION

An understanding of Mexican tax policy cannot be gained from a superficial examination of the recent changes in the taxes themselves. Rather, in order to understand current tax policy, it is necessary to analyse policy and structural changes taking place in Mexico, and to understand the cultural, educational and political influence on the tax norms.[1]

President Carlos Salinas de Gortari's administration has been marked by the continuation of the change in direction initiated by his predecessor, Miguel de la Madrid Hurtado, as well as by structural changes which would have been difficult to conceive of under the previous administrations of the Institutional Revolutionary Party. Of course, tax policy could not be omitted from such changes, particularly because of the change in economic performance and the opening of the borders to international trade.

In this context, the government is continuing its efforts to strengthen public finances not only by the sale of state-owned companies (thus ceasing to intervene in productive activities that correspond to the private sector), but also by improving internal finances through tax collection. The 1991 and 1992 reforms coalesced the changes the country experienced during 1989 and 1990, introducing provisions that appear to enhance the tax collection process and foster taxpayer compliance. In addition, certain technical features were introduced to remove certain aspects of previous reforms that were difficult to implement, without abandoning tax collection policy in the process. This policy was expanded by broadening the tax base and by augmenting the policing capabilities of the Ministry of the Treasury and Public Credit.[2]

The following improvements in the Mexican tax system have taken place since 1988 (the beginning of the Salinas administration):[3]

- 14 of the 19 federal taxes in existence at the beginning of 1988 have been eliminated;
- the tax adjustments aim to promote investment insofar as tax rates have been significantly lowered, as compared to rates in the United States and Canada;
- important benefits are available with respect to dividends, instantaneous depreciation of investments and inflation adjustments for assets and liabilities;
- a broad tax simplification process was commenced concurrently with a system of control over taxpayers which rewards the compliant taxpayer and rigorously sanctions tax evaders and untimely taxpayers."[4]

These points summarize the scope of the tax changes that have taken place in the last four years. However, it is important to include the numerous changes in tax norms – principally in the area of income tax and taxpayer obligations – which Mexicans are accustomed to and which are fundamentally due to amendments to tax laws in order to eliminate evasion of income tax.

Clearly, much remains to be done before Mexico will have an internationally competitive system, and one which is easily understood by the majority of Mexicans. It is important to remember that 90 percent of Mexican companies are small. We need a tax system which is accessible and understandable to these small companies so they can compete with foreign companies that enjoy less confiscatory tax systems, with lesser tax rates, and which do not require excessive administrative expenses and a constant and costly need for specialized professional assistance.

Contents

I. Introduction
II. 1993 Tax Measures
  A. General
  B. Federal income tax
  C. Value added tax
  D. Special tax on production and services
  E. Tax on acquisition of real property
  F. Tax on new automobiles
  G. Penalties
  H. New peso
  I. Several liability
  J. Tax vouchers
  K. Tax opinions
  L. Residents abroad
  M. Legal powers of review and determination of taxes
  N. Other
III. Tax Incentives and Subsidies
  A. Exemptions and preferential treatments
IV. International treaties
V. Tax Expectations for 1993
VI. Toward Tax Simplification

1. See the Tax Survey on next page.
2. Información Dinamica de Consulta (IDC), *Sección Fiscal* (28 October 1992), ANO VII No. 162, at 2803.
3. Addres by Dr Pedro Aspe Armella, Minister of the Treasury and Public Credit, to the National Chamber of the so-called Transformation Industries.
4. See *supra* note 2, at 2803.

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Tax Survey

In 1992, *Expansion*, a prestigious business and financial publication in Mexico, published the results of a survey conducted among 695 executives regarding tax policy:

- 94% of those surveyed considered the tax provisions to be too complex;
- 63% found that a real tax simplification in Mexico has not taken place;
- 85% stated that the tax burden for businesses is reflected in their overall business costs;
- 72% use private external advisors (attorneys and accountants) to resolve their company's matters;
- 92% were of the opinion that modifications in the tax provisions were too frequent;
- 93% considered the criminal provisions relating to tax matters too rigorous.

The survey established criteria to improve the tax system:

- carry out a true tax simplification;
- relay to the taxpayer simple and clear tax provisions, with fewer changes;
- listen to the opinion of the taxpayer and permit valid deductions; and
- provide adequate training to the administrative personnel of the Ministry of the Treasury and Public Credit.

The conclusions of the survey reflect that

- while there has effectively been a change in tax policy, the change lacks the necessary tax simplification. The tax system needs to be adapted with an eye towards increased competitiveness with foreign systems, particularly with respect to Mexico's trading partners;
- a decision has been made not to make further amendments to the tax legislation since it was considered more important to provide security and permanence in the norms to the taxpayer than to issue changes to effect simplification;
- in accordance with a democratic perspective, real changes in the tax provisions should come from the voters through their representatives in the House of Representatives and the Senate; not as a unilaterally established policy of the Executive Branch;
- changes toward tax simplification have now become necessary so that those subject to the tax norms are able to comply and correspondingly assume responsibility for their failure to comply; and
- finally, the survey is an important indicator of what the tax reform in Mexico will be, as the reform is based on a selective analysis of the small and medium size companies that constitute more than 90% of the Mexican business sector.

Expansion, "Tax Survey" (November 1992) (Grupo Editoral Expansion), at 122.

The government has traditionally relied on frequent amendments to the tax system as a means to correct defects or to respond to taxpayer actions that are detrimental to tax policy. For example, in 1990, the government discovered that due to the late payment of taxes it was incurring a revenue loss as a result of inflation. The concept of "actualization" of tax payments was introduced so the tax authorities could recoup the loss caused by late payments through the actualizations, i.e. the substitution of the nominal value of such payments for their real value through the use of indices that actualize the value of the taxes due. At the same time, the authorities continued to impose late payment penalties as a sanction for failure to make timely payments.[5]

Nevertheless, under the 1990 reform, the taxpayer was able to credit the amount that was paid late in the principal payment, because the actualization was considered to have the same nature as the tax payment. This was true because late payment penalties have the character of an indemnification for the lack of timely payment and therefore have never been deductible. However, by 1991 the original actualization policy for tax payments had been modified because the deductibility of the portion corresponding to the actualized tax payment was prohibited. This evidences a certain sanctioning nature in the 1991 reform that is contrary to the original principle that results in, among other things, a financial burden and uncertainty for the taxpayer.[6]

Reforms were also included in the FTC in 1991 which tended to increase taxpayer control.[7] One clear example is the imposition of several liability on companies which, having the obligation to inscribe shareholders or partners in the Registry Book of Shares, made inscriptions without demonstrating that they had retained and paid the income tax resulting from the transfer.[8] This new liability imposes an unfair obligation on commercial companies because, under Mexican commercial legislation, a person is severally liable when he directly participates in the commission of certain acts. In this case, a commercial company – because it is an issuer of shares or partnership participation – does not involve itself as a party in the transactions that the holders or owners of such shares or partnership participations effect. Such transactions are beyond the control of the issuer because by law, the shares or partnership participations are created to circulate in the market.[9] Therefore, several liability should be imposed on the parties involved in the actual transaction, and not on third parties that have no connection with the transaction.

Another important change is the requirement that certain taxpayers obtain expert opinion with respect to financial statements for tax purposes. The confiscatory intention of the federal government is very clear; it seeks to know in greater detail what is going on in companies through the mandatory tax opinion. As a general rule a self-assessment system is applied in Mexico, so that the taxpayer determines its obligations and makes payments accordingly. Meanwhile, the government has the opportunity and right to review taxpayer accounts and to make any necessary determinations with respect to the correct application of the tax norm. In this case, it is clear that since 1991 the government has intended to restrict the taxpayer's right to freely contract, and to require taxpayers to present expert opinions with respect to their financial statements. Thus without using its arsenal of verifi-

5. Federal Tax Code ("FTC"), Art. 17A.
6. *Id.*
7. FTC Art. 26.
8. FTC Art. 26, Sec. XI.
9. Mercantile Corporate General Law, Art. 32A, Secs. 83 and 84 Sec. IX.

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cation tools, the government can ascertain whether the tax laws have been complied with. This obligation imposes another economic burden on the taxpayer.[10]

II. 1993 TAX MEASURES

A. *General*

No changes were made in the tax legislation at the beginning of this year.[11] This came as an unexpected contrast to previous years, as the government has traditionally made substantial amendments to the tax laws year after year. However, the various amendments made during 1992 and previous years cannot be overlooked because many of these changes entered into full force on 1 January 1993.

1992 was an important year for amendments to the federal taxes, i.e. a total of 25 amendments were made, including a reform of the tax laws and miscellaneous circulars issued by the Ministry of the Treasury and Public Credit. On 25 July 1992 numerous reforms were effected, and rules for administrative simplification were issued under the Simplified Tax Regime.[12] However, it is not expected new tax provisions will be introduced in 1993 (or the near future) to amend existing legislation,[13] although the Ministry of the Treasury and Public Credit may issue general obligatory rules in miscellaneous circulars through which new administrative provisions can be implemented.[14]

Mexico needs a tax system in which the basic structure of its legislation is preserved in order to achieve legal certainty for taxpayers, which permits them to make medium and long-term plans and strategies.

For 1993, the Law of Income of the Federation establishes an income tax policy designed to strengthen public resources; reduce tax rates and promote productive investment; redistribute the tax burden in favour of the lower income population; broaden the tax base; and promote a more internationally competitive tax system.[15] In accordance with these tax policies, the government formulated a number of changes.

The reforms to the tax regime focused on three general goals. First, a reduction of the average tax rates and an expansion of the tax base; second, establishment of internationally competitive tax rates, especially in respect of Mexico's trading partners in light of NAFTA; and third, strengthen the collection of taxes by promoting tax policing though the increased presence of tax authorities, diversifying controls and increasing sources of information.[16] Additionally, to adjust the tax system to international standards, to promote the influx of capital into Mexico, double taxation agreements will continue to be concluded.

B. *Federal income tax*

- The tax rate for companies was reduced from 39.3 to 35 percent.
- The tax on dividends was eliminated.
- The maximum income tax rate for individuals was reduced from 50 to 35 percent.
- The tax rate for the individual income tax was actualized according to the National Consumer Price Index ("INPC") and a subsidy was established which in 1992 could reach up to 50 percent of the tax.
- The withholding rate on financial interest payable to individuals was reduced.
- The capital gains tax on the sale of a residence was abolished.
- The limit on special savings accounts was increased from two to eight minimum wages, in effect for the Federal District.

C. *Value added tax*

Tax rates were reduced from 20 and 15 percent to 10 percent.

Application of the zero percent rate will be continued during 1993 as it applies to taxes on the sale and importation of patent medicines and products destined for food. However, the zero percent rate does not apply to the following, which are taxed at 10 percent:

- the sale of food prepared for consumption in the same establishment in which it is sold;
- different volumes or weights of milk;
- syrup or concentrates for the preparation of soft drinks dispensed in open containers, using electrical or mechanical equipment, and concentrates, powders, syrups of essences or extracts, and flavours which upon being mixed permit the obtainment of soft drinks; and
- caviar, smoked salmon and baby eels.[17]

D. *Special tax on production and services*

- The special tax on bottled water and soft drinks and the special tax on insurance policies were repealed.
- The rate of the special tax on cigarettes and tobacco was reduced, as was the special tax on alcoholic beverages.
- A mechanism was introduced that decreases the rate of the special tax on alcoholic beverages.
- A mechanism was introduced that decreases the rate of the special tax on beer as of 1993.

E. *Tax on the acquisition of real property*

The 10 percent tax rate in effect in 1990 will gradually be reduced to 2 percent in 1994. The rate for 1993 is 4 percent.[18]

10. IDC (23 January 1991), ANO VI, No. 117, at 1917.
11. The changes that were made in 1992 will be implemented and enforced as from 1993.
12. IDC (10 February 1993), ANO VIII, No. 167, at 2933.
13. The government stated that it did not consider it necessary to make further amendments to the tax system, i.e. the system is considered efficient, modern and competitive, and one with which it specifically seeks to give permanence to the tax provisions and security to the taxpayers.
14. These circulars frequently go further than the legal provisions they are supposed to regulate.
15. See *supra* note 2, at 2932.
16. It is hoped that the tax revenue will increase by approximately 2.4% in real terms, with respect to that of 1992, and increase the government's participation in tax revenues from 40.2% in 1992, to 40.9% in 1993.
17. Law of Income of the Federation, Art. 16, Sec. B, Sub-Sec. II.
18. Transitory Disposition of Miscellaneous Fiscal Law, Art. 22 Sec. I of 20 December 1992.

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The government intends to provide incentives relating to housing within the framework of the social policy which, to a significant extent, has been championed by President Salinas' administration. This is evident in the federal income tax exemption for residences, and in the reduction in the tax rate on the acquisition of real property.

F. *Tax on new automobiles*

The average rate has been reduced from 50 to 10 percent and, correspondingly, the maximum marginal rate of 50 percent has been reduced to 17 percent. Economy models are exempted from the tax. The purpose of these reductions is to provide incentives to the automotive industry and to stimulate modernization of vehicles in Mexico.[19]

G. *Penalties*

Penalty rates have decreased between 1990 and 1993, basically due to the fact that the rate of inflation in real terms has decreased.[20] The penalty for late payment of taxes was 3 percent in 1990; 2.25 percent in 1991; 1.5 percent in 1992; and 2.7 percent in 1993.[21]

There has also been a modification (confiscatory in nature) to the calculation of penalties for spontaneous payments.[22] When a taxpayer spontaneously pays all omitted taxes in a single payment, i.e. without having been issued an assessment by the tax authorities, the resulting penalties will be assessed from the date the tax was omitted until the date payment is made. Previously, a taxpayer could pay penalties not exceeding one year – a measure that benefited both the taxpayer and the tax collector, because it encouraged taxpayers to regularize their fiscal situation.[23]

H. *New peso*

According to the new Monetary Law which established the introduction of the new peso (eliminating three zeros from the old peso), as of 1993 two new monetary units will be in circulation, i.e. old pesos and new pesos. Any form of obligation may be paid with either unit.[24]

If 1992 taxes are paid in cash, they may be paid in new pesos or in old pesos. However, if payment is made by check, payment must be made in new pesos. Likewise, any tax accounting must be expressed in new pesos and centavos and, where relevant, fractions of the latter, as established by the new monetary unit and the Rule/Circular 18C of the Miscellaneous Circular for 1992.

I. *Several liability*

A change was made with respect to several liability for payments made to a resident abroad by another resident abroad. Several liability is imposed on Mexican companies, when a resident abroad provides such companies with dependent or independent personal services whereby payment for such services comes from another resident abroad.

J. *Tax vouchers*

As of 1 November 1992, the taxpayer must issue tax vouchers that comply with regulations established in FTC Articles 29 and 29A, in addition to regulations set forth in Rules 23 and 24 of the Miscellaneous Circular in effect for 1992.

K. *Tax opinions*

Another important change for 1993 is that certain companies are required to provide a tax opinion (as discussed above), issued by a public accountant or firm of accountants duly authorized for such purposes.[25]

L. *Residents abroad*

1. Income from salaries exempt from federal income tax

As of 1 January 1993, the period in which to compute tax residence for dependent services rendered in Mexico is based on the following: when the services are rendered for less than 183 days within a 12-month period during 1993 (whether or not consecutive) no income tax will be due. If the services are rendered for a period exceeding 183 days, the following applies:

- not exceeding 32,000 new pesos – exempt;
- exceeding 32,000 new pesos, but not more than 256,000 new pesos – 15 percent will be applied to the amount exceeding 32,000; and
- exceeding 256,000 new pesos – a 30 percent rate will be applied without the right to any deductions.[26]

2. Exempt income from fees

No income tax is due on fees paid by residents abroad, whether individuals or companies, that do not have a permanent establishment ("PE") abroad or, if they do have a PE, if the service is not related to such PE. However, this rule only applies if the service rendered lasts less than 183 days during a 12-month period (whether or not consecutive). If the period of service exceeds 183 days, the formula set forth above applies.

3. Relation to Title V of the ITL

The recent double taxation treaty with Canada and the treaty with the United States do not contain provisions complementary to the provisions of Title V of the ITL that regulate payments to foreigners.

19. See *supra* note 2, at 2932.
20. For example, if a taxpayer elected to make payments of taxes in instalments, the penalty rate was 2.0% in 1990; 1.5% in 1992; 1% in 1992; and 1.8% in 1993.
21. See *supra* note 2, at 2928.
22. Transitory Diposition, Art. 2 Sec. I (20 December 1992).
23. *Id.*
24. Law of Income of the Federation, Art. 20.
25. Tax opinions relating to 1992 must be presented by companies and businesses by 31 March 1991, and for individuals by 30 April 1993.
26. ITL, Art. 146 (the "tax pardons" provision).

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ITL Article 4-A provides that treaties which establish lower rates or different exemptions than those provided for in the ITL only apply when the taxpayer is resident in the country at issue under the terms of the treaty. Thus, assuming that domestic legislation (rather than the treaty) was applied to a taxpayer who is a resident abroad, application of Article 4-A would have to be challenged, since this would be a situation that could be corrected by the treaty, insofar as the treaty contains a mutual agreement procedure to resolve such a situation.

The entire regime for foreigners is susceptible to amendment and improvement. Nevertheless, the legislature should concentrate its efforts on a review of the PE concept, because the regime contains provisions at odds with internationally accepted concepts, thereby producing distortions. This is particularly relevant because the payments abroad provisions only apply in cases where the PE is situated in Mexico.

M. *Legal powers of review and determination of taxes*

Based on the exercise of their legal powers of verification, until 1990 the tax authorities could only determine taxes omitted in the last 12-month fiscal year for taxpayers who filed or should have filed a tax return, and for taxes corresponding to the period of time between the end of the fiscal year and the time the powers are exercised. However, if irregularities were found in the payment and determination of taxes, the tax authorities had the right to review up to five preceding years.[27] After 1993, the "tax pardons" provisions will be expanded in order to enlarge the review capabilities of the authorities, i.e. they will be able to review the past taxes up to five years even though no irregularities existed in the last period (year) of review.

The government has decided to eliminate the "tax pardon," whose sole purpose was to motivate taxpayers to comply with the law. For fiscal year 1993, the tax authorities may determine taxes issued in fiscal years ending in 1990, 1991 and 1992, as well as taxes corresponding to the period of time between the end of the fiscal year and the time when the cited powers are exercised.[28]

N. *Other*

As from 4 January 1993, procedures which have been carried out in the Offices of the Federal Treasury will be done in the Reception Booths for Tax Procedures, located in post offices or in the Tax Attention Booth of each Federal Tax Office. Procedures may no longer be carried out in the Offices of the Federal Treasury, where one may only verify the post office corresponding to one's tax domicile.[29]

III. TAX INCENTIVES AND SUBSIDIES

The crediting of an investment in the agricultural and forest sectors against an equivalent amount of the tax on assets, determined for the fiscal year is permitted; this amount may also be credited against past fiscal years.[30]

An incentive is granted for the import of machinery, equipment and consumer articles in the border zones and the free zones for companies and commercial centers established in those areas.

In relation to purchase/sale agreements for oil executed by the federal government and Petroleos Mexicanos or its subsidiaries, federal tax subsidies are granted to settle the patrimony[31] or trust for the issuance of ordinary certificates of participation "Petrobonos".[32]

There is also an incentive for savings plans and savings and loan companies.

A. *Exemptions and preferential treatment*

The exemptions relating to the tax on the acquisition of real property provided by federal law, in favour of decentralized entities, are no longer in effect, except for exemptions relating to property belonging to such entities that is considered part of the public domain.

Also no longer in effect are the provisions of the special laws, regulations, accords, circulars and administrative provisions (which contain total or partial exemptions or consideration for persons subject to taxation) that grant preferential or differential treatment with respect to income and federal taxes that are different from those established in the FTC, presidential decrees, international treaties, and the law which establishes such taxes and regulations.[33]

IV. INTERNATIONAL TREATIES

In the 1991 tax reform, Article 4A was added to the ITL, providing that international treaties which establish lesser tax burdens or exceptions different from those provided in the ITL will only be applied when the taxpayer is resident in the country under the treaty itself. Without engaging in a profound analysis of the constitutionality of such provisions, this reform grants foreign taxpayers the right to treaty benefits but only if they are resident in the contracting country to such treaty, under the terms of the treaty.

27. *Id.*
28. FTC Art. 64.
29. Transitory Disposition of Miscellaneous Fiscal Law (4 January 1993). This system, called the Tax Box, arguably makes tax procedures more difficult. The administrative function of the Mexican tax system relates to procedures such as inscription of companies, businesses and individuals, opening of establishments, mergers changes in domicile, suspension of activities, liquidation of assets, making of instalment payments, clarifications, requests for the issuance of identification certificates, receipt of informative returns, procedures for administrative actions with respect to returns, notifications and payments made, procedure for tax credits, filing of tax documents, incorporation into the census of importers, refund requests, etc. More importantly, foreign investors, particularly when they open companies in Mexico, must follow these procedures in order to commence operations, import machinery or consumer goods, or obtain tax identification certificates. Hopefully, such measures are consistent with the other changes the government has introduced as they relate to the flow of foreign investment into Mexico.
30. Law of Income of the Federation, Arts. 14 and 16.
31. E.g. capital, net worth.
32. IDC (20 January 1993), ANO VIII No. 167, at 2928 and 2927.
33. Law of Income of the Federation, Arts. 17 and 18.

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Mexico has entered into tax information exchange agreements with the United States and Canada, and has entered into double taxation treaties with Canada, Ecuador, France Italy, Spain and the United States. Negotiations for such treaties have been concluded with Belgium, Germany, the Netherlands and Switzerland, and negotiations are ongoing with Norway and the United Kingdom.

V. TAX EXPECTATIONS FOR 1993

The first and most relevant point for the tax reforms for 1993 without a doubt concerns the old complaint about the dramatic tax changes which take place annually. These changes have unduly complicated an understanding of and compliance with the tax law. In addition, the changes have hindered companies from planning their tax operations for the medium and long term since, on many occasions, once a plan is put into effect, changes in the tax laws modify the essence and consequences of the plan. As a result, on 10 November 1992, President Salinas, through the Minister of the Treasury and Public Credit, presented the Tax Reform Package to the House of Representatives for the year 1993. Contrary to that which has occurred in the preceding 21 years, the reform package only included the bill for the Law of Income of the Federation, the projected budget of expenditures of the federation, and the bill for the reform of the federal fee law. Interestingly, the usual proposals for reforms to the tax laws were not included since the adjustments made in July 1992 were considered adequate for the next year.

There probably will not be any reforms to the tax laws for 1993, or until the end of the present administration. This does not necessarily mean, however, that the Ministry of the Treasury and Public Credit will not issue new general resolutions in tax matters, commonly known as the miscellaneous resolutions which, while attempting to clarify the tax provisions, effectively create new legal situations that significantly change the fiscal regime.

For 1993, tax policy still has a policing nature. It cannot be denied that a policing environment exists in Mexico and that it has produced excellent results for the Mexican tax authorities during this administration. Since the introduction of the media publicity directed at compliance, the obligatory tax opinion and the campaign which has been carried out against "selected" taxpayers (artists, businessmen, politicians, professionals, etc.), these steps – intelligently taken by the government – have resulted in considerable increases in the taxes collected from 1989 to the present.[34]

In comparing the Mexican tax rates to those in the United States and Canada, it is important to recognize that the Mexican government has made an immense effort to reduce the federal income tax rates. Nevertheless, there is a difference in the determination of the taxable base which, in general terms, means that taxes are paid at higher rates in Mexico.[35]

Lastly, it is important to note that (compared to previous years) the present relationship existing between the policing government and the taxpayers has markedly improved. As of 1989, the tax authorities pretended to considerably increase the collection of revenue because a large number of taxpayers were blatantly violating the country's tax laws, a practice that had to be stopped. The situation has been improving, primarily due to the tax discipline effected by the Ministry of the Treasury. We have become aware of the benefits, and we have accepted the consequences of correctly acting as the governed and as the government. This results in the good of all, and obviously indicates a general improvement in the Mexican tax culture. [36]

The results accomplished by the Mexican government are extraordinary. Of course, much remains to be done, particularly with respect to simplification of the tax norms and a reduction in the tax rates applicable to individuals. It is time that evaders and those who violate the laws are punished, and those who duly comply with the norms are recognized and applauded. That is no more than just.[37]

VI. TOWARD TAX SIMPLIFICATION

The tax authorities have made many attempts to simplify the tax system so that it is understood by the majority of Mexicans. Nevertheless, to accomplish a true tax simplification, a fundamental change in attitude is required. First, the authorities need to gain confidence that taxpayers will comply with their tax obligations. Second, taxpayers must believe that voluntary compliance contributes to the common good of the society as a whole. It is a Mexican cultural tradition that individuals seek to evade taxes while the state seeks to close loopholes that have been available for the maneuvers and imagination of the professionals, and to exercise its right of collection by means of force and "tax terrorism".

Many speakers have called for a simplification of Mexican tax law. In this respect, it is worth mentioning some considerations that have been presented. During the Ninth International Forum, organized by the Ludwig Von Smises Research Institute, a work entitled "A Simplified Tax Model: the Option for Mexico" was presented by Mr Albin Rabushka. Mexico would benefit greatly by reducing its tax system to a single tax which would reach 5 percent of its gross national product, but only with respect to the federal income tax, leaving other federal taxes and social security intact. Mr Rabushka's proposal is really due to the need for tax simplification, understood as a future need, under the policy of collecting more tax revenue by the public sector and requiring that more economically active Mexicans abide by tax norms and comply with the tax obligations in an easy, simple and responsible manner.

Mr Javier Moreno Padilla, in his address at the 17th Annual Congress of the College of Professors and Researchers of Tax Law and Public Finances, A.C., held in Puebla, Mexico, maintained that the essential factor to establish an equilibrium between the different national interests, which would permit simplification of the tax norms, is "tax education" that favours both the "rationality of the system and also its justice". I would agree with this position.

34. IDC (23 December 1992), ANO VII No. 166, at 2871 and 2870.
35. *Id.*
36. *Id.*
37. *Id.*

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According to Mr Moreno Padilla, to implement an administrative tax simplification, the following steps should be taken:

- develop clear and simple legislation that permits the taxpayers to understand its content so they can meet their obligations, which should be expressed in relation to their capabilities;
- norms of control must exist on the part of the treasury authorities;
- coherence must exist between the normative bodies. The issuance of excessive rules that discourage and confuse must be controlled;
- minimum tax quotas should be applied. An individual should have an economic incentive to produce; excessive taxes inhibit private sector initiative;
- norms should originate from the taxpayers, through a democratic exercise of representation in the House of Representatives and Senate. The provisions of the Executive Branch are normally estranged from the reality which they pretend to regulate;
- norms should be stable and permanent to guarantee the legal security and permit taxpayers to have confidence in, and knowledge of the norms.

> "Tax laws will receive a simpler treatment when the taxpayers comply with them to a greater degree in a spontaneous manner; at such time, it may be said that the objective of the technique and tax psychology of the taxpayers have been effectively reached."

We hope that Mexico will be a country that can achieve this desired tax simplification. For the present, it is our responsibility, as professionals in this area, both national and foreign, to begin such change by framing the problems and proposing solutions.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

AUGUST 1993

49th Congress of the International Institute of Public Finance: Public Finance and Irregular Activities, Berlin, 23-26 August (English):

International Institute of Public Finance, General Secretariat, University of Saarland, 6600 Saarbrücken 11, Germany, Tel.: 49-681-302 3653, fax: 49-681-302 4369.

Principles of International Taxation, Amsterdam, 23 August-3 September 1993 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel. 31-20-626 7726, Fax: 31-20-620 9397.

SEPTEMBER 1993

Interpretation of Tax Treaties, Amsterdam, 13-14 September 1993 (English):

IBFD, International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel. 31-20-626 7726, Fax: 31-20-620 9397.

Treaty shopping workshop, Monte Carlo, 13-14 September 1993 (English):

Elizabeth Husband, ITPA Conference Liaison Office, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-62910, Fax: 44-732-63762.

OCTOBER 1993

47th Annual IFA Conference, Florence, 3-8 October 1993; main subjects: interpretation of double taxation conventions, non-discrimination rules in international taxation (English, French, German, Spanish):

Secretary of the Conference, STRUMENTI, c/o ENIC, via Santa Caterina d'Alessandria 12, 50129 Florence, Italy, Tel.: 39-55-474737, Fax: 39-55-475037.

EC Corporate Tax Directives, Amsterdam, 14-15 October 1993 (English):

IBFD, International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

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KNOWLEDGE AND TECHNOLOGY TRANSFERS TO AND FROM THE UNITED STATES

CHARACTERIZATION OF TRANSFERS OF COMPUTER SOFTWARE

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Mr Adess joined Kirkland & Ellis in June 1969 and was admitted to the partnership in January 1975.

Mr Adess was a Consultant to the American Law Institute Federal Income Tax Project on International Aspects of United States Income Taxation, which resulted in a number of important changes in the international aspects of US taxation made by the 1986 Tax Reform Bill. He is a member of the American Bar Association Committee on Foreign Activities of US taxpayers and has served on a number of Chicago Bar Association Federal Taxation Committees, including as former vice-chairman of the Corporation Distributions, Reorganizations and Foreign Tax Subcommittee. He is also a former member of the ABA Corporate Stockholder Relationship Committee – Distributions Subcommittee.

Mr Adess has lectured on International Aspects of US Taxation and on Tax-free Reorganizations, Liquidations and Incorporations and various international tax subjects at both the Law School and Graduate School of Business at DePaul University and on international aspects of US taxation at Northwestern School of Law; he has spoken on a variety of topics at numerous tax conferences, seminars and institutes, including the University of Chicago Federal Income Tax Conference; Practicing Law Institute; International Fiscal Association; the World Trade Institute; the Chicago Tax Club; the Colorado Springs Tax Institute; the Texas Tax Institute; the Illinois Institute on Continuing Legal Education; Chicago Bar Association Tax Conferences; and Tax Executives Institute. Mr Adess has authored articles on various tax subjects.

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I. INTRODUCTION

The characterization of transfers of intangibles has significant tax implications. The sale of an intangible may produce capital gain, while its license will produce ordinary income. For cross-border transfers of intangibles the characterization of a given transaction as a sale rather than a license has foreign tax credit and withholding tax implications and raises possible Subpart F issues. Rapid technological advancements in the computer software industry, coupled with new and varied forms of transferring such technology and pricing such transfers, are creating particular difficulties in characterizing software transactions under traditional tax principles. There is disagreement even within the software industry itself as to whether transfers of computer software should be characterized as sales or licenses for tax purposes.

This paper first briefly describes the tax principles underlying the sale versus license characterization of patent, know-how and copyright transfers. The paper then focuses on the current debate regarding the proper characterization of transfers of copyrighted computer software, an issue which has global tax implications and could potentially have significant implications well beyond the tax law.

Contents

I. Introduction
II. Transfers of Intangibles: Sale Versus License
  A. Patents
  B. Know-how
  C. Copyrights
III. Characterization of Computer Software Transactions
  A. Overview
  B. Description of representative software transactions
  C. Framework of the issue
  D. The software coalition's position
  E. IBM's position
  F. Evaluation of the competing positions
IV. Conclusion

II. TRANSFERS OF INTANGIBLES: SALE VERSUS LICENSE

The tax treatment of a transfer of an intangible depends on the nature of the intangible (e.g. patent, know-how or copyright) and the scope of the interest being transferred (e.g. exclusive or non-exclusive rights, full rights or rights which are limited in geographic scope or duration). For purposes of applying these principles, the transfer of an interest in an intangible must be distinguished from the transfer of a

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tangible article produced with the intangible. Moreover, the parties' characterization of the transfer is not controlling for tax purposes.

A. *Patents*

Internal Revenue Code Section 1235[1] provides special rules governing certain transfers of patents. A transfer that does not qualify under Section 1235 must be examined under general tax law principles to determine whether the transfer constitutes a sale or a license and whether it generates capital gain or ordinary income to the transferor.

1. Scope

For purposes of Section 1235, the term "patent" includes patents granted under Title 35 of the United States Code and any foreign patents that grant rights generally similar to those granted under a US patent.[2] Section 1235 is also applicable to transfers of a pending patent application and to transfers of the right to obtain a patent with respect to a product that is patentable.[3]

2. Characterization of transfer

The owner of a patent or patentable product may transfer to a third party the rights to the patent or may grant to the third party a license to use the patent.

(a) *Sale*

A patent transfer generates long-term capital gain if the transfer satisfies the rigid requirements of Section 1235 or if it qualifies for such treatment under other Code provisions.[4]

(1) *Transfers under Section 1235*
Section 1235 applies only to transfers by the individual who created the property or an individual who acquired the property from the creator for consideration before the invention was reduced to practice. Thus, treatment under Section 1235 is available only to certain *individual* transferors and not to *corporate* transferors.

The holder of a patent must transfer property that consists of all substantial rights in the patent to an unrelated person in order to qualify under Section 1235. Section 1235 requires that the property being transferred convey all rights with respect to the patent that are of value at the time the rights to the patent are transferred.[5] Accordingly, in order to qualify under Section 1235, the patent rights being transferred must not be subject to geographic limitations within the country in which the patent was issued, duration limitations more restrictive than the life of the patent or use limitations. A transfer of a non-exclusive license with respect to a patent will prevent a subsequent transfer of all remaining rights under the patent from qualifying under Section 1235.[6] Moreover, the retention of a right to use the patent may make the transfer ineligible under Section 1235.

Section 1235 provides long-term capital gain treatment for the transfer of a patent regardless of the transferor's holding period for the patent, the method of payment for the transferred interest and the transferor's status as a professional inventor. Section 1235 only covers the patent transferor's tax treatment; the tax treatment of the transferee is governed by general principles of the tax law regardless of whether the transfer qualifies under Section 1235.

(2) *Transfers not subject to Section 1235*
A patent transfer by a corporate transferor (or by an individual in a transaction not eligible for Section 1235) may constitute a sale that is eligible for long-term capital gain treatment. The extent to which the transferor must transfer all substantial rights with respect to the patent in order for the transaction to qualify as a sale is not entirely resolved. The Supreme Court in a case pre-dating the advent of the federal income tax has held that an assignment of a patent (as opposed to a license) must include the exclusive right to make, use and sell the invention throughout the United States.[7] If the transferor has the unconditional right to terminate the transfer or if the transferor transfers rights with respect to the patent for a period less than the entire useful life of the patent, the transaction will be characterized as a license rather than a sale.[8] Patent transfers which are subject to geographic or field of use restrictions may qualify as sales under non-Code Section 1235 case law, even though such restrictions would be fatal under Section 1235.[9] The prior grant of a non-exclusive license to another will not preclude a subsequent transfer from qualifying as a sale.[10] However, the retention of a right to use the patent may prevent sale treatment.

If a patent transfer constitutes a sale for tax purposes, it will be eligible for capital gain treatment only if the patent constitutes a capital asset in the hands of the transferor. Patents generally qualify as capital assets.[11] However, in the hands of a professional inventor, the patent would be inventory, stock in trade or similar property, and therefore would not be eligible for capital gain treatment.[12] To qualify for long-term capital gain treatment, the transferred property must have a holding period of at least one year, which in the case of a patent begins no earlier than when the patentable idea is actually "reduced to practice".[13] Accordingly, the holding period for a patent generally will not begin until there is a demonstration that the idea actually works.[14]

Payments for a transferred patent may be made in a lump sum or may be made over the life of the patent on the basis of use. A patent transferee may deduct as depreciation payments

1. Unless otherwise noted all references are to the Internal Revenue Code.
2. Treas. Reg. § 1.1235-2(a).
3. Id.
4. Rev. Rul. 69-482, 1969-2 C.B. 164. See also Treas. Reg. § 1.1235-1(b).
5. Treas. Reg. § 1.1235-2(b)(1).
6. *Blake v. Commissioner*, 615 F.2d 731 (6th Cir.), *cert. denied*, 449 U.S. 832 (1980).
7. *Waterman v. Mackenzie*, 138 U.S. 252 (1891).
8. *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004 (Ct. Cl. 1967).
9. See *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955); *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955); *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958).
10. *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004 (Ct. Cl. 1967).
11. Treas. Reg. § 1.1221-1(c).
12. Code Sec. 1221(1).
13. *Lamar v. Granger*, 99 F. Supp. 17, 42 (W.D. Pa. 1951).
14. *Allied Chemical Corp. v. United States*, 66-1 USTC ¶9212 (S.D.N.Y. 1966), *aff'd*, 370 F.2d 697 (2d Cir. 1967).

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contingent on use at the time they are made.[15] Lump-sum payments are depreciable over the useful life of the patent.[16]

(b) *License*

If a patent transfer does not qualify as a sale of the patent, the transfer will constitute a license. A license involves a conveyance of rights under the patent in which the transferor retains legal title to the patent. The rights to make, use or sell articles produced under the patent may be conveyed by the license. Generally, a license will impose territorial and/or temporal restrictions on the transferee's use of the patent. The payments under a license may be made in a lump sum or may be contingent on the use or productivity of the patent.

Since no sale of property is involved in a license, the payments received by the transferor are ordinary royalty income.[17] The patent transferee is entitled to deduct such payments when made if the transferee is a cash-basis taxpayer or when accrued if the transferee is on the accrual method of accounting.[18]

B. *Know-how*

The tax law governing know-how is not as developed as the tax law governing patents. However, once an owner of a process determines that the process qualifies as know-how, an interest in the know-how may be transferred through a sale or a license.

1. Scope

The definition of know-how does not appear anywhere in the Code or Regulations. A non-patentable process must qualify as know-how in order to be considered property that is potentially eligible for capital gain treatment. The IRS has taken the position that information which constitutes a secret formula or process qualifies as know-how and that know-how may also include other secret information which does not rise to the level of a formula or process.[19] Although courts have generally adhered to the view that secrecy is a requirement for know-how, some courts have on occasion taken a more liberal approach to the definition of know-how. The Tax Court, for example, has allowed a non-secret formula to qualify as know-how in a situation in which it was transferred in conjunction with secret know-how.[20] Services performed may also be treated as a component of know-how if the know-how itself is the fruit of the transferor's labor or if the services are ancillary and subsidiary to the transfer of know-how.[21]

2. *Characterization of transfer*

The owner of know-how may transfer to a third party the rights to the know-how or may grant to the third party a license to use the know-how.

(a) *Sale*

The Code does not contain a specific provision governing know-how that is analogous to Section 1235. However, the IRS has adopted an approach which borrows heavily from the patent area. In order for a transfer of know-how to qualify as a sale, the transferor must transfer, for the entire life of the know-how, all substantial rights in the know-how together with the right to prevent its unauthorized disclosure. A transfer of know-how for a period shorter than its entire life will not qualify as a sale.[22] The IRS also has required that the transfer cover all rights to the know-how within all the territory of a country.[23] Although there is no case law specifically involving transfers of know-how which are subject to geographic or field of use restrictions, the principles developed with respect to transfers of patents are likely to be applicable.

A transfer of know-how that constitutes a sale will be eligible for long-term capital gain treatment if the know-how constitutes a capital asset in the hands of the transferor. A transfer of know-how by a professional developer gives rise to ordinary income because the know-how is not a capital asset under Section 1221. Rather such know-how is property held for sale to customers in the ordinary course of business.[24] In the case of know-how that constitutes a capital asset, the holding period required for long-term capital gain treatment commences when the taxpayer acquires the know-how or, if the know-how was developed by the taxpayer, when the know-how is reduced to practice.[25] If the transfer of know-how is ancillary to the transfer of other property and such other property satisfies the long-term holding period requirement, the know-how also satisfies such holding period requirement.[26]

Payments for transferred know-how that are contingent on the use of the know-how should be deductible as an allowance for depreciation at the time the payments are made.[27] A lump-sum payment for transferred know-how is depreciated over the useful life of the know-how, provided that such life can be reasonably estimated.[28] Know-how may not have a useful life which can be estimated, however, because the period over which secrecy will be maintained may be uncertain; if a limited useful life cannot be established, depreciation may not be allowed.

(b) *License*

A know-how license is treated substantially the same as a patent license. As with a patent, if a transfer of an interest in

15. *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945), *acq.*, 1959-2 C.B. 3.
16. Treas. Reg. § 1.167(a)-3.
17. Sec. 61(a)(6); Treas. Reg. § 1.61-8(a).
18. See Treas. Reg. § 1.461-1(a)(1); Sec. 461(h).
19. See Rev. Rul. 64-56, 1964-1 C.B. 133.; See also Rev. Rul. 71-564, 1971-2 C.B. 179 (treating trade secrets as know-how).
20. *United States Mineral Products Co. v. Commissioner*, 52 T.C. 177 (1969).
21. See Rev. Rul 64-56, 1964-1 C.B. 133.
22. See *DuPont v. United States*, 288 F.2d 904 (Ct. Cl. 1961); Rev. Rul 71-564, 1971-2 C.B. 179; *Pickren v. United States*, 378 F.2d 595 (5th Cir. 1967).
23. Rev. Rul. 64-56, 1964-1 C.B. 133.
24. *Ofria v. Commissioner*, 77 T.C. 524 (1981).
25. See *Lamar v. Granger*, 99 F. Supp. 17 (W.D. Pa. 1951).
26. *United States Mineral Products Co. v. Commissioner*, 52 T.C. 177, 199 (1969).
27. See *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945), *acq.*, 1959-2 C.B. 3.
28. Treas. Reg. § 1.167(a)-3.

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know-how does not qualify as a sale, it will constitute a license. Payments with respect to a know-how license constitute ordinary income to the transferor and are deductible by the transferee.[29]

C. *Copyrights*

As in the case of patents, there is a considerable body of law defining a copyright and the rights embodied in it. The availability of capital gain treatment for sales of copyrights is more limited than in the case of patents, however, because of the exclusion of copyrights held by the creator from the definition of a capital asset.

1. Scope

The term "copyright" is defined in Title 17 of the United States Code. A copyright exists the moment that a "work" is fixed in a tangible form, even prior to its publication. The copyright laws protect virtually any writing, work of art or creation in the entertainment field, as well as computer software and the writing of a program on a computer chip.[30] A copyright is an intangible that is separate from any physical embodiment of it; a transfer of a copyright differs from a transfer of a copyrighted article.[31]

2. Characterization of transfer

The owner of a copyright may transfer to a third party the rights to the copyright or may grant a license to use the copyright.

(a) *Sale*

In order for a transfer of a copyright to qualify as a sale, the transferor generally must transfer all substantial rights in the copyright.[32] However, the transfer of a fragment or subset of all rights under a copyright may qualify as a sale. One type of fragmentation that is permissible is a transfer covering the rights with respect to a single medium (e.g. a sale of just the movie rights). Geographic restrictions on the rights transferred also may not prevent sale treatment.[33]

The general provisions of the Code governing long-term capital gain treatment apply to the sale of a copyright. However, capital gain treatment may not be available for a sale by the creator of a copyright because the copyright will not constitute a capital asset in the creator's hands.[34] This exclusion from the definition of capital asset applies to copyrights held by an *individual* creator, but may not apply to *corporate* creators.[35] Capital gain treatment is also denied if the copyright is held for sale to customers in the ordinary course of business.[36] For a holder other than the creator, the holding period for long-term capital gain treatment commences when the copyright is acquired; for the creator, the holding period begins when the copyrightable idea is fixed in a tangible medium.[37]

Payments that are contingent on the use of the copyright should be deductible as an allowance for depreciation at the time such payments are made.[38] A lump-sum payment is depreciated over the useful life of the copyright.[39]

(b) *License*

A copyright license is treated substantially the same as a patent license. As with a patent, if a transfer of an interest in a copyright does not qualify as a sale, it will constitute a license. Payments with respect to a copyright license constitute ordinary income to the transferor and are deductible by the transferee.[40]

II. CHARACTERIZATION OF COMPUTER SOFTWARE TRANSACTIONS

A. *Overview*

The computer software industry has drawn a line in the sand over the proper tax characterization of transfers of copyrighted computer software. On one side is IBM, arguing that payments for software transfers, all of which take the form of a license, are properly characterized as royalties. On the other side is a coalition of 19 software manufacturers (the "software coalition"), contending that revenue from software transfers is properly characterized as proceeds from the sale of a product. Although the specifics of particular software transactions vary greatly, the issue has initially been joined in connection with the broad category of transactions in which pre-packaged, copyrighted software is transferred to a customer who is entitled to use such software in perpetuity.

This type of software transaction does not purport to be a transfer of the underlying copyright and hence the sale versus license issue cannot be resolved through application of the rules discussed above which govern copyright transfers. Rather, these software transactions more closely resemble transfers of copyrighted articles. The software coalition analogizes these transactions to the sale of one or more copies of a copyrighted book. However, the software transaction differs in form from the paradigm case of the transfer of a copyrighted book because of, among other things, the significant limitations imposed on the software transferee which are not imposed on the purchaser of a book. Indeed, the computer software transaction is universally cast in the form of a license in order to address concerns about computer piracy by providing the software developer with contractual rights pursuant to the license agreement in addition to the protection afforded by the copyright laws.

29. See Code Secs. 61(a)(6), 162(a).
30. See *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240 (3d Cir. 1983), *cert. dismissed*, 464 U.S. 1033 (1984).
31. 17 U.S.C. Sec. 202.
32. See, for example, *Stern v. United States*, 164 F. Supp. 847 (E.D. La. 1958), *aff'd*, 262 F.2d 957 (5th Cir), *cert. denied*, 359 U.S. 969 (1959).
33. See *Herwig v. United States*, 105 F. Supp. 384 (Ct. Cl. 1952).
34. See Code Secs. 1221(3), 1231(b)(1)(C).
35. See Rev. Rul. 55-706, 1955-2 C.B. 300, superseded on other grounds by Rev. Rul. 62-141, 1962-2 C.B. 182.
36. Code Sec. 1221(1).
37. 17 U.S.C. Sec. 102.
38. See *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945), *acq.*, 1959-2 C.B. 3.
39. Treas. Reg. § 1.167(a)-3.
40. See Code Secs. 61(a)(6), 162(a).

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The focus of the current debate in the computer software industry centers on a proposed IRS ruling sought by the software coalition that income earned by a foreign manufacturer on the transfer of copyrighted software to US customers constitutes sales income rather than royalty income and therefore is not subject to withholding under Section 881. It appears that the software coalition hopes that such a published ruling will encourage foreign jurisdictions, Canada in particular, to adopt a similar rule so that US software manufacturers will not be subject to foreign withholding on income earned on computer software exports.

B. *Description of representative software transactions*

The facts set forth in the proposed ruling are relatively simple. However, IBM cautions that the skeletal transaction described in the ruling in fact encompasses a wide range of complex arrangements between software manufacturers and their customers which should not be homogenized.

1. Industry practice

There are a wide variety of software products being marketed today by the software industry and both the products themselves and the forms in which they are marketed are continually evolving. The developer of computer software may market its product (i) by licensing another entity to reproduce and distribute the software to customers or (ii) by reproducing the software itself for distribution to customers directly or through a distributor. The treatment of the first type of transaction which involves a reproduction license conveying an interest in the underlying copyright is not at issue in the current debate. Rather, the dispute focuses on the end-user transactions in which the software developer transfers a finished software product to a customer for business or personal use.

(a) *Basic transaction*

The most straightforward type of transaction is the delivery to a customer of an off-the-shelf software package contained on a computer disk. The customer will pay a fixed, lump-sum price and will obtain the perpetual right to use the software. This type of transaction may involve an individual acquiring basic word processing software for use on his PC or a business acquiring extremely sophisticated software for use on multiple computers.

(b) *Delivery and pricing variations*

Numerous variations on this basic transaction have been developed by the software industry in response to competitive pressures and the varying business needs of its customers. Software may be packaged not as a separate computer disk but together with the hardware on which the program is to be run. Alternatively, a software developer may install the software directly on the customer's computer or may deliver a software product to the customer through electronic transmission. A software developer may deliver to the customer its entire library of software products in CD-ROM form with access to the individual programs restricted; the customer will pay for, and receive the access codes for, only those programs it selects.

The same software is often priced differently depending on the customer's intended use. The price of a particular software product may be determined based on the capacity and power of the computer system on which the customer will run the software. Moreover, software which will be run on a local area network may be priced based on the number of users who have access to the network. A business with multiple computers may obtain from the developer multiple copies of the same software product; alternatively, the developer and the customer may enter into an arrangement under which the customer receives a single copy of the software and has the right to make a fixed number of additional copies for its internal use.

These alternative transactions differ from the simplest software transaction because of variations in delivery and pricing terms. However, these transactions all involve the payment of a lump-sum price and the right to use the software for its entire useful life.

(c) *License agreement*

Of primary importance to computer software firms is the protection of the value of the copyrights underlying their software products. There is widespread concern that the copyright laws do not provide adequate protection with respect to computer software. Therefore, in order to maximize the protection of the software developers, virtually all end-user transactions are documented in the form of a license.

Computer programs are protected under the copyright laws as literary works. Under the copyright laws, the owner of a copyright is granted the exclusive right to reproduce and distribute copies of the copyrighted work for the duration of the copyright protection. The rights of the owner of the *copyright* are limited, however, and the owner of a *copy* of the copyrighted work is granted certain rights under the law. Under the "first sale" doctrine, the owner of a copy of a copyrighted work is entitled freely to sell or dispose of that copy, although special provisions applicable to computer software prohibit the commercial rental or lease of the copy without the authorization of the copyright owner. The owner of a copy of a computer program has the right to copy or adapt the program to the extent necessary in order to use the program and to make backup or archival copies. Such copies may be transferred by the owner of the copy in connection with a transfer of all of his interest in the program.

Preservation of the value of the underlying intangible is a particular problem in the case of computer software. First, it is extremely easy and inexpensive to make perfect copies of computer software. Second, a single copy of a software package may be used by multiple persons simultaneously. These characteristics make computer software piracy a major concern throughout the software industry. Although software developers are vigilant in pressing their rights under the copyright laws, there is concern that the copyright laws may not be adequate in the case of computer software. Because of

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this concern, computer software transactions are cast in the form of a license. Under this arrangement, the customer does not become the owner of the software copy and therefore does not acquire the rights provided under the copyright law to the owner of a copy of a copyrighted article. Moreover, the license agreement imposes explicit restrictions on the customer's use of the software.

The license agreements under which copyrighted software is transferred provide that the software developer retains ownership of the software copy. Moreover, the license agreement prohibits the customer from sublicensing, renting or leasing the copy to another user. The license agreement prohibits copying of the software except to the extent required for use on the customer's computer system or for the purposes of making backup or archival copies. Perhaps most importantly, the customer is prohibited from using the copy on more than one machine at a time and from reverse compiling or disassembling the software. Finally, the customer may transfer the software to a third party but must include a copy of the license agreement and must destroy any copies of the software. The restrictions imposed under the license agreement prevent the simultaneous use of the software by multiple persons and prevent the customer from transferring the software to a third party except in a transaction under which the third party would be subject to the license agreement. Thus, the software industry believes that the use of a license provides important protection to the software developer which complements the protection provided by the copyright laws.

2. Proposed ruling fact pattern

The fact pattern on which the proposed ruling is based involves a foreign corporation which develops and produces software products abroad for sale to end-users in the United States. Each software product consists of a copy of a program recorded on a carrier medium together with any associated documentation. The end-user pays a fixed lump-sum price for the software product. The foreign corporation requires that end-users enter into a license agreement, under which the end-user has the right to use the software in its own business for the remainder of its useful life but may copy it only for archival purposes and may use the software on only a single computer. The license agreement also prohibits the end-user from decompiling or reverse engineering the software program.

Under one scenario set forth in the proposed ruling, the foreign corporation which produced the software sells directly to the end-user. Under an alternative scenario, the foreign corporation uses a US corporation as its distributor.

C. *Framework of the issue*

The current debate regarding the tax treatment of software transactions focuses on transfers of pre-packaged software to customers for personal or business use. Transactions involving custom-designed software are not at issue. Transactions involving the grant by the software developer of a license to reproduce and distribute software also are not at issue.

The ruling proposed by the software coalition covers transfers to US customers by a foreign corporation of computer software developed abroad. Because the foreign corporation is not engaged in a trade or business in the United States, at issue is the characterization of the income from such transactions for purposes of Section 881. Under Sections 881 and 1442, a 30 percent withholding tax is imposed on fixed or determinable annual or periodical income paid to foreign corporations from US sources. Royalties earned by a foreign corporation from the use of a copyright in the United States are subject to the 30 percent withholding tax, unless such tax is reduced or eliminated by treaty. However, income derived from the sale of property is not subject to this withholding tax. The proposed ruling concludes that the software transaction is properly characterized as a sale and the income derived therefrom by the foreign corporation is not subject to the withholding tax.

The stated interest of the software coalition in sponsoring this ruling lies in convincing foreign jurisdictions to take the same position with respect to income earned by US firms on transfers of software to customers in such jurisdictions. The particular focus is on Canada which imposes a 10 percent withholding tax on royalties paid to US persons. The software coalition hopes that issuance of the proposed ruling by the IRS will encourage Revenue Canada to accept the position that transfers of software by US developers to Canadian customers should be characterized as sales, the income from which is not subject to the Canadian withholding tax.

IBM and several other US software firms have opposed the issuance of the proposed ruling. One of IBM's primary objections to the proposed ruling is that if the IRS were to treat the software transaction as a sale, the industry's position that such transactions constitute licenses and not sales for purposes of protecting the intellectual property rights involved would be undercut. Software transactions are carefully cast in the form of licenses in order to maximize the protection of the underlying intangibles; this enhanced protection is extremely important to software developers. IBM is concerned that if the software coalition succeeds in its efforts to obtain the proposed ruling, the sale characterization provided thereunder could be carried over to other areas of the law. If the transactions were treated as sales for purposes of the copyright laws, the rights of the customer with respect to the software would be enhanced and the developer's ability to control the use and subsequent disposition of the software would be restricted. Quite apart from the intellectual property issues, however, IBM has raised credible questions about the tax policy implications attendant to a ruling which allows a taxpayer to structure a transaction one way for non-tax purposes and yet argue for a different tax characterization.

D. *The software coalition's position*

In support of the proposed ruling the software coalition offers a detailed analysis of why software transactions should be treated as sales for tax purposes. Its analysis first focuses on the characterization of the software being transferred as a copyrighted article rather than an interest in a copyright; the analysis then focuses on the characterization of the transfer itself as a sale rather than a license.

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1. Computer software is a copyrighted article

The customer acquires in the software transaction the perpetual use of the software product but not any right to exploit the copyright underlying the software. The price paid by the customer is commensurate with the value of the use of the software not the use of the underlying copyright. Thus, the software coalition contends that the software transaction is similar to the sale of a copyrighted book. The software coalition notes that the tax law makes precisely this distinction between an interest in a copyright and a copyrighted article in the foreign sales corporation context; the temporary regulations provide that copyrighted software (as opposed to the copyright itself) constitutes export property eligible for benefits under the foreign sales company rules.[41]

In the software transaction, the software developer retains some control with respect to the software. However, the software coalition asserts that this retained control pertains to the underlying copyright rather than the copyrighted article. The customer receives the full right to put the copyrighted article, the software product, to its intended use. The license agreement simply preserves for the developer its full rights in the copyright and transfers to the customer only the copyrighted article.

2. The software transaction constitutes a sale

The determination of whether a transaction is a sale or a license for tax purposes depends on the substance of the transaction and not its form. Thus, the software coalition believes that the fact that the parties to a software transaction label the transaction as a license should not be dispositive for tax purposes. Moreover, a determination that the software transaction should be characterized as a sale for tax purposes will have no impact on the legal rights of the parties under the license agreement. For example, the IRS may recharacterize a finance lease as a sale, but this treatment by the IRS does not permit either party to claim that it is no longer bound by the terms of the lease.

The principles of Rev. Rul. 55-540[42] are applicable in characterizing the software transaction. The software coalition contends that, under Rev. Rul. 55-540, the following two factors are indicative of a sale: (1) the payment of an amount commensurate with the value of the property over an early and relatively short part of the property's useful life, and (2) the acquisition of the right to use the property in perpetuity. Notwithstanding variations in the delivery and pricing terms agreed to by the software developer and the customer, both of these factors are present in a software transaction: the price is a fixed amount which reflects the value of the software and is paid in a lump sum and the customer receives the right to use the software for its entire useful life. The specific transactions entered into by software developers and their customers are widely varied and complex; however, the two characteristics of payment of a lump-sum price and acquisition of the right to perpetual use are common to all end-user transactions. It is these common characteristics that are dispositive for tax purposes. Therefore, under Rev. Rul. 55-540, the software transaction should be characterized as a sale.

The software coalition further argues that the IRS applied the principles of Rev. Rul. 55-540 in this manner in a recent technical advice memorandum (T.A.M.) involving payments with respect to computer software. At issue in T.A.M. 9231002 (3 April 1992) was the treatment of income from extended maintenance contracts for computer software. Under these contracts, the software firm agreed to provide to the customer updates developed by the firm with respect to a software product that the firm had previously transferred to the customer. Like the software originally transferred to the customer, the updated version would be transferred pursuant to a license agreement. Although the transfers took the form of a license, the IRS concluded that the transactions should be characterized as sales under Rev. Rul. 55-540. Accordingly, the IRS ruled that the payments under the extended maintenance contracts constituted amounts received for a sale or other disposition for purposes of the Section 451 rules governing the treatment of advance payments.

The software coalition notes that the characterization set forth in the proposed ruling is consistent with the approach some courts have adopted for commercial law purposes. Software transactions have been treated as sales of goods for purposes of the Uniform Commercial Code (U.C.C.).[43]

The software coalition believes that its proposed treatment of the software transaction as a sale rather than a license is also consistent with the analysis of the essential elements of a license for other purposes of the tax law. In the context of both mineral rights transactions and trademark and franchise transactions (prior to the enactment of Section 1253), the analysis has focused on whether the transaction reflects a joint economic enterprise. A royalty payment reflects the transferor's continuing interest in the transferee's use of the transferred property; lack of this type of continuing interest is reflective of a sale rather than a license.[44] Because no such continuing interest or joint economic enterprise exists in the software transaction where the payment to the software developer is not based in any way on the profitability of the customer's use of the software, the software coalition contends that the transaction is properly characterized as a sale rather than a license.

In the software coalition's view, the characterization of the software transaction as a sale should apply for all federal income tax purposes. Thus, the implications of the proposed ruling will extend beyond the narrow withholding tax question. Moreover, even if the issue were limited to the withholding tax question, the issue is one of international significance which cannot be addressed solely in the context of the US–Canadian tax treaty negotiations.

E. *IBM's position*

IBM's analysis in opposition to the issuance of the proposed ruling focuses on the rationale for characterizing the transac-

41. Temp. Reg. § 1.927(a)-1T(f).
42. 1955-2 C.B. 39.
43. See e.g. *RRX Industries v. Lab-Con, Inc.*, 772 F.2d 543 (9th Cir. 1985); *Harper Tax Services, Inc. v. Quick Tax, Ltd.*, 686 F.Supp. 109 (D. Md. 1988).
44. See e.g. *Ima Mines Corp. v. Commissioner*, 32 T.C. 1360 (1959), *acq.*, 1960-2 C.B. 5; *Conde Nast Publications, Inc. v. U.S.*, 575 F.2d 400 (2d Cir. 1978).

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tion as a license for tax purposes. IBM also addresses the implications of the proposed ruling from a tax policy perspective.

1. The software transaction constitutes a license

The determination of the proper tax treatment of a transaction requires an analysis of the specific facts of the particular transaction. In the computer industry where the transactions engaged in by software manufacturers and their customers are widely varied and continually evolving, the development of a rule which has general application may be impossible and, in IBM's view, is imprudent. IBM believes that even the software coalition's preliminary analysis of the standard software transaction as a transfer of a copyrighted article is an oversimplification which places artificial importance on the fact that a physical copy of the software is transferred. In many transactions, the customer will not actually receive a physical copy of the software; rather, the software is electronically transmitted to the customer or is installed directly on hardware acquired by the customer. In other transactions, the customer receives a single physical copy of the software together with the right to make a fixed number of additional copies for its internal use. Alternatively, the customer may receive a single copy of software which is to be used on a network of computers. In such cases, the price is based on the usage of the software; even though the customer receives only a single physical copy of the software, the price paid will be very different from the price paid by an individual retail customer who acquires a single physical copy for use on one machine. The price of a copyrighted book – the paradigm copyrighted article to which the software coalition draws analogies – is not based on the number of users of the book over its life. Moreover, the focus on the physical software copy will become even less meaningful in the near future as electronic transmission becomes more and more prevalent in the software industry. Although IBM does not dispute that the physical software copy is a copyrighted article, IBM believes that the significant differences among software transactions even with respect to the most basic component, the physical software copy, demonstrate that the determination of the proper tax consequences must focus on the specifics of each software transaction as a whole.

The proper characterization of a transaction for tax purposes requires an analysis of the attendant facts and circumstances and where applicable the underlying contractual arrangements between the parties. Accordingly, a detailed examination of the ownership attributes held by each party to the transaction is required. IBM argues that the factors set forth in Rev. Rul. 55-540 and identified by the software coalition are not alone dispositive. No single attribute is determinative of whether a sale has occurred, and the relevant inquiry includes factors beyond those relied on in Rev. Rul. 55-540.[45] In IBM's view, the following attributes are particularly relevant in the context of a computer software transaction:

(a) the retention or relinquishment of control over the software product by the developer,
(b) the conduct of the parties with respect to the license agreement,
(c) the economic nature of the fee for the software,
(d) the allocation of economic risk and reward between the software developer and the customer, and
(e) the existence of tax-independent reasons for the form of the software transaction.

IBM contends that all of these factors support the conclusion that the types of pre-packaged software transactions it engages in should be treated as a license for tax purposes. IBM expressly limits its analysis to such transactions because of the important factual differences which make it imprudent to generalize about all software transactions.

Under the terms of the standard license agreement used in software transactions, the developer retains control over how the customer may use the software product. The customer may use the software on only one machine at a time, the customer may not lease or assign the software and the customer may copy or modify the software only in limited circumstances. Moreover, the developer retains title to the software. IBM argues that this retention of title and control by the developer is inconsistent with a sale.

Software transactions are universally cast in the form of a license. The software industry has been extremely diligent in pressing its rights both under the copyright laws and under the license agreements through which software is transferred. Moreover, corporate customers have become increasingly sensitive to avoiding violations of the license agreements through which they obtain software. IBM believes that the conduct of software developers and their customers is consistent with a license rather than a sale of the software product.

The fee paid in a transaction, even a one-time fee, is considered to be consistent with a license if the fee is solely for the use of the product. In the software transaction, the price paid by the customer reflects its right to use the software rather than its right to own the software. The value to the customer is in the actual use of the software and not in possession or ownership of a tangible physical copy. Although the customer acquires the right to perpetual use of the software, in IBM's view this "perpetual" use element is not particularly relevant in the context of computer software which can quickly become obsolete.

IBM further argues that the economic rewards with respect to the software lie principally with the software developer. The customer acquires only the right to the internal use of the software. The developer retains the economic profit potential associated with the transfer of the software to an unlimited number of other customers. The risks associated with the software also fall mainly on the developer who has borne the cost of developing and marketing the software and who must bear the risk that computer software piracy or obsolescence will reduce the future value of the software. The economic risk to the customer is limited to the loss of the price paid in the event that the software becomes obsolete.

Finally, IBM believes that the tax-independent reasons for structuring the software transaction as a license are compelling. The use of a license agreement is essential to the preservation of the developer's rights with respect to the

45. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

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copyright underlying the software. Indeed, the proponents of the ruling would not likely be willing to renounce the character of their software transactions as licenses for contract or copyright purposes in order to achieve sales treatment for tax purposes.

The analysis of a computer software transaction must necessarily take into account the specific rights transferred and retained by the parties. Despite the insistence of the software coalition, Rev. Rul. 55-540 cannot be viewed as requiring that every transaction involving a one-time charge and a perpetual term constitutes a sale. IBM points to General Counsel Memorandum (G.C.M.) 39580 (24 November 1986), in which the IRS considered a software transaction involving a perpetual term license and a one-time charge. The IRS concluded that the terms of the agreement were not consistent with a sale. Under the IRS's analysis, the rights retained by the transferor under the license agreement were sufficient to preclude the characterization of the transfer as a sale of either the copyrighted article or an interest in the underlying intangible. Moreover, contrary to the software coalition's criticism, the analysis in G.C.M. 39580 clearly distinguished between the copyrighted article and the underlying copyright, with the IRS concluding that neither was sold in the software transaction at issue.

Even if the analysis of the software transaction were limited to the two Rev. Rul. 55-540 factors identified by the software coalition, IBM insists that such factors would not support the characterization of a software transfer pursuant to a license agreement as a sale. The two factors which are considered by the software coalition to be indicative of a sale are (i) payment over a relatively short period of an amount approximating the price at which the software could have been purchased, and (ii) acquisition of the right to use the software for its remaining useful life. The price paid in a software transaction does not approximate the sales price for the same software. The price charged is based on the developer's assumption that it can prohibit unauthorized copying by the customer; if the developer were to sell the software it would forfeit control over copying and would have to be compensated for this risk. Moreover, unlike a customer that receives software under a license agreement, the *owner* of a software copy may be entitled to unlimited use of the software on a computer network; although software developers believe that the copyright laws prevent such use by the owner of a copy, the risk that such use would be permitted following a sale would require a higher price in the case of a sale. Thus, IBM concludes that the software coalition's analysis of the factors of Rev. Rul. 55-540 in the software context is based on a flawed factual premise.

IBM further contends that the IRS's conclusion in T.A.M. 9231002 that amounts received under an extended software maintenance contract constituted sales proceeds for purposes of the advance payment rules of Treas. Reg. § 1.451-5 is based on a similarly flawed premise. In applying Rev. Rul 55-540, the IRS assumed that the payments received by the developer under the maintenance contracts approximate the amount it would charge if it sold the software outright. That simply is not the case. Moreover, the IRS failed to take into account the ownership attributes retained by the software developer. Perhaps most importantly, the IRS in T.A.M. 9231002 expressly stated that its characterization of the payments as sales proceeds is applicable solely for purposes of Treas. Reg. § 1.451-5. The IRS specifically acknowledged that the payments may constitute royalties for purposes of other sections of the Code. Given the untenable position that a single transaction could be characterized as a sale for some tax purposes and a license for other tax purposes, IBM believes that T.A.M. 9231002 cannot be accorded much precedential value.

The other precedents relied on by the software coalition are similarly unconvincing to IBM. The fact that copyrighted software constitutes export property for purposes of the foreign sales company regulations does not address the issue of the characterization of the transfer of such software; indeed, export property may be the subject of a sale or a license. The fact that computer software transactions have been found by some courts to be subject to the provisions of the U.C.C. as sales of goods also should not be read to require an identical conclusion in the tax context. The U.C.C. has a specific purpose of modernizing and making uniform the law governing commercial transactions and its broad application is important to that purpose; the U.C.C. was not intended to have implications outside the commercial law context. Moreover, IBM believes that, at best, the U.C.C. case law is inconclusive since some courts have held that computer software licenses are not sales of goods subject to Article 2 of the U.C.C.

2. Issuance of the proposed ruling would not be sound policy

The transactions engaged in by the software industry are widely varied and highly complex. IBM believes that the simple fact pattern set forth by the software coalition in the proposed ruling is wholly inadequate to permit proper characterization of actual software transactions. An area where the facts vary from transaction to transaction and party to party is not the appropriate subject of a published ruling. The characterization of software transactions for tax purposes must be done on a case by case basis, with the focus on the particular facts rather than on broad generalizations.

Of even greater concern to IBM are the tax policy implications of the proposed ruling. A ruling that the software transaction is a sale would completely disregard the terms and conditions of the business arrangements agreed to by the parties to the transaction. The implications of a published ruling in which the tax characterization of the transaction is entirely inconsistent with the terms of the transaction could be far-reaching. The issuance of the proposed ruling would represent the IRS's blessing of a taxpayer's desire to assert one characterization for tax purposes while maintaining the opposite characterization for non-tax purposes. To date both the courts and the IRS have been unwilling to allow a taxpayer to disavow its form of a transaction in order to achieve more favourable tax consequences. To the extent the software coalition's real interest relates to the problem of Canadian withholding tax on income from software transactions, IBM believes that the issuance of the proposed ruling by the IRS is

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not the most sensible approach to the problem. Even if the IRS were to issue the ruling, there is no certainty that Canada and other foreign jurisdictions would take positions that are consistent. IBM concludes that the foreign withholding tax question could be better addressed directly through the bilateral treaty negotiation process.

Finally, and perhaps most importantly, the potential impact of the proposed ruling on the development of the intellectual property law with respect to computer software is extremely troubling to IBM. Software transactions are carefully structured as licenses in order to maximize the protection accorded to the underlying copyrights; treatment of the transactions as a sale for purposes of the intellectual property law would not be in the interest of any software developer. The risk that the characterization of the transactions as sales for tax purposes would have implications outside the tax law is unacceptable to IBM, particularly in a situation where the underlying tax issue could be dealt with more efficiently through other means.

F. *Evaluation of the competing positions*

In supporting their positions as to the proper characterization of the software transaction, both the software coalition and IBM struggle to fit the software transaction within the parameters of traditional tax analysis. However, each side is simply trying to fit a square peg in a round hole. The principal precedent that both sides focus on – Rev. Rul. 55-540 – addresses the sale versus lease issue rather than the sale versus license issue. Moreover, because of the unique characteristics of software and the transactions through which it is transferred, the determinative factors identified in existing precedents are not readily applicable in the context of the software transaction. By carefully tailoring the facts, each side is able to construct an argument that the existing precedents support its view as to the proper character of the software transaction. These competing analyses do not satisfactorily resolve the issue.

The proper characterization of the software transaction cannot be considered in a vacuum; the broader tax policy ramifications of a ruling that the software transaction constitutes a sale rather than a license must also be taken into account. IBM makes a very credible case that the software transaction should be characterized for tax purposes consistent with its legal and economic form – as a license. Consideration of all the implications, both for tax policy and beyond the tax law, weighs in favor of rejecting the proposed ruling.

As an initial matter, software transactions are continually evolving as new technologies are developed and the software transaction of the future will look less and less like the paradigm case of the sale of a copyrighted book. The current similarities between the software transaction and the traditional sale of a copyrighted article are disappearing and therefore should not form the basis for a published ruling as to the characterization of software transactions.

Software developers deliberately document the transfer of software in the form of a license agreement. This chosen form has important and substantial legal ramifications for both the developer and its customer. Where the form of a transaction is designed to achieve legitimate, non-tax objectives, the IRS generally should respect that form. Moreover, the parties that have chosen the form should not be permitted to disavow that form for tax purposes simply to achieve more favorable tax treatment. The software coalition is asking the IRS to declare that the software transaction will be treated as a sale for tax purposes in order to improve the software developers' tax position while the same transaction will be treated as a license for all other purposes in order to protect the software developers' valuable intangibles. The IRS should not lightly take such a step.

Finally, the tax savings that the software coalition envisions will arise from a ruling that the software transaction constitutes a sale may carry a very high price tag. Such a ruling would not go unnoticed by those engaged in litigation over the intellectual property rights associated with computer software. An IRS ruling characterizing the software transaction as a sale will likely have implications outside the tax law, implications which will undercut the intellectual property protections that the software industry has long fought for. The software industry should carefully consider whether the proposed ruling is really in its best interest.

IV. CONCLUSION

The debate over the proposed ruling characterizing the transfer of computer software as a sale rather than a license for tax purposes has been simmering for a year and a half. The software coalition has submitted to the IRS detailed arguments supporting the proposed ruling and IBM has submitted equally detailed arguments in opposition to the ruling. However, the IRS has yet to act.

To the extent that the purpose of the proposed ruling was to influence Canada to take a similar position with respect to computer software royalties earned in Canada, the ruling may no longer be necessary. Canadian finance officials recently announced their willingness to eliminate by tax treaty the withholding tax imposed on payments to non-residents for the use of computer software in Canada. Thus, the software coalition may have realized its goal of eliminating the Canadian withholding tax on computer software transfers to Canadian customers without resorting to an IRS ruling that would universally characterize the software transaction as a sale.

Indeed, the use of tax treaty provisions to eliminate the withholding tax on computer software transfers may be the best route for achieving the broader goals of the software coalition while avoiding the legitimate concerns raised by IBM with respect to the proposed ruling. The tax authorities can narrowly address the tax treatment of payments for computer software transfers through carefully drafted treaty language without being required to take a position with respect to the proper characterization of the underlying transaction as a sale or a license. This route avoids the risk that the proposed ruling's characterization of software transactions as sales would impair the intellectual property protection afforded by structuring such transactions as licenses. Perhaps the interests of the software coalition would be best served by redirecting their efforts toward the treaty negotiation process and abandoning the controversial proposed ruling.

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INTERNATIONAL:

How Do Revenue Audits Affect Taxpayer Compliance?

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Contents

I. Introduction

II. The Effect of Audits on Taxpayer Compliance
- A. Analytical studies
- B. Regression modelling of aggregate US data
- C. Experimental studies
- D. Survey studies
- E. Professional literature
- F. Summary of specific issues

III. Effective Audit Strategies
- A. Theoretical predictions
- B. Research tests
- C. Professional literature

IV. Overall Conclusions and Limitations

I. INTRODUCTION

The purpose of this article is to summarize, evaluate and report on the existing professional and research literature on what tax audit strategies are likely to be most effective in enhancing tax compliance. In compliance research, especially survey research, definitions are of critical importance. This is true when comparing research that originates in one country, but even more so when transporting research findings from one country to another. It is possible to define "compliance" in a number of ways. For instance, "voluntary compliance" composes specific compliance (i.e. future voluntary compliance arising from a specific audit) and general compliance (i.e. future voluntary compliance arising from the existence of an audit programme).

In the United States, the Internal Revenue Service (IRS) is most concerned with the filing of an accurately completed, timely and fully paid return. The Panel on Taxpayer Compliance Research (Roth, Scholz and Witte, 1989, p. 2) adopted a definition of compliance implying no assumptions about taxpayers' motivations:

> Compliance with reporting requirements means that the taxpayer files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the Internal Revenue Code, regulations, and court decisions applicable at the time the return is filed.

Another type of compliance exists in terms of collecting additional tax detected through audit. In other words, this is "compliance" in the sense that the taxpayer was made to comply in that instance.

This article is structured as follows. In Part II, research into whether audits encourage voluntary compliance is reviewed. Part III reviews research on audit types, strategies and features which are claimed to be most effective in detecting non-compliance and assessing additional tax. Some overall conclusions are then made in Part IV.

II. THE EFFECT OF AUDITS ON TAXPAYER COMPLIANCE

The interdisciplinary nature of this type of research has a number of implications to a review such as this. First, it is important to compare like with like. For this reason, the review separately analyses the major types of research. Conclusions from each of these respective areas can be outlined and compared, although the inherent limitations of these research areas must also be noted. This enables overall findings to reflect inherent trade-offs between differing research methods. The breakdown used in reviewing the literature in relation to whether audits encourage voluntary compliance is as follows:

1. *Analytical (Economic Deterrence) Models* – These have drawn upon the economics of crime literature and assume a utility maximizer, an amoral "rational economic evader" who assesses the likely benefits and costs associated with evasion behaviour.

2. *Regression Modelling* – These econometric studies typically draw upon large US data bases such as the IRS Taxpayer Compliance Measurement Program, for analy-

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sis. As such, they do use aggregate "actual data", normally to test propositions derived from the models formulated in 1. above.

3. *Experimental Studies* – These studies test propositions from analytical models, but in a controlled laboratory setting, which models the tax reporting process. Parameters such as the tax rate, the probability of audit and the penalty rate can be manipulated to identify the effect of such changes on future compliance.

4. *Survey Studies* – Survey work is valuable as it identifies taxpayers' actual perceptions and attitudes about relevant variables. Occasionally, ex-post self-reported non-compliance is identified, although future intentions to comply (or to evade) are normally not measured in survey research - indeed such measurements would probably not be reliable.

5. *Professional Literature* – This includes accounting and law journals and periodicals specific to the tax profession. These journals (and sometimes conferences) involve an interface between researchers, practitioners and revenue authorities.

In a sense, the first category above, analytical models, represents *theoretical statements* about audit effectiveness and audit strategy. The next three categories collectively comprise the research that tests these theoretical predictions. The last category is one which is usually not a formal test of a theory, but the professional literature is still valuable. First, it represents reality in that practitioners are involved in the actual practice and conduct of audits. The importance of practitioners in encouraging voluntary compliance has only been realized and subject to serious research over the last decade. Second, there is an interface between research and practice, so that they both influence each other.

A summary of the review findings then follows in Part II.F. The summary addresses four specific issues:

(1) the impact of specific audits;
(2) the impact of a general audit presence in the community;
(3) taxpayers' perceived coverage rates;
(4) direct revenue effects.

A. *Analytical studies*

These models incorporate the concept of an economically rational taxpayer (or evader) who will evade tax as long as the pay-off from evading is greater than the expected cost of being caught. Allingham and Sandmo (1972) proposed a seminal economic deterrence model based on the expected utility function of the taxpayer who evades.[1] This model incorporates several aspects. First, the taxpayer has some level of risk aversion, the more risk averse the taxpayer is, the less likely (s)he is to evade taxes. Second, the taxpayer needs to have knowledge regarding the tax system in order to assess the probability of being detected and the extent of the penalties that may be incurred upon detection. Allingham and Sandmo prove that increasing the probability of an audit unambiguously reduces evasion.

Early economic models have drawn criticism for a number of reasons. Graetz and Wilde (1985) stated that the models were too simple, as they ignored the interrelationship with the revenue authority. Lewis (1982a, p. 132) reports that:

> the central frame of references should be what taxpayers' perceptions actually are rather than what they are assumed to be on the basis of rational and self interest assumptions .... [T]he decision to evade tax is based on an individual's perception of the chances of being caught, the size of the fine and tax rates, not on what they actually are.

In addition, apart from the parameters listed in the above quotation, there may be other psychological and sociological variables affecting perceptions and attitudes, and eventually, actual evasion behaviour. Graetz et al. (1986, p. 2) stated that even as a purely economic model, expected utility theory's exclusive focus on the individual taxpayers' decision-making promotes "an unduly restrictive vision of the compliance problem and potential responses to it". They state "an inadequate theoretical construct may both distort empirical analyses and imply unhelpful policy responses".

Extensions to the early models counter some of the criticisms. For instance, Alm (1988) analyses the joint choice of evasion and tax avoidance and concludes that the existence of another avenue of tax minimization alters the conclusions of some simple evasion models (i.e. if evasion penalties increase, taxpayers may turn to avoidance). This is of course true to the extent that evasion and avoidance are substitutes. Government policies to reduce evasion may not always increase the tax base if avoidance behaviour is possible and its cost is not prohibitive. The speed and spread of responsive avoidance behaviour and the search for new avoidance techniques may be another factor affecting the tax base. Of course, in practice substantial avoidance techniques may not always be available, e.g. as is now the case in New Zealand.

Beck and Jung (1989a) also extend previous economic models by incorporating uncertainty about taxable income and the associated liability. They make a number of interesting findings to be empirically tested in the future:

(1) Unless taxpayers are highly risk-averse, an increase in post-audit income uncertainty is much more likely to lead to a reduction in reported income.[2]
(2) Taxpayers' incentives to purchase tax advisory services as a means of reducing uncertainty are shown to depend on the audit probability and ordinary and penal tax rates. Increasing the audit probability will not necessarily lead to increased use of these services.

1. This expected utility function is expressed as:
$E(U) = (1-p)U(W-QX) + pU(W-QX-a(W-X))$
Where:
U = cardinal utility
p = probability of investigation
W = actual income (known only to the taxpayer)
Q = tax rate
X = declared income
a = penalty rate (a is assumed > 0)

2. One should note that post-audit income uncertainty, should normatively speaking, decrease and not increase.

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(3) The effects of tax rate changes depend on taxpayers' risk-taking attitudes and have an indeterminate effect upon reported income.
(4) Taxpayers' reporting decisions are identical under both progressive and proportional rate structures.

In summary, both early analytical models of evasion and recent extensions to them find that increasing the probability of audit encourages taxpayer compliance. Recent work suggests that if there is some uncertainty about the audit probability, then this will likely result in less aggressive reporting. This suggests a rationale for a tax agency not to fully disclose information relating to its audit strategies.

B. *Regression modelling of aggregate US data*

After the development of the analytical models reviewed in the preceding section, researchers were keen to empirically test their propositions. Empirical studies into tax law enforcement in the United States have greatly benefited from the Taxpayer Compliance Measurement Program (TCMP) and Exact Match File which allowed progress in this area.

With the assumption of a random audit strategy as an inexact but reasonable first approximation to true audit policy, Witte and Woodbury (1985) and Beron et al. (1988) both found that tax audits can be important stimulants to compliance, but these must be carefully designed for specific taxpayer groups. Witte and Woodbury note that the compliance effect is most significant on small proprietors, but only very small, although significant, on the compliance of middle income and wage earners.[3] They comment that the decline in audit rates in the United States in the 1970s could have accounted for a substantial portion of the decline in compliance during that period; and they state (at p. 8): "Our results certainly suggest that increased audit rates could have an important and salutary effect on voluntary compliance .... [O]verall audit rates have a lagged effect on compliance."

The findings of Dubin and Wilde (1988) generally support Witte and Woodbury and an economic approach to the compliance problem. They suggest (at p. 70) that different models of IRS behaviour may apply to different audit classes.

Beron et al. (1988) find that audits are more effective at inducing accurate reporting of deductions rather than income reporting, and suggest that significant compliance effects also stem from other policing activities such as matching procedures, checking for errors, the provision of information and educational programmes, pursuing tax in arrears and taking penal action, e.g. civil and criminal prosecutions. Several reasons are given for not finding consistent deterrent effects of audits, not least being the non-disclosure of the IRS's audit selection policy to academic researchers and also some inherent problems in model specification. The non-disclosure of audit policies on individual returns has meant that researchers have had to calculate audit probabilities themselves (from the aggregate data supplied) without knowing the reason for the audit. This makes it difficult to test the effects of one audit strategy against another audit strategy.

Klepper and Nagin (1989b) also use TCMP data to find marked variations in compliance levels according to the line item in the tax return and the difficulty of establishing non-compliance and penalty imposition for those line items. It is now widely recognized that research into attitudinal variables on compliance must explicitly consider and control the opportunity to evade, which may vary for different line items in tax returns.

Dubin, Graetz and Wilde (1990) return to this issue using more recent data – the studies above used 1969 data. Specifically, they note the drop in audit rates over 1977-1986 (individuals down 2.5 to 1 percent and companies down from 9.5 to 3 percent). This corresponded to a natural consequence of the budget policies of the period and also to a policy of substituting third party information reporting with increased IRS matching and penalties.[4] They estimate that self-reported taxes would have been US$ 15.6 billion higher in 1986 (about 4 percent of total reported taxes) had the audit rate remained constant at its 1977 level. They conclude:

> Our results corroborate the central role of audit rates in the revenue collection process. The impact of the decade long fall in audit rates on tax collections seems to have been serious indeed. A budgetary practice of including IRS audit personnel within a general political philosophy limiting the desired size of government agencies is enormously costly. Additional dollars spent on tax audits appear to have substantial marginal productivity....

In summary, the results of regression modelling research indicate that there is a deterrent effect to audits and that for most classes, audits have positive effects on compliance. However, these findings must be interpreted with caution. There are inherent problems in model specification which influence the results found, and Beron, Tauchen and Witte conclude that economists' understanding of the effects of audits is not very thorough.

Long and Burnham (1990) do not share the views of Dubin, Graetz and Wilde. They believe that given an audit programme is in place, it is hard to determine what the effects of varying detection probabilities are, due to changes in other enforcement resources (p. 756). They comment the IRS itself concluded "indirect revenue effects are very difficult to measure, we do not currently have estimates of them". This is discussed further in Part II.E. on professional literature.

C. *Experimental studies*

Experimental compliance studies are slightly different from regression models using large data bases, but as a group, experimental studies are similar in design. In a controlled laboratory setting, conditions are set up to mirror the tax reporting situation. That is, each subject receives an income and must decide how much to report. Taxes are paid on reported income only, but underreported income may be discovered with a certain probability of audit, in which case the subject must pay specified fines. At the end, subjects normal-

3. Possibly middle income wage earners are an already compliant group and one would not expect to find large significant effects on such a group.
4. They do not appear to control for changes in the tax and economic environment over the decade.

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ly receive a reward for their participation, conditional on their performance.

The parameters studied in experimental studies have traditionally been those used in economic deterrence studies (see above "Analytical Studies"). These can be manipulated with relative ease. The first study by Friedland (1978) examined responses to changes in tax rates, penalties and frequency of audits. Some of the earlier studies can be criticized on the grounds that their parameters, e.g. audit and penalty rates, were unrealistic.[5] In recent times, researchers have attempted to maintain "parallelism" with real world settings and have used "neutral" instructions. Many studies use student subjects which could potentially be of concern; however, responses from students have been shown to be similar to responses from other subject groups. The results from laboratory experiments must be interpreted with caution, especially in making generalizations about their results.

James Alm, a leading experimental researcher (1991, p. 584) has reviewed earlier experimental work and suggests:

1. Individuals report less income as the tax rate rises.
2. An increase in the penalty rate increases compliance.
3. More frequent audits encourage greater compliance.
4. Many individuals overweight the probability of audit, behaving as if the probability is higher than it actually is.
5. Compliance is reduced when individuals feel that they are treated unfairly relative to others, regardless of the source of the inequity (from the tax or the expenditure side).
6. The compliance decision is made jointly with the labour supply decision.
7. Individuals pay more in taxes when they receive something for their tax payments.
8. Compliance can be encouraged with rewards as well as penalties.
9. The institutions that determine the use of tax payments affect compliance. Individuals pay more in taxes when faced with a public programme that they select and that they know enjoys widespread support.
10. The introduction of uncertain tax policies increases compliance in the absence of government expenditures and decreases compliance in their presence.
11. A tax amnesty lowers post-amnesty compliance if the amnesty is not well designed.
12. Some individuals pay taxes because they believe that cheating is wrong.

Alm, McClelland and Schulze (1992) find that subjects tend to overweight the low probability of audit, resulting in the payment of more taxes than expected utility theory would predict. For instance, they found that even with a zero probability of audit, there was an average of 20 percent compliance in their experiment (expected utility theory would predict zero compliance). Alm et al. conclude (p. 36):

> In short, individuals exhibit a remarkable diversity in behaviour. They sometimes appear to overweight low probabilities, they sometimes appear to be risk-seeking, they are on occasion cooperative, and at other times they are free-riders. Whether any theory of compliance can be developed to explain such behaviour is unknown at present. However it is apparent that some new theory is needed.

Alm, Jackson and McKee (1992) also confirm that taxpayer reporting increases with greater audit and penalty rates, although they find that the increases are not large (an elasticity of 0.17) and "... given the difficulties in raising the audit rate significantly, the scope for increased compliance via increased audits seems limited".

In summary, it is generally accepted that in experimental settings, subjects who have been audited report greater post-audit compliance. Again, caution must be exercised in interpreting the research findings. First, to ensure that the conditions of the relevant experiment closely follow accepted research methods. Second, the magnitude of the effect of audits on compliance ranges widely.

D. *Survey studies*

Following the work of Vogel (1974) and the call of Lewis (1982a), numerous studies have collected survey data on tax evasion behaviour. The majority of these studies have been conducted in the United States, although survey data has also been collected in Sweden, Norway, the Netherlands, Australia and New Zealand.

Many studies have reported on the frequency with which respondents self-report cheating behaviour. Analysis following such surveys concentrates on what demographic and attitudinal variables are significantly (statistically) related to admitted cheating behaviour. A summary of these studies is given in Table 1, and shows wide variations in self-reports. In some studies audits were a significant correlate, although in other studies, no associations were found between previous audits and evasion behaviour.

Survey results should be interpreted cautiously. First, it is important to ensure sampling error and non-response bias is minimized. Second, differences across studies may be attributed to differences in the way taxpayers were sampled, differences in the wording or definitions used in survey questions, and when the survey was conducted.

Despite these comments, surveys are potentially very useful if they are representative of the taxpayer population, although they can be very expensive in terms of time and money. Accordingly, academic researchers have traditionally only been able to complete small-scale surveys, typically based in overseas countries.

Kinsey (1990) uses cross-sectional survey data to examine the effects of enforcement contacts made by the IRS on taxpayer sanction perceptions, the perceived fairness of tax laws and future intentions to cheat on taxes. On the future intention to cheat, she finds that the net effect of personal contact (with the IRS) is greater willingness to comply with the law.

The analysis included the outcome of the audit (paid more or did not pay more tax), and those respondents assessed additional taxes were more likely to plan to file fully compliant returns in the future. This group also reported higher sanction

5. Chang et al used audit rates of 10, 50 and 90% with implied penalty rates for these three cases, respectively being 900, 100 and 11%.

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perceptions and gives evidence of both deterrence and experiential effects among tax non-compliers contacted by the IRS about possible problems with their returns.

Table 1
International Statistics of Admitted Tax Evasion

Country	Time Period	Level of Evasion	Author
US	1974	33%	Spicer (1974)
	1975-1980	12%	Tittle (1980)
	1977	5.3% (OD)* 14.5% (UI)*	Mason & Calvin (1978)
	1981	24.7%	Grasmick & Scott (1982)
	1978	32%	McCrohan (1982)
	1982	14%	Rossi and Grasmick (1985)
	1984	20%	Yankelovich Skelly & White (1984)
	1987	28% (UI)	Porcano (1988)
Sweden	1969	16.4% (OD) 17.7% (UI)	Vogel (1974)
	1979	33%	SIFO (1979)
	1981	18.6%	Warneryd & Walerud (1982)
Norway	1980	18% (UI)	Isachen, Klovand & Strom (1982)
Netherlands	1981-1982	27%	Elffers Weigel & Hessing (1987)
Australia	1982	25% (UI)	Wallschutzky (1984)
New Zealand	1989	23% (UI) 12% (OD)	Hasseldine (1992)

Notes:
* (OD) = Overstating Deductions
* (UI) = Understating Income

Her study also included vicarious enforcement efforts and she suggests that the diffusion of tax information about instances of apparently unfair enforcement may persuade previously honest tapayers to join the ranks of non-compliers.

Kinsey's survey study is significant and unique because of its rigorous and in-depth focus on this topic. The essence of her conclusion is that future intentions to comply are influenced by the outcome of the audit, i.e. the effectiveness of the IRS in detecting non-compliance. That is, those who have paid more taxes perceive a greater probability of detection and intend to comply, whereas those who have been non-compliant in the past lower their perceptions of certainty and continue past habits. Further, the results for vicarious contacts suggest little deterrence effects – that is, respondents talk more to others about fairness (e.g. arbitrary decisions and rude treatment) than the effectiveness of the IRS.

E. *Professional literature*

The Report of the 1989 Peat Marwick Professors Symposium considered that innovative uses of computer technology could enable the the IRS to enhance the quality and efficiency of their audit programmes. They did note that the effect of uncertainty (e.g. audit probability) on compliance remains an important question.

The publication of journals like the *Bulletin* and *Tax Notes* allows rigorous academic research to be published in the professional domain. For instance Dubin, Graetz and Wilde (1987) state: "in our judgement, the dramatic diminution of IRS' audit capacity has been a massive policy mistake".

A contrasting view stems from Long and Burnham (1990) who believe that it is highly unrealistic to think that tougher enforcement of the current tax law can have a significant impact on the deficit, querying whether the TCMP accurately measures non-compliance at all! They believe that the major cause of the "tax gap" is complexity and ambiguity in tax requirements and not dishonest taxpayers. They comment (p. 756):

> The lack of any clearly observed evidence of deterrence perhaps may be explained by the fact that many of the cases of non-compliance that IRS auditors detect appear to have arisen because of a misunderstanding of tax requirements or uncertainties about how these requirements should be applied. It seems doubtful that doubling or tripling the audit rate would have much impact on these problems. In addition, as we previously saw even when the return of someone who deliberately cheated is audited by the IRS the agency rarely requires more than the payment of the taxes it claims have been misreported, plus accrued interest. Furthermore, the IRS is unlikely to detect all of the unreported income if the taxpayer has made a deliberate effort to keep the sources hidden. Thus, even when audited, the calculating tax cheat seldom is worse off than if he or she had reported the correct amount in the first place. Some deterrent!

In Australasia, a Tax Compliance Intensive Weekend Workshop was held in August 1989 and the work of Professor Ian Wallschutzky (1988, 1989, 1991, 1992) is also notable.

F. *Summary of specific issues*

The next four subsections will synthesize research in four sub-areas of whether audits affect compliance. Because of cross- country differences in social norms and conduct, it is important to view some of these with caution especially the section on coverage, rates, etc. where not only are we dealing with different taxpayers, but also with a different tax authority and socio-legal structure.

1. The impact of specific audits

On balance, across the four differing methods contained in this section, the research literature suggests that specific audits do improve compliance behaviour, as they contain both an education and deterrent effect. This is subject to two

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qualifications. First, it assumes that the taxpayer's group or audit class does not already have a high voluntary compliance level. For example, the compliance of middle income wage earners is unlikely to improve due to a specific audit, as they are already acknowledged as one of the most compliant groups. Second, it assumes that audits are carried out competently and unreported income is detected and assessed with penalty.

2. The impact of a general audit presence

Research accepts that there should be a general audit presence in the community. The issue is how large should the presence be? Opinions differ here with some research stating that audit activity should be increased and others saying there are more effective methods, or at least that the IRS can select audit cases better. Because of the "ripple effect",[6] it is again important that audits be conducted not only effectively but also fairly. There is an implicit acceptance among researchers that a revenue authority should not publish their specific audit strategy, but rather promote the view that a variety of factors may lead to audit. Interestingly, in the United States, taxpayers who might rate highly for audit attention will be given a "second chance", and be sent a "self-audit" checklist by the IRS.

3. Taxpayers' perceived coverage rate

Survey and experimental research indicates that individual taxpayers often overestimate the audit coverage rate (see Alm (1991)). Whether businesses share this view is unknown. As the probability of detection does influence taxpayer behaviour, it is in the best interests of the revenue for the audit rate to be made to seem as high as possible. Hasseldine and Kaplan (1992) found that 24 percent of their New Zealand respondents (drawn from electoral rolls) reported having been audited by the New Zealand Inland Revenue Department, although as the authors did not define the term "audit", a letter from a district office querying an item may have constituted an "audit" for some people.

4. Direct revenue effects

Of these four specific areas, this has been the least researched. Of course the direct revenue effects in terms of tax collected are dependent on case selection and the auditor's expertise. Two opposing views are shared by prominent researchers. Dubin et al. believe that audits have large direct and indirect revenue effects. Long and Burnham dispute this view. Accordingly, no firm conclusions can be made on this issue.

III. EFFECTIVE AUDIT STRATEGIES

The breakdown used in reviewing the literature in relation to the audit types, strategies and features most effective in detecting non-compliance and assessing additional tax is as follows:

1. *Theoretical Predictions* – This largely draws on a sub-part of the economic deterrence models discussed in Part II.A.
2. *Research Tests* – There has been little research conducted on the effectiveness of specific and pure audit "strategies". Rather the effect of withholding position and positive approaches to compliance have been canvassed more fully in the research literature and these are summarized here.
3. *Professional Literature* – Practitioners and revenue authority officials often share their views on effective auditing in professional journals.

A. *Theoretical predictions*

Extensions to the analytical models discussed in Part II.A. by a handful of researchers have concentrated on the existence of an optimal enforcement policy. Tauchen and Witte (1986, p. 40) note that even in simple multi-period models, developing an optimal audit policy is problematic. An audit strategy based on a taxpayer's previous history of evading achieves a higher level of compliance at the same cost as a random audit policy.

One of the most readable books for policy-makers on the economics of evasion is by Cowell (1990), who outlines an analytic framework for evasion decisions and points out how important the fundamental choice is between threats and thoroughness. Whether one emphasizes either the audit enforcement effort or the penalty regime is related to whether evasion is to be eliminated, or merely curbed to ensure that a government's budget constraint is met. A policy response to evasion is closely related to government's wishes for the actual role of the revenue authority, i.e. a revenue maximizer in terms of dollars or coverage of the population. If equality between taxpayers is to be preserved, attention should focus on audit enforcement rather than on the use of large penalties.

There are also several recent interactive theoretical models specifically related to tax enforcement which significantly extend the economic deterrence models discussed in the preceding section. Graetz et al. (1986) develop a model which explicitly integrates the relationship between the taxpayer and the revenue authority (assumed to have a revenue maximizing function over time) and considers the normal parameters found in the general economic deterrence models. Beck and Jung (1989b) also develop a model of the interplay between taxpayers' reporting decisions and tax audit policies under environmental conditions of uncertainty and information asymmetry. They state (p. 482):

> Our major conclusions are that increases in penalties, the tax rate, and tax liability uncertainty diminish taxpayers' reporting aggressiveness when penalties are proportional to the tax deficiency and transferable to the tax agency.

The fact that some of the relationships found by Beck and Jung depend on the underlying penalty structure has policy implications in the areas of tax penalty formation and efforts to simplify the tax structure.

Scotchmer and Slemrod (1989) show that optimal enforcement policy requires some randomness in the assessment of taxable income whenever reducing randomness is costly. One interesting result of their paper, which contrasts with

6. This "ripple effect" may be positive or negative.

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Graetz et al. (1986), is that tax collection agencies should not necessarily maximize revenue, but should maximize taxpayers' expected utility which will require a different view of randomness.

B. *Research tests*

There appears to have been little empirical research specifically conducted on audit types, strategies and features most effective in detecting non-compliance and assessing additional tax. Most of the literature on this topic seems to relate to the experiences of various revenue authorities around the world which provide a description of their enforcement efforts. One of the most commonly accepted strategies in encouraging compliance is to promote the use of withholding in the tax system, and although this is a little unrelated to audit per se, the use of such a system does of course have implications for audit policy. Another approach advocated by some authors is for revenue authorities to embrace "positive approaches" to tax compliance.

Hasseldine and Bebbington (1991) assert that policies covering both economic and psychological responses may be implemented and merit consideration by tax authorities. In this regard, legal sanctions would represent an economic variable whereas informal sanctions and appeals to conscience represent psychological responses. While research exploring the effect of formal sanctions on compliance has been relatively extensive (e.g. probability of detection and monetary penalties), less attention has been given to psychological responses.

Under standard economic deterrence models, the taxpayer's decision is based upon his/her beliefs about the probabilty of detection and legal penalties, if detected. Note that the taxpayer's decision is not driven by the actual probability of detection or the actual legal penalties. These models suggest that changes in the taxpayer's knowledge of tax system variables, such as formal economic penalties, will affect the taxpayer's decision on whether to evade or not. Educational programmes directed at taxpayers represent one source for this type of knowledge, although this information could also stem from other sources.

Among a group of US taxpayers, Violette (1989) recently found that a communication describing formal, legal sanctions increased compliance to a hypothetical tax scenario. A limitation of general deterrence theory is its unwarranted emphasis on economic variables such as the threat of legal sanctions. Similarly, Kinsey (1984) concludes that informal sanctions in the form of social stigma are an important factor in deterring deviant behaviour and may have applications to tax compliance. Freiberg (1990) contends that informal social sanctions have been under-utilized and should be considered as an avenue for improving tax compliance behaviour.

Grasmick and Scott (1982) contend that policies that increase the public's sense of moral duty to comply should be the most effective strategy for improving compliance, although they note such an approach may be difficult to implement as a national policy. Foremost among these reasons is that a moral appeal might be interpreted as a sign that authorities have no other way to extract compliance (Rossi and Grasmick, 1985). Implementation problems aside, an important initial question concerns whether communications of a moral or conscience nature are likely to influence compliance behaviour. Rossi and Grasmick (1985) also caution that such appeals may be limited to the extent that taxpayers have strategies to "neutralize" any guilt feelings.

Hite (1989) tested a positive approach to conscience appeals in the form of a public education programme, finding that an approach which emphasized free IRS services available to taxpayers did influence non-compliant respondent's opinions about the helpfulness of the IRS. She concludes that tax administrations should place greater emphasis on positive strategies.

Hasseldine and Kaplan (1992) compare responses from taxpayers receiving an appeal to conscience to responses from taxpayers not receiving such an appeal. An appeal to conscience, unlike legal or informal sanctions, does not impose penalties, but instead is intended to influence the taxpayer's evaluation of the equity of the taxpayer's exchange relationship with government. Because the prior two approaches only apply penalties, they are not expected to influence taxpayer beliefs. On the other hand, an appeal to conscience, because it may influence perceptions of equity, is expected to influence taxpayers' beliefs. Equity has been often cited as an important contributor in evasion decisions (Falkinger, 1988; Kaplan and Reckers, 1985).

The results of Hasseldine and Kaplan (1992) demonstrate that the communication of informal sanctions to taxpayers may result in higher tax compliance. However, the communication of existing legal sanctions for tax evasion in New Zealand or of a conscience appeal did not significantly result in improved hypothetical compliance. In contrast with Violette (1989), the group receiving the informal treatment were more likely to comply than those subjects receiving the legal communication of economic sanctions currently applicable in New Zealand. This reinforces suggestions made by researchers that more attention should be given by policymakers to methods other than the communication of existing legal sanctions to increase tax compliance. However, for taxpayers with prior experience in receiving "cash income", the use of legal sanctions may remain appropriate.

Unlike Schwartz and Orleans (1967) and Grasmick and Scott (1982), the conscience appeal did not significantly affect hypothetical compliance, although it was successful in increasing beliefs about the immorality of evasion behaviour. That is, the views of the morality of evasion appear to be pliable. This change of beliefs may have long-term benefits for a tax system that are not expected with other approaches using the threat of deterrence as a mechanism to extract compliance.

C. *Professional literature*

In an article in *Tax Notes*, entitled "Lower audit rate doesn't mean less scrutiny", IRS officials comment that although the use of audits is on the decline, they are still scrutinizing

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returns carefully. That is, the IRS is turning to more positive approaches and to the use of matching techniques to encourage compliance. Melia (1987, p. 1316) in his review of the Massachusetts state experience sums it up nicely:

> Tax administrators must realize that all taxpayers are different and respond out of different motivations. Some respond from fear of audit, some from guilt over failing to perform a basic obligation as a citizen and others out of gratitude when their government offers an amnesty or finally prints a tax form in plain English.

He believes any strategy to improve voluntary compliance must have three key elements: the stick (threat and reality of punishment), the carrot (valuing honest taxpayers with respect) and the conscience (a public education programme that spreads the message that evasion is a serious crime that picks the pockets of honest taxpayers and undermines the ability of all levels of government to perform their role).

IV. OVERALL CONCLUSIONS AND LIMITATIONS

One obvious limitation or caution of this article is that care must be taken in transporting the findings of international research into other countries where there may be subtle and not so subtle differences in the tax regime and social culture. This is why authors such as Lewis (1982) and Jackson and Milliron (1986) have called for further international studies in the tax compliance area.

Research strongly suggests that people who are audited are more likely to comply than those people who have not been audited. In addition, a general audit presence has a deterrent effect. So an audit programme should be an integral part of efforts to encourage compliance. Because it is taxpayers' perceptions that are important in compliance decisions (even if it is perceptions of economic variables), a communications strategy must also be a crucially important input into efforts to increase voluntary compliance.

Theoretical research predicts that audits which are targeted to some audit class (e.g on the basis of profession, age, gender, income, etc.) will stimulate compliance more than a simple random auditing rule. A concern of this is that there has been little empirical research into the effects of different audit strategies. Nor are there any clear published guidelines on how to develop audit classes, although there are probably many officials in revenue authorities around the globe, with their own entirely valid beliefs in this respect. Research into the uncertainty effects of audits is continuing and clearcut conclusions are not easy or indeed feasible.

Many now agree that audits should not be used in isolation. This is because as only a small percentage of taxpayers can be audited, it is inefficient as a sole mechanism to improve voluntary compliance. Rather, other measures such as taxpayer information and education, tax simplification, information reporting and the use of informal sanctions may significantly affect actual compliance decisions. Accordingly, it is suggested that revenue authorities should maintain a general audit presence, but alternative and complementary approaches designed to encourage compliance (e.g. positive approaches) should be examined. Research in the United States strongly suggests that the withholding position at tax preparation time and the influence of tax preparers are key variables in such decisions.

There is a sense of trade-off between the conclusions from the two broad areas of this review. Audits do reduce evasion, but they must be used in conjunction with other methods. High audit rates are probably a phenomenon of the past.

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INTERNATIONAL:

ISSUES RAISED BY INTERNATIONAL COOPERATION IN REVENUE ENFORCEMENT: DIRECTIONS FOR THE FUTURE[1]

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I. INTRODUCTION

The established rule in international law is that no State will enforce the revenue laws of another State.[2] In these days of overseas investment and multinational corporations, this "principle of sovereignty" has the potential to promote tax avoidance. It makes tax enforcement extremely difficult where the taxpayer or his affairs are outside the jurisdiction. Many nations attempt to overcome these problems by entering into bilateral double taxation agreements.

The purposes of double taxation agreements are threefold: to prevent double taxation, to avoid tax treatment in one country that discriminates against the nationals of another country and to facilitate administrative cooperation between tax authorities. This article is concerned with the latter. It examines the ways in which nations cooperate to enforce their revenue legislation. Focusing, in particular, on Australia's double taxation agreements with the United States and Japan, two of its major trading partners, this article studies the provisions that mandate cooperation between the parties and considers the ways in which that cooperation takes place in the light of those provisions. Finally, the future direction of information exchange is discussed.

Contents

I. Introduction
II. Taxing Jurisdiction
III. Cooperation Between Taxing Authorities
IV. Limitations on Cooperation
A. Reciprocity
B. Excluded information
C. Other limitations
V. Mechanics of Information Exchange
A. Exchange on request
B. Automatic exchanges
C. Spontaneous exchanges
VI. Confidentiality
VII. Conclusion

II. TAXING JURISDICTION

Most nations exercise their jurisdiction to tax on two bases: that the income was generated in that nation (i.e. source) and/or that the recipient of the income was either a resident or a citizen of that nation (i.e. residence). In Australia, residents are taxed on their worldwide income, regardless of its source, and non-residents are taxed only on their Australia-sourced income. The same is essentially true in the United States.

In Japan, however, while non-residents are taxed only on their Japan-sourced income, there are two categories of residents and two separate tax treatments. The categories are permanent and non-permanent resident, distinguishable by the length of time spent in Japan. Permanent residents are those who are domiciled in Japan or have been in Japan over five years, and non-permanent residents are those who have been in Japan between one and five years. Permanent residents are, as in Australia and the United States, taxable on their worldwide income, while non-permanent residents are taxable on their foreign-sourced income only if and when it is brought into Japan.

The wide net cast by the worldwide taxation of residents, combined with local taxation of local-sourced income, creates potential for double taxation. In addition, the existence of tax havens, different tax rates in different jurisdictions and special tax benefits for specified activities lead taxpayers to manipulate their activities to take advantage of lower tax rates or to use tax havens or to disclose their activities in the beneficial jurisdiction while keeping them from the tax authorities in other jurisdictions. In many instances, in the absence of double taxation agreements, tax authorities would be powerless to discover these activities.

1. An earlier draft of this article appears in the proceedings of the 5th Australasian Tax Teachers' Association Conference held in Christchurch, New Zealand, 17-19 January 1993.
2. Dennis D. Curtin, "Exchange of Information under the United States Income Tax Treaties", 12 *Brooklyn J.Int'l L.* (1986), at 35, citing Lord Mansfield in *Holman v. Johnson*, (1775) 1 Cowp. 341, 343, 98 E.R. 1121.

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III. COOPERATION BETWEEN TAXING AUTHORITIES

Although each double taxation agreement is specifically negotiated between the two parties, most are based on either the 1963 or the 1977 OECD Model Convention for the Prevention of Double Taxation.[3] Both OECD models contain information exchange provisions, although with the benefit of hindsight to reveal the flaws in the 1963 Model Convention, the provisions regarding information exchange in the 1977 Model Convention purport to better enable information exchange.

As a result of these two Model Conventions, nearly every double taxation agreement contains a provision mandating that tax authorities exchange information to facilitate enforcement of their respective tax laws. At a minimum, these treaty provisions all contain the following:

- provision for the type of information that is exchangeable, identified by purpose;
- provision for the protection of the information exchanged;
- provision for exclusion from exchange of specified types of information;
- provision that the tax authority must be legally entitled to the information.

In the Australia–US agreement, entered into in 1982 and based largely on the 1977 Model Convention, the relevant provision is Article 25 (Exchange of Information):

> (1) **[Exchange of information]** The competent authorities shall exchange such information as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which this Convention applies provided the information is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.
> (2) **[Non-disclosure]** Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those (including a Court or administrative body) concerned with the assessment, collection, administration or enforcement of, or with litigation with respect to, the taxes to which this Convention applies.
> (3) **[Public Policy]** No information shall be exchanged which would be contrary to public policy.
> (4) **[Access to documents]** If specifically requested by the competent authority of one of the Contracting States, the competent authority of the other Contracting State shall provide information under this Article in the form of copies of unedited original documents (including books, papers, statements, records, accounts or writings) to the same extent such documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.
> (5) **[Collection of Taxes]** Each of the Contracting States shall endeavour to collect on behalf of the other Contracting State amounts equal to such taxes imposed by the other State as will ensure that any exemption or reduction in rate of tax granted under this Convention by that other State shall not be enjoyed by persons not entitled to such benefits.

In the Australia–Japan agreement, entered into in 1969 and taking effect in 1970, it is Article 18 (Mutual Agreement Procedure):

> (1) **[Exchange of information]** The competent authorities of the Contracting States shall exchange such information (being information available under the respective taxation laws of the Contracting States) as is necessary for carrying out the provisions of this Agreement or for the prevention of fraud or for the administration of statutory provisions against avoidance of the taxes to which this Agreement applies.
> (2) **[Information to be treated as secret]** Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment or collection of the taxes to which this Agreement applies, or the judicial determination of appeals in relation thereto.
> (3) **[Trade secrets]** No information shall be exchanged which would disclose any trade secret or trade process.
> (4) **[Limitation on exchange of information]** A competent authority shall not be obliged by this article to disclose to the other competent authority any information which does not relate directly to the affairs of a taxpayer with whom that other competent authority is concerned.

The treaty obligation to exchange information is mandatory – note the language "competent authorities ... shall exchange". Nonetheless, the scope of the exchange is limited by a variety of factors, not the least of which is the attitude of the parties to the information exchange. Although the principle of sovereignty should not affect mere requests for information – as such requests would, at best, merely enable the requesting party to enforce its own revenue laws – historically it created a mindset that cooperation is not to be expected and, consequently, that requests for assistance would be futile.[4]

Tax authorities are gradually coming to accept that cooperative exchange of information is necessary if they are to gain the information they need to properly assess their taxpayers. Since the "basic prerequisite for successful tax enforcement efforts is the compilation of information on taxpayer activities",[5] "the only way of stemming the growing tide of international tax evasion and avoidance is through effective cooperation"[6] to acquire the information. In particular, Australia's cooperative relationships with both the United States and Japan have been steadily improving.

One example of this new mood favouring cooperation is the advanced pricing agreement effected between Apple Computers and tax authorities in the United States and Australia early in 1991. This negotiated agreement stipulates a transfer pricing methodology that all three parties will use to determine an arm's length price for transfers between branches of the Apple Computer company in the United States and Australia.

The concept of advanced pricing agreements originated in the United States, where they are permitted under US law by virtue of Revenue Procedure 91-22. The procedure entails

3. Other possible models include the UK Colonial Model, the US model and the UN Model Double Taxation Convention Between Developed and Developing Countries.
4. Lee Burns and R. H. Woellner, "Bilateral and Multilateral Exchanges of Information", 23 *Taxation in Australia* (1989), at 656, 657.
5. Gregory P. Crinion, "Information Gathering on Tax Evasion in Tax Haven Countries", 20 *International Lawyer* (1986), at 1209, 1213.
6. Lee Burns, "Finding the Information Trail: Some Experiences in International Tax Enforcement", *Current Issues in Criminal Justice* (1989), at 111. Cf, Michael D'Ascenzo, "Developments in Transfer Pricing Enforcement and Complex Audit Strategy in the Australian Tax Office", 5 *Australian Tax Forum* (1988), at 471, 480-81.

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negotiating an appropriate transfer pricing methodology on the basis of information provided by the taxpayer.[7] The amount of information required is so substantial as to be considered onerous by some, resulting in limited use of the advanced pricing procedure to date.

Normally a bilateral agreement between the IRS and the taxpayer in these circumstances does not protect the taxpayer from incurring double tax liability due to taxation in another jurisdiction. Yet, insofar as any double taxation problems will be resolved through information exchange and use of the competent authority procedure, it is only logical that these two mechanisms be invoked before the fact, rather than after. In particular, due to the different policies of different tax authorities as regards penalties and interest on refunds, an adjustment after the fact using the competent authority procedure may not fully restore the taxpayer.[8] From this thinking emerged advanced pricing agreements that also involved the tax authority of the other jurisdiction.[9]

The Apple Computer agreement is an example of the sophisticated result of such foresight. In announcing the successful negotiation of the agreement, Apple's representatives indicated their feeling that the benefits of the advanced pricing agreement procedure far outweigh the alternatives.[10] In particular, requisite evidentiary submissions were far less than would be expected in litigation and costs were significantly less.

In addition to a comparatively reasonable stance on the part of the IRS (*vis-à-vis* attitudes displayed in audit-type situations), Apple's application was also greeted with enthusiastic cooperation by the Australian Tax Office (ATO). The ATO used its data on the profitability of other Australian companies to determine a benchmark and, doubtless will include this benchmark figure in its data for future transfer pricing cases. The ATO's support for the advanced pricing procedure and its determination that the procedure succeed is evidenced by the amount of time and effort it devoted to this seminal application.

Another example of cooperation between taxation authorities is the Pacific Association of Tax Administrators (PATA). The members, Australia, Japan, Canada and the United States, meet twice a year to discuss common problems and potential solutions, as well as to exchange views on coping with international tax avoidance.[11] Each member is represented by its competent authority.

PATA has an executive council as well as working parties that set themselves to airing specific problems encountered by each. PATA has also developed a Code of Good Practice to which each member attempts to adhere vis-a-vis its relationships with the others.

Information has also been exchanged between PATA members. In fact, the close relationship between the four PATA members has resulted in the spontaneous exchange of information that may not have otherwise been made available. For example, Australia has recently received a list of "paper companies" in Hong Kong from a PATA member.[12]

IV. LIMITATIONS ON COOPERATION

As the opposition to cooperation fades, the limitations on treaty information exchange that remain exist in the provisions of the treaties themselves. The two major limitations are reciprocity and exclusion from exchange.

A. *Reciprocity*

All double taxation agreements require reciprocity as a general principle. A contracting state may not supply information that it would not be entitled, under its own law, to receive.[13] Further, a state may not request information that it would not be entitled, under its own law, to receive. In the Australia-US agreement, this principle is found in the language of Article 25(1): "provided the information is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes". Similarly, in the Australia-Japan agreement, the language "(being information available under the respective taxation laws of the Contracting States)" draws the limitation.

The implication of this requirement is twofold. First of all, no request for information may be made until all domestic investigation avenues have been exhausted.[14] Secondly, if the information is not legally attainable domestically, it may not be requested of the treaty partner.

Tax authorities are not required to provide information that the requesting party "could not obtain under its own domestic laws".[15] The domestic information gathering powers of Australia, Japan and the United States illustrate the scope of this limitation. Since a detailed consideration of these powers is beyond the scope of this paper, the examination will, of necessity, be brief.

Under the provisions of the Australian Income Tax Assessment Act (ITAA), the Commissioner has the right of full and free access to all buildings, places, books, documents and other papers for the purposes of the Tax Act.[16] The Commissioner also has power to require any person to furnish information, attend and give evidence and produce all books, documents and other papers in the person's custody and under their control.[17] The result is that "where the information or

7. Karl William Viehe, "Advance Pricing Agreements: Stability for Transfer Pricing", *International Taxation Journal* (1992), at 49-50.
8. Carlton M. Smith, "Use of Advance Pricing Agreements Enhanced by New Revenue Procedure", *The Journal of Taxation* (June 1991), at 374, 378.
9. According to a Tax Management interview with IRS Assistant Commissioner (International) Regina Deanehan, there has yet to be an advance pricing agreement applicant taxpayer who requests that the foreign competent authority not be involved. See 1 *Transfer Pricing Report* (1992), at 76.
10. Kathleen Matthews and Emily E. Elliot, "For Apple Computer, an APA Helps Keep Auditing Nightmares Away", 51 *Tax Notes* (1991), at 280.
11. Michael D'Ascenzo, "Developments in Transfer Pricing Enforcement and Complex Audit Strategy in the Australian Taxation Office", 5 *Australian Tax Forum* (1988), at 471, 481.
12. Id.
13. Eric B. Switzer, "Exchange of Information Articles", 26 *Canadian Tax Journal* (1978), at 306, 310.
14. See generally para. 9(a) of Commentary to Art. 26 of the 1977 OECD Model Convention.
15. Burns, *supra* note 6, at 117.
16. ITAA Sec. 263.
17. ITAA Sec. 264.

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the person controlling it is physically in or linked to Australia, the ATO will usually be able to obtain that information unless it falls within one of the formal exceptions to the ATO's power".[18]

This latter power should enable to Commissioner to get information needed from a local person who has some knowledge of overseas activities (especially in the case of multinationals).[19] As a practical matter, however, companies may be in a position to dictate that only high-ranking employees, especially directors, disclose information to the ATO.[20]

The investigatory powers of the Information and Examination Division of the Japanese National Tax Administration appear to be similar to, although not quite as broad as, those of the ATO. The books and records of the taxpayer may be examined[21] and, if deemed necessary, third parties who have had dealings with the taxpayer may be questioned or compelled to disclose their books or records of those dealings.[22] In addition, tax officials have authority to elicit the cooperation of other government agencies to access documents and other information deemed "necessary in the examination of the taxpayer's income".[23]

Interestingly, while Japan's domestic information gathering powers appear to be as wide as those of Australia and the United States, it has limited the information it can supply pursuant to a treaty request by looking to its domestic restrictions on public disclosure and treating restricted information as excluded from exchange. This will be discussed in greater detail below.

The US Internal Revenue Service also has the authority to "examine any books, papers, records, or other data",[24] as well as to "summon the person liable for tax...or any officer or employee...or any person having...books of account...or any other person".[25] This ability to issue a summons appears to go beyond the investigatory powers of either Australia or Japan.

Ultimately, "the aim of a DTA in this regard is not so much to extend domestic investigative powers, but rather to bilaterally broaden the territorial scope for the application of those powers".[26] The interpretation of reciprocity in this regard offers a clear demonstration of this aim.

One other aspect of reciprocity is the notion that there is no obligation to provide information where no information is being provided by the other side in exchange.[27] Such an attitude has the potential to become petty, as well as to severely restrict information flows. "Accordingly, since the success of any reciprocal exchange of information program is determined by the extent of mutual cooperation, all competent authorities should advocate the adoption of a liberal reciprocity policy."[28]

B. *Excluded information*

In addition to the requirement of reciprocity, information exchange is further limited to only that information that the treaty partners have agreed to disclose. Therefore, where the partners have provided for protected classes of information, those classes are excluded from exchange. Generally, certain information is excluded from exchange in order to protect taxpayers.[29]

Limitations on disclosable information do not present any particular problems as regards the Australia-US treaty, the broad coverage of which even includes information to prevent fraud.[30] In fact, the only category of information excluded under Article 25(3) of the Australia-US treaty is that which is contrary to public policy.[31]

While the Australia–Japan treaty contains the same broad language as the Australia–US treaty *vis-a-vis* fraud, it excludes from exchange information "which would disclose any trade secret or trade process".[32] This exclusion is particularly important to the Japanese, as there does not seem to be any trust that information exchanged will be kept confidential.[33]

The Australia–Japan treaty also requires that the information disclosed "relate directly to the affairs of a taxpayer with whom that other competent authority is concerned".[34] While this latter limitation has been interpreted to mean that the information provided must relate to a resident of Japan,[35] in fact, the Australia–Japan treaty does not contain the language found in Article 1 of the OECD Model: "This Convention shall apply to persons who are residents of one or both of the Contracting States." Accordingly, tax authorities are entitled, under Article 18(4), to request information about non-resident taxpayers. The limitation of Article 18(4) is that the information requested must have a direct relationship to the affairs of the taxpayer. The problem it presents, therefore, is in determining what "direct" is.

Although a provision like Article 18(4) does not exist in the Australia–US treaty, the fact that Article 25 does not contain the sentence: "The exchange of information is not restricted by Article 1" which is found in the OECD Model Convention, while Article 1 of the Australia–US treaty does restrict

18. Burns & Woellner, *supra* note 4, at 657.
19. Burns, *supra* note 6, at 114.
20. S. Breckenridge, "Transfer Pricing, International Cooperation, Transfer of Information, International Tax Audits and Treaties", paper delivered at the Taxation Institute of Australia NSW Division 1989 Intensive Seminar, Sydney, 31 October 1989, at 22.
21. Shotokuzeiho (Income Tax Law), Law No. 33, 1965, Sec. 234.
22. Japan, Ministry of Finance, Tax Bureau, *An Outline of Japanese Taxes 1990*, at 72.
23. Income Tax Act, Sec. 235.
24. Internal Revenue Code (1986), Sec. 7602(1).
25. *Id.*, Sec. 7602(2).
26. Burns and Woellner, *supra* note 4, at 658.
27. Curtin, *supra* note 2, at 67.
28. Id. at 68. This conclusion is echoed by Switzer, who feels that the principle of reciprocity should be abandoned completely. See Switzer, *supra* note 13, at 321.
29. P. Ann Fisher, "Treaty Aspects and Information Exchange", 17 *Brooklyn Journal of International Law* (1991), at 77, 85.
30. Burns and Woellner, *supra* note 4, at 659.
31. This limited exclusion is unusual. Most tax treaties "provide that trade or professional secrets must not be disclosed". Gregory J. Degulis, "Information Disclosure and Competent Authority: A Proposal", 17 *Case Western Reserve Journal of International Law* (1985), at 485, 510.
32. Australia–Japan treaty, Art. 18(3).
33. Mitsuru Ohsaki, *Kokusaiteki Sozei Kaihi* (International Tax Avoidance) (Tokyo: Ministry of Finance Printing Bureau, 1991), at 424.
34. Australia–Japan treaty, Art. 18(4).
35. Burns and Woellner, *supra* note 4, at 659.

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application of the treaty to residents of one or both treaty partners has been taken to mean that the information exchanged must relate to a resident.[36] This restriction impedes the ability of tax authorities to discover "laundering" of transactions through countries with which no double taxation agreement exists.

C. *Other limitations*

Another limitation is that only information necessary for the relevant purpose may be disclosed.[37] Interpretation of the word "necessary" could have a significant restrictive impact, especially as what is necessary in the eyes of one tax authority may not be so in the eyes of the other tax authority. This problem is somewhat alleviated by the commentary to Article 26 of the 1977 OECD Model Convention, which states that information should "be exchanged to the widest possible extent".[38] This implies that a narrow interpretation of the word necessary is undesirable.

One area where tax authorities are not generally limited by treaty language as regards the scope of their requests is whether the information requested has already been gathered. "Exchange is not limited to information already in the possession of the administration. The requested authority may be obliged to collect the information...regardless of whether or not the requested authority has any interest in the information".[39] While the requested authority may bear this obligation, there are doubtless many instances when it will not be carried out. Whether such inaction is deliberate would be difficult to say. Nonetheless, various delays due to the low priority likely to be assigned to a request from a foreign taxing authority may ultimately result in frustration of that request.

It is interesting to note, in this connection, that Japan has specifically entered a reservation to Article 26(2) of the OECD Model Convention. It will only "supply information obtained through special investigation or special examination as long as such investigation or examination is concerned with taxation in Japan".[40] While the Australia–Japan agreement is not based on the 1977 OECD Model Convention, it can be expected that Japan would take the same stance, nonetheless.

V. MECHANICS OF INFORMATION EXCHANGE

According to the Commentary to Article 26 of the 1977 OECD Model Convention, the first paragraph of the information exchange provisions implies three different types of information exchange: on request, automatic (also known as routine) or spontaneous.

A. *Exchange on request*

The stereotypical image of information exchange is that Country A, in the course of auditing Taxpayer X, comes to suspect that Taxpayer X has had dealings in Country B which have not been disclosed and therefore makes a request to Country B for information. The incidence of information requests in the United States has risen in recent years,[41] demonstrating the importance of this form of information exchange. The types of information involved includes information of control of companies and legal or financial documents relating to a taxpayer under investigation.[42]

In the case of a specific request, the requesting country would have to (a) very clearly identify the taxpayer and the information sought, (b) show that the taxpayer is subject to the laws of the requested country, and (c) show good faith.[43] Where the old attitude toward cooperation continues, such a request might be met with a variety of delays, resulting in untimely receipt of information, if it were to be provided at all. However, the procedure toward such requests in the United States illustrates the modern attitude toward information exchange.

In the United States, after the Revenue Service Representative for the requesting country has ascertained the legitimacy of a request, i.e. ensuring that it contains the three points mentioned above, the Criminal Investigation Division of the district in which the information is located assists in procuring the information.[44] The taxpayer is not informed that information is being provided to a treaty partner unless (1) the information is not in IRS files, (2) the taxpayer is not currently being examined by the IRS or (3) the IRS believes the information is confidential business information, such as a trade secret.[45] Needless to say, even with such a well established procedure, information requests are often subject to inadvertent delays simply because the relevant tax authority gives higher priority to its own domestic workload.

One situation in which an information request is likely to receive priority attention is when a quid pro quo can be expected, i.e. when the parties are exchanging information on the same taxpayer pursuant to simultaneous audits. In 1989, Australia and the United States entered into a Working Arrangement for the conduct of simultaneous examinations intended to enable the two countries to conduct simultaneous audits of selected taxpayers and exchange the information collected during those audits.[46]

Under the Working Arrangement, each country will nominate taxpayers that it wishes to audit and receive from the other country an indication of interest in participating. The nominee should be a taxpayer with activities in both countries who appears to have substantial non-compliance with the tax laws

36. Id.
37. See specifically language of Australia–US treaty, at Art. 25(1) and of Australia–Japan treaty, at Art. 18(1).
38. OECD Model Convention, Commentary on Art. 26, para. 2.
39. Burns, *supra* note 6, at 117; cf OECD Commentary on Art. 26(2).
40. OECD Commentary: Observations and reservations on Art. 26.
41. Curtin, *supra* note 2, at 52.
42. Degulis, *supra* note 31, at 496.
43. Burns and Woellner, *supra* note 4, at 662.
44. Curtin, *supra* note 2, at 53.
45. Degulis, *supra* note 31, at 496, n. 87, citing Goodrich, "Canada–United States Tax Accounting – Competent Authority, Section 482 Transfers and Joint Audits", 8 *Canada–U.S. Law Journal* (1985), at 95, 103.
46. Working Arrangement Between the United States Internal Revenue Service and the Australian Taxation Office for the Conduct of Simultaneous Examinations under the Terms of the Exchange of Information Provisions of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 2 November 1989 (hereafter referred to as the "Working Arrangement").

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of both countries and activities involving a tax haven. If both countries agree to simultaneously audit the nominee, then formal requests for exchange of specific information will be issued, although it is anticipated that spontaneous exchanges will also take place.

The United States has similar working agreements with several other countries and has found the procedure quite effective.[47] By and large it enables tax authorities to "obtain and exchange information more efficiently and thoroughly and with greater specificity and speed".[48] The ATO also plans to make greater use of simultaneous audits.[49]

B. *Automatic exchanges*

As the name implies, an automatic exchange of information involves the regular provision of pre-determined information without a specific request. Basically, treaty partners agree in advance on the type of information and the timing of the exchange.[50] The types of information most often subject to automatic exchange is that relating to periodic receipts, especially of investment income.[51] Australia and Japan established a system of automatic information exchange on real estate investment in 1989.[52] As a result of information provided by the ATO, the Japanese National Tax Administration has been able to investigate several cases of tax evasion among Japanese engaging in foreign investment.[53]

Automatic information exchange is a relatively inexpensive way to cooperate with one's treaty partners.[54] Because the type of information subject to automatic exchange is routinely received by the tax authority, it is fairly simple to provide to the treaty partner.[55] In fact, the United States will only supply information collected by tax officials "in the ordinary course of their business".[56] However, treasury regulations require that the IRS annually submit to its treaty partners copies of US tax forms showing "a payee with an address in the respective partner's countries".[57] A decade ago, the United States provided treaty partners with half a million documents annually;[58] doubtless that figure has greatly increased since then.

Crinion has stated that automatic exchanges of information are the only exchanges that are effective.[59] Certainly automatic exchanges are by far the largest volume of information exchange and are becoming increasingly more sophisticated. Magnetic tapes containing the relevant data are used by the United States in its routine exchanges with Germany and Canada.[60]

C. *Spontaneous exchanges*

A spontaneous exchange occurs when the tax authority of one country supplies without request information about a taxpayer that it believes may be of use to another country. The information supplied would have been discovered during its own investigation or in the course of complying with an information request from another treaty partner. "Exchange of information articles in treaties will be considered to authorize such spontaneous exchanges if they (1) contain general language indicating that the competent authorities shall exchange such information as is necessary 'for carrying out the provisions of this convention' or 'for the prevention of fraud or the like in relation to the taxes which are the subject of this convention,' and, (2) do not specify any particular manner in which the exchanges are to be carried out."[61]

Australia frequently engages in spontaneous exchange, probably providing more information than it receives.[62] This is consistent with the overall cooperative attitude demonstrated toward information exchange by the ATO.

No matter which type of exchange is undertaken, there are no required forms that the information provided must take. This has often resulted in information received under an exchange being useless or, at best, difficult to use.[63] This is particularly a problem insofar as certain forms may be required to render information admissible as evidence before a judicial body.[64]

In an attempt to overcome this problem the Fiscal Division of the OECD has developed a standard multilingual form to facilitate recognition and processing of data received.[65] This form has great potential use to Australia, particularly as regards information received from Japan.

VI. CONFIDENTIALITY

Once the various limitations on the type of information to be exchanged and the manner in which the exchange is to take place have been overcome, there remains a final hurdle of whether the country to which the information is being given could misuse the information.

In most countries, the information received by taxation authorities is required by law to be kept confidential; it usually cannot be released to anyone outside of the taxation authority. Where this is the case, double taxation agreements have served to facilitate information exchange by including the tax authority of the treaty partner as an information recipient. At the same time, confidentiality is protected by limiting the uses to which the treaty recipient can put the information. In the case of the Australia-US agreement, that limitation is found in Article 25(2); in the Australia–Japan agreement it is in Article 18(2).

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47. Crinion, *supra* note 5, at 1237-38.
48. *Id.* at 1238.
49. Robin Woellner and Lee Burns, "International Information Flows – The Tax Implications", 6 *Australian Tax Forum* (1989), at 143, 195.
50. Burns and Woellner, *supra* note 4, at 662.
51. Switzer, *supra* note 13, at 308.
52. "Hawai de no Nihonjin Fudosan Torihiki: 460 Oku-enbun ga Fumeiro" (Japanese Real Estate Transactions in Hawaii: ¥46,000,000,000 Under the Table), Nihon Keizai Shinbun (Japan Economic Journal), 2 October 1991.
53. Steve Burrell, "ATO Helps Japan Trace Tax", *The Australian Financial Review* (9 August 1991), at 10.
54. Go Kawada, *Kokusai Kazei no Kiso Chishiki* (*A Basic Knowledge of International Taxation*) (Tokyo: Zeimu Keiri Kyokai, 1990), at 332.
55. Woellner and Burns, *supra* note 49, at 191.
56. Curtin, *supra* note 2, at 52.
57. Id.
58. Degulis, *supra* note 31, at 496.
59. Crinion, *supra* note 2, at 1235.
60. Woellner and Burns, *supra* note 49, at 193.
61. Curtin, *supra* note 2, at 51.
62. Woellner and Burns, *supra* note 49, at 197.
63. Crinion, *supra* note 5, at 1235.
64. Switzer, *supra* note 13, at 310.
65. Woellner and Burns, *supra* note 49, at 193.

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An example of the confidentiality requirements placed by domestic law are the secrecy provisions in the ITAA, which bind the ATO not to disclose any information without legislative authority. While the provisions of double taxation agreements override all provisions of the ITAA except Section 160AO and Part IVA,[66] it is still necessary that the information disclosed not exceed the limits on information exchange discussed above.

In the United States, tax returns and information related to computation of a taxpayer's tax liability are considered confidential.[67] Section 6103 establishes circumstances under which such information may be disclosed and to whom. Section 6103(k)(4) provides that disclosure may be made to the competent authority under a double taxation agreement "but only to the extent provided in, and subject to the terms and conditions of, such ... agreement". In further authorizing disclosure to the likes of "persons have material interest", "committees of congress", "federal officers for administration of federal laws not relating to tax administration", and for "statistical use", arguably the scope of Section 6103 is much broader than the Australian secrecy provisions. However, insofar as treaties made under the authority of the United States are the supreme law of the land,[68] the limitation of Article 25(2) of the Australia–US double taxation agreement takes precedence over the IRC[69] and would serve to prevent any information provided to the United States by Australia from being used for any purpose other than tax enforcement.[70] For example, the United States "will not provide information received from one treaty partner to another".[71]

Japanese secrecy provisions are more like those of Australia, although Japan does not see the existence of the double taxation agreement as an authorization for disclosure. In principle, Japan's policy reflects the language of the treaty, i.e. it feels that information exchanged may only be used by tax authorities concerned with tax assessment and collection or in legal actions relating to tax assessment and collection.[72] In spite of this stated policy, however, it entered a reservation to the OECD Model Convention to the effect that "it would be difficult for Japan, in view of its strict domestic laws and administrative practice as to the procedure to make public the information obtained under domestic laws, to provide information requested unless a requesting State has comparable domestic laws and administrative practice as to this procedure".[73] In all likelihood this is to be interpreted to mean that Japan will very closely scrutinize the laws of its treaty partner. As mentioned above, Australia's confidentiality provisions probably come close enough to satisfy Japan's requirement. The US provisions, on the other hand, may give the Japanese authorities pause.[74]

In fact, Japan has engaged in positive information exchange with 34 of its 36 double taxation treaty partners. In 1986, it engaged in 113,000 instances of information exchange.[75] The number of cases of exchange grew to 118,000 in 1987 and continues to grow at present. The bulk of these are pursuant to automatic exchanges; spontaneous exchanges remain uncomfortable to Japanese tax authorities.

A country receiving information under a treaty exchange is prohibited by the limitations on disclosures contained in the treaty from passing that information on to a third party.[76] In spite of this, however, the Japanese have indicated that they are not adverse to spontaneously supplying to a treaty partner information uncovered as a result of information received from another treaty partner.[77] This is an interesting position, given the general Japanese reluctance to engage in spontaneous exchange.

The limitation on disclosure overprotects taxpayers, since it means that a revenue authority has no access to information originating in a country with which it has no treaty, even if it has a treaty with another country in receipt of the same information. Australia, the United States and Japan have, to some degree, overcome this problem by entering into bilateral double taxation agreements with most of the industrialized nations of the world.

The United States has gone one step further by signing the OECD Council of Europe Multilateral Convention for Mutual Administrative Assistance in Tax Matters.[78] This convention provides for a broader based exchange of information, while at the same time mandating strict secrecy. For example, the IRS has adopted a procedure whereby it will notify US citizens of the information being requested and will allow objection through the administrative appeal mechanism.[79] While the convention has now taken effect, its impact is limited by the fact that only the United States and a handful of northern European countries have ratified it to date.[80]

VII. CONCLUSION

Increased international transactions have created the potential for tax liability by a single taxpayer in multiple jurisdictions. This, in turn, creates the potential for tax avoidance. Double taxation agreements exist to prevent both double taxation and tax avoidance.

66. Income Tax (International Agreements) Act, Sec. 4(2).
67. IRC Sec. 6103(a).
68. US Constitution, Art. VI, cl. 2.
69. See discussion in Curtin, *supra* note 2, at 36, n. 8.
70. The notion that the US standards of confidentiality may be low is interesting when compared with the concern of US taxpayers that "other countries' controls over the dissemination of confidential taxpayer information may not be as strict as the rules applicable in the United States." See, J.L. Andrus, M.C. Bennett, D.M. Merrick, D.I. Meyer, C.D. Swenson, and L.B. Terr, "Competent Authority Assistance in Tax Controversies under the New IRS Procedures", *Tax Notes* (1991), at 1279, 1284.
71. Degulis, *supra* note 31, at 496, n. 90.
72. Kawada, *supra* note 54, at 330.
73. OECD Commentary: observations and reservations on Art. 26.
74. Indeed, Japanese tax authorities have been reluctant to cooperate with the IRS in its attempts to secure audit information in at least one case. See *United States v. Toyota Motor Corporation*, 569 F.Supp. 1158 (C.D. Calif. 1983), cited by J. Huston, T. Miyatake & G. Way, *Japanese International Taxation* (1990), at 6-149.
75. H. Sakurai, "Saikin no Kokusai Kazei wo Kaerimite" ("Looking Back on Recent International Taxation"), 9 *International Taxation* (1990), at 8, 11.
76. Woellner and Burns, *supra* note 49, at 198.
77. Kawada, *supra* note 54, at 333.
78. Fisher, *supra* note 29, at 85.
79. Id.
80. The United Kingdom cited its large network of bilateral double taxation agreements as the principle reason that it did not sign the convention. This rationale is interesting, since the United States has embraced the convention, while at the same time seeking to expand its network of treaty partners. Id. at 86.

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All of the double taxation agreements discussed herein contain specific provisions for exchange of information to counteract attempts at tax avoidance. Constraints of confidentiality make it extremely difficult to know exactly how treaty partners have reacted to their treaty obligations.[81] Nonetheless, it is certain that as the potential for tax avoidance increases, so too does the willingness of treaty partners to cooperate to combat it.

While the precise details of exchangeable and excluded information may vary slightly between treaties, there is a consistent pattern of including as exchangeable information calculated to facilitate tax enforcement without damaging the taxpayer's business efforts.

The arrangements made between Australia and the United States and Australia and Japan for regular and routine exchange of information, as well as the Working Arrangement between Australia and the United States on simultaneous audits are examples of the type of international cooperation in revenue enforcement already taking place. International alliances such as PATA also demonstrate recognition by tax authorities that further cooperation is necessary. While there are still difficulties and times when tax authorities cannot or will not cooperate, those situations seem to be diminishing. On the other hand, the exchange measures described above can be expected to continue, and in fact increase, over the years to come.

81. See, e.g. Degulis, *supra* note 31, at 511: "At present, there exists no body of tax information which highlights the administrative actions of both treaty partners with regard to a particular transaction." The gist of Degulis' article is that tax planners could engage in more efficient tax planning if they had access to information concerning the mechanics of tax treaty implementation between treaty partners.

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KAZAKHSTAN AND RUSSIA:

TAX FOUNDATION SIGNS AGREEMENTS WITH KAZAKHSTAN AND RUSSIA

Charles E. McLure, Jr.

Hoover Institution, Stanford University, Economic Advisor to the Tax Foundation Delegation

On 15 March 1993 the Tax Foundation led a delegation of representatives of American and British business to Alma Ata, Kazakhstan to discuss with officials of the government of Kazakhstan tax aspects of improving the investment climate of the country. Most of the delegation then proceeded to Moscow, where from 21-24 March it met with officials of the Ministry of Finance, the State Tax Service and two committees of the Supreme Soviet.

While in Alma Ata, the delegation concluded a joint protocol with the Ministry of Finance and the State Tax Inspectorate calling for adherence to generally accepted principles of tax policy and also for specific measures needed to improve the investment climate of Kazakhstan. Since the Tax Foundation had previously presented a detailed report to representatives of the Russian government based on meetings held in Moscow in July 1992 (see the January 1993 issue of the *Bulletin*), the memoranda of understanding signed with the Ministry of Finance and the State Tax Service and with the committees of the Supreme Soviet were more general than the Kazakhstan protocol.

Among the members of the Tax Foundation delegations were representatives of Chevron Overseas Petroleum and British Gas, both of which anticipate developing the petroleum reserves of Kazakhstan; Conoco, which has oil interests in Russia; Bechtel, the multinational construction firm; Baker Hughes, a supplier of oil-field equipment and services; Citibank; Archer Daniels Midland Company, a major food processing company; Philip Morris International, a conglomerate in tobacco products and food processing; three major international accounting firms, Arthur Andersen, Ernst & Young and Price Waterhouse; and the law firm of Baker & McKenzie.

PROTOCOL

Tax Aspects of Improving the Investment Climate in the Republic of Kazakhstan[1]

The delegation sponsored by the Tax Foundation wishes to encourage and support the Republic of Kazakhstan in its transition to a free market economy, so it can become an active member in the world commercial and political community. A successful transition is important for many reasons, most notably because it will improve the standard of living for the Kazakhstani people and enhance the prospects for prosperity.

The delegation further wishes to see multinational enterprises and other investors become trusted partners in the successful transition process. Prosperity in Kazakhstan, among other things, requires that the tax policy and administrative system not discourage the personal saving and capital investments that are necessary for the economic progress that will increase the national wealth and welfare of the people of Kazakhstan. To achieve this objective, the tax policy and administrative system of the Republic of Kazakhstan must

1. The signatories to the Protocol between Kazakhstani institutions and the Tax Foundation were as follows:

Derbisov, E.Z.	*Minister of Finance*
Ospanov, M.T.	*First Deputy Minister of Finance* *Chief of the Central Tax Inspectorate*
Daniel A. Witt	*Executive Director* Tax Foundation
W.E. Frenzel	*Distinguished Fellow* Tax Foundation
Charles E. McLure, Jr.	*Economic Adviser to the Tax Foundation Delegation* *Senior Fellow* Hoover Institution Stanford University
Jack A. Barbanel	*Chairman* East-West Trade and Commerce Group

Other members of the Tax Foundation delegation to Almaty were:

Mr George W. Reardon	*Director of Taxes* Archer Daniels Midland Company
Mr Steven J. Willoughby	*Tax Manager* Arthur Andersen & Co.
Ms Clyde Tyree Crook	*International Tax Manager* Baker Hughes Incorporated
Mr John L. Fruth	*Partner* Baker & McKenzie
Ms Diana S. Dowling	*Associate* Baker & McKenzie
Mr Marlen E. Lawson	*International Tax Manager* Bechtel Group, Inc.
Ms Linda Senat	*Senior Tax Advisor* British Gas, PLC
Mr David M. Krattebol	*Vice President – Finance* Chevron Overseas Petroleum, Inc.
Mr Richard C. Lam	*Manager and Tax Counsel* Chevron Overseas Petroleum, Inc.
Mr David K. Tomney	*Vice President and Senior Tax Counsel* Citibank USA
Mr John R. Braden	*Partner* Ernst & Young
Ms Stella Aris	*Manager* Ernst & Young Kazakhstan
Mr Gregory Galligan	*Director of International Taxes* Philip Morris International
Mr Robert Call	*Project Manager, Eastern Europe* Philip Morris Europe, SA
Mr Ray Darnell	*Senior Manager* Price Waterhouse

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simultaneously satisfy certain requirements, including fairness, stability, reliability, simplicity, clarity, and economic neutrality. Foreign investment in Kazakhstan should be encouraged by a tax system which incorporates these characteristics as key tenets of a long-term tax policy.

At meetings held in Almaty from 15 to 19 March 1993 the Tax Foundation; the sponsoring delegation of the Tax Foundation; the Ministry of Finance, represented by Derbisov E.Z., Minister; the Central Tax Inspectorate, represented by its Chief, Ospanov M.T.; as well as the Committee for Economic Reforms, Finance, and the Budget of the Supreme Soviet, represented by its Chairman, Takezhanov S.T., have recognized that specific concrete actions are required to achieve the long-term goals stated above.

The undersigned mutually pledge to use their best efforts to accomplish the actions set forth below to achieve those goals and thus attempt to reconcile the revenue requirements of the Republic of Kazakhstan with the goal of developing a system which will encourage savings, local investment, and foreign investment.

Procedural Actions

The Republic Of Kazakhstan should provide an open legislative process for dealing with tax matters that permits adequate opportunity for interested parties to express their views on tax legislation before it is enacted. Such a process requires timely publication of proposed legislation, in order to allow adequate time for analysis and preparation of comments. The Tax Foundation undertakes to solicit and coordinate relevant comments from the private sector. Such comments from experienced tax professionals will promote clarity in laws, help ensure that specific legislation is consistent with long-term goals, and assist the Republic in avoiding mistakes of other overly complicated tax systems. Such comments may include written drafts of proposals as well as legislative acts and instructions of other countries, as appropriate.

The Central Tax Inspectorate should formally issue public, legally binding regulations interpreting legislation, instructions to taxpayers, and clarifying rulings on questions raised by taxpayers in order to assist them in understanding and complying with the law. Whether such guidance is of a general nature or occurs in response to requests by specific taxpayers for clarification, it must always be within the framework of the legislation; the Tax Inspectorate must never go beyond the letter and intent of the law. The process for issuing such guidance must take into account the complexity of the matter and may involve advance public comment on regulations of general interest. Rigorous internal review and publication of all such guidance will help assure consistency and clarity of guidance. The Tax Foundation will consult with the Tax Inspectorate to assist in drafting specific administrative procedures designed to accomplish these objectives.

In formulating tax policy, the Government and the Supreme Soviet should seek the views of the Central Tax Inspectorate in its areas of expertise. This will help to assure that newly enacted legislation does not needlessly increase the complexity of the system.

The Government of the Republic of Kazakhstan should provide a mechanism for prompt review at the Republic level of positions taken by local tax inspectors. Local tax authorities should not be allowed to deviate from the laws and normative acts adopted by the Government of the Republic of Kazakhstan or change them unilaterally. Nor should local tax authorities be allowed to alter agreements concluded between the Government of the Republic of Kazakhstan and foreign investors. The Tax Foundation will consult with the Supreme Soviet, the Ministry of Finance, and the Central Tax Inspectorate to assist in drafting specific administrative procedures designed to accomplish this objective.

The Tax Foundation will provide assistance and recommendations for improving the organization and operation of the Central Tax Inspectorate. Such assistance and recommendations will be based on generally recognized principles of tax administration. One commonly accepted principle is the establishment of a professional and responsible tax inspectorate composed of a national cadre of trained personnel having expertise in the administration, implementation, enforcement and interpretation of the tax laws of the country. A professional tax inspectorate is responsible for uniform and fair administration of the tax laws; its integrity must be beyond question. Advancement and promotion must be based on objective considerations of merit, performance, and experience, without regard to political influence or favor. In many countries the tax inspectorate has the budgetary resources necessary to fulfill its mission in an independent manner.

Types of Taxes

The Government of the Republic of Kazakhstan has made substantial progress in the tax legislation enacted in 1991, and since amended. Some of these laws now need to be re-examined to see that they are achieving intended objectives and especially that they are not discouraging investment.

Many forms of taxation currently found in the Republic of Kazakhstan create undesirable economic distortions and are unfair. These include taxes on turnover or gross receipts, which burden business enterprises, including those that are not earning an adequate return, and thus discourage investment. There may be a limited role for excise taxes and for property taxes to fund local governments, but excessive reliance on these taxes should be avoided.

Clear income sourcing rules are needed to distinguish between income sourced in Kazakhstan and income sourced outside Kazakhstan. Sourcing rules are necessary for the proper taxation of branches and non-resident foreigners. The Tax Foundation will consult with the Government in preparing a draft of such legislation.

The Republic of Kazakhstan should reduce the number of separate taxes and contributions designated for specific activities. Allocations for special purposes should come from the general budget. Reducing the number of separate taxes will reduce the complexity of the system for both administrators and taxpayers. The allocation of budget resources will be more flexible if expenditures are not tied to specific revenue sources.

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Accounting for Profits

The Republic of Kazakhstan should allow internationally accepted accounting standards to be used for maintaining the basic accounting records for calculating tax liability. The use of common international concepts and accounting language will promote understanding between the agencies of the Government of Kazakhstan, international lenders, and potential investors. It will minimize administrative and compliance costs over time by improving uniformity of approach and, therefore, understanding.

Provision must be made to ensure that the value of depreciation and other allowances is not eroded by inflation and changes in the value of the currency. This may be accomplished by periodically adjusting the value of assets for inflation (without imposition Of tax on such adjustments) or by permitting the investor to maintain its books in a freely convertible currency.

Tax Rates

The expectations of the Republic from foreign investment in the Republic of Kazakhstan must be realistic. Foreign investment can be expected to yield many benefits for the Republic. These include foreign currency, high quality jobs for Kazakhstan citizens, and a higher standard of living. It should be recognized, however, that increased tax revenues from foreign investments alone will not solve the problems of current budget deficits.

Both statutory and effective tax rates should be moderate, so as not to discourage saving and investment. The members of the Tax Foundation delegation appreciate the need to control budget deficits and the difficulty of reducing public expenditures (including subsidies to state enterprises) under the current circumstances. It is important, however, to remember that in the long term only a growing private sector can provide productive employment, a rising standard of living, and the tax revenue needed to finance essential government services. An overburdened private sector will not experience the saving and investment needed for dynamic growth.

Treatment of Tax Losses

Business enterprises should be allowed to carry tax losses forward for a reasonable period so they can recoup their start-up costs before starting to pay taxes. This is the common practice throughout the world. Such loss carry-forwards should be adjusted for inflation or changes in the value of currency to protect them from the loss of value.

Losses from one line of business in Kazakhstan should be allowed to offset the income from other lines of business in Kazakhstan controlled by the same business entity.

Creditability of the Profits Tax

It is important that the profits tax qualify for a foreign tax credit in jurisdictions which allow such credits. A critical consideration for most potential foreign investors is that profits earned in Kazakhstan should not be subjected to double taxation. Although individual investors with unique circumstances or investors from particular countries may not find a credit necessary or advantageous, the Tax Foundation delegation believes that the standards generally used to determine the creditability of foreign taxes are consistent with the broader policy of taxing only realized economic income. The Tax Foundation will consult with the Government in drafting proposed legislation to ensure that all technical requirements for creditability are met.

It would be desirable to adopt technical changes to the profits tax to meet the normal requirements for creditability. Creditability generally requires that the profits tax be imposed by law and be based on net income, calculated by deducting from revenues received all expenses associated with earning such revenue.

Value Added Taxes

A VAT that is properly structured and applied does not discourage saving and investment. The Tax Foundation notes that under the current Kazakhstan law the VAT paid on fixed assets is added to the cost of the assets and is not recoverable. The inability to recover the full VAT paid to suppliers of fixed assets is contrary to common international practice and represents a major disincentive to capital intensive industries. In some cases it raises important issues of definition, and it increases costs of compliance and administration. To avoid discouraging investment in capital intensive industries, the Republic of Kazakhstan should reconsider the treatment of VAT paid on fixed assets. The Government of the Republic of Kazakhstan recognizes the importance of this view, and will strive to bring its law into conformity with such standards when conditions in the Republic permit.

Mechanisms should be developed to ensure that the VAT does not adversely affect the cash flow of an investor. Refunds must be paid promptly to avoid loss of value due to inflation and currency devaluation.

The application of VAT to financial services and credit card services involves extremely complex issues. This problem should be discussed with representatives of these industries, especially those actively considering doing business in the Republic of Kazakhstan.

Excise Taxes

The Republic of Kazakhstan should avoid the use of excise taxes that discriminate against the production and consumption of high quality consumer products. This can be achieved by utilizing specific excises (indexed for inflation) or by levying ad valorem excise taxes at uniform rates.

Currency Matters

The Tax Foundation delegation believes that provisions for mandatory conversion of foreign currency should be avoided. Potential foreign investors view mandatory currency conversion requirements as an unproductive cost of doing business, especially while the economy of Kazakhstan is unstable and there are no secure opportunities and instruments for reinvestment of local currency. The Government of the Republic of Kazakhstan has noted these views but has

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advised the Tax Foundation delegation that the present circumstances in the Republic do not permit flexibility on this point, but agrees to continue to review and discuss this matter.

Stability During the Transition Period

During the transition to a market economy and for the period of potential instability, it is important that foreign investment be encouraged. The Republic should adopt a clear policy that investors will be guaranteed stability in the total amount to be paid as taxes, duties, fees, etc. This policy should be reflected in any new laws that give legislative authority for implementing agreements made before those laws come into effect. During this transition period the Republic must develop the reputation of being a reliable business partner. Different formulas may be applied to give effect to this guarantee. The Tax Foundation will consult with the Government in drafting specific legislation for consideration by the Republic.

Expatriate Taxation

The Law Concerning Income Tax on Citizens of the Republic of Kazakhstan and Stateless Persons should be amended with respect to the taxation of foreign citizens. Enactment of the following provisions should simplify administration and encourage additional Western technology and training:

- Limit the taxation of foreign citizens working in Kazakhstan to Kazakhstan source income only;
- Specifically identify the items to be excluded from taxation in Kazakhstan which are paid as an increment to the employee's compensation in connection with taking up residence and working in the Republic;
- Consider reducing statutory rates to bring effective tax rates into line with those in many other countries;
- Remove the prohibition on enterprises, institutions, and organizations paying the tax on the salaries of citizens; and
- Exempt foreign citizens from the application of the social taxes, when such foreign citizens' salaries are paid in a foreign currency.

The Tax Foundation will consult with the Government of the Republic of Kazakhstan in drafting specific legislation for consideration by the Republic in these areas.

Training, Education and Exchange of Information

Continued cooperation, dialogue, and information sharing between private sector investors and policy makers from the Supreme Soviet, the Ministry of Finance, and the Central Tax Inspectorate, and other Ministries would be desirable. Contingent on funding, the Tax Foundation stands ready to assist the Republic of Kazakhstan in these efforts. The parties will explore jointly the feasibility of establishing a training program for Kazakhstan tax administrators and possibly also for tax policy makers from the Ministry of Finance and the Supreme Soviet. The objective of this program would be to train Kazakhstan personnel in principles of free market economics and tax policy; advanced business practices; accounting and finance; and computer technology as it relates to tax collection. The program could include business men and women to ensure that the curriculum is practically oriented, and not simply theoretical.

Conclusion

We, the undersigned, are fully committed to continued cooperation and educational programs to help advance the long term policy goals of the Republic of Kazakhstan outlined above. The Tax Foundation, working in cooperation with its members and other interested parties, will consult with the tax authorities of the Republic of Kazakhstan in designing and implementing a tax system and will seek opportunities for further cooperation with the Kazakhstan signatories.

Signed in duplicate in Almaty, 19 March 1993. This protocol is prepared in the English and Russian languages, both being equally valid.

[See footnote 1 for the list of signatories.]

MEMORANDUM OF UNDERSTANDING

Tax Aspects of Improving the Investment climate in Russia[2]

The delegation sponsored by the Tax Foundation, the Supreme Economic Council of the Supreme Soviet of the Russian Federation, and the Commission on Budget, Plans, Taxes, and Prices of the Supreme Soviet of the Russian Fed-

2. The Memoranda of Understanding are printed only once. The second set of Russian institutions and signatories are indicated in brackets.

Signing on behalf of the Supreme Economic Council of the Supreme Soviet of the Russian Federation and the Commission on Budget, Taxes and Prices of the Supreme Soviet of the Russian Federation:

On behalf of the Supreme Economic Council:	
Karpov P. A.	*Vice President*
On behalf of the Commission on Budget, Plans, Taxes, and Prices:	
Eduard V. Vedernikov	*First Deputy Chairman*

Signing on behalf of the Ministry of Finance of the Russian Federation, the State Tax Service of the Russian Federation and the Tax Foundation:

For the Ministry of Finance of the Russian Federation:	
Gorbachev S.V.	*Deputy Minister of Finance*
For the State Tax Service of the Russian Federation:	
Gusev, V.V.	*Acting Head* State Tax Service

Signing both Memoranda on behalf of the Tax Foundation:

Daniel A. Witt	*Executive Director* Tax Foundation
Charles E. McLure, Jr.	*Economic Adviser to the Tax Foundation Delegation* *Senior Fellow* Hoover Institution Stanford University *Foreign Adviser* Supreme Economic Council Supreme Soviet of the Russian Federation

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eration [the Ministry of Finance of the Russian Federation, and the State Tax Service of the Russian Federation] (the participants) encourage and support Russia in its transition to a free market economy so it can take its rightful place in the world commercial and political community. A successful transition is important for many reasons, most notably because it will improve the standard of living for the Russian people and enhance the prospects for World peace and prosperity.

The participants further wish to see multinational enterprises and other investors from around the world become trusted partners in the successful transition process. Prosperity in Russia, among other things, requires that the tax policy and administrative system not discourage the personal savings and capital investments that are so necessary for the economic progress that will increase the national wealth and welfare of Russia. To achieve this objective, the Russian tax policy and administrative system must simultaneously satisfy certain requirements.

During our meetings 21-24 March 1993, in Moscow, the participants have identified long-term tax policy goals which are appropriate for a successful market economy, especially one which encourages saving, investment, and international commercial cooperation. The undersigned agree that achievement of these goals should be based on the following principles:

Stability

Stability is a critical feature of a tax system that will encourage saving and investment. A stable system creates certainty, is reliable, and makes planning and economic assessment possible.

Reliability

Investors and global commercial enterprises should be able to rely on continued application of the tax laws and their interpretation which are in existence at the time they make their investments and commercial commitments. Taxpayers must be able to rely on published laws, decrees, regulations, and rulings on a long term basis. Laws must be administered fairly and consistently, with limited administrative discretion. Taxpayers should be protected from unreasonable and capricious interpretations of the law. Changes in interpretations of tax laws should only be applied prospectively, never retroactively.

Certainty

Laws and regulations interpreting them must state precisely the tax consequences of various actions. Legally binding advance rulings interpreting new provisions of the tax system that otherwise might be unclear must be readily available. It is crucial that regulations and letter rulings be issued quickly.

Simplicity

Simplicity helps ensure the taxpayer understanding of the tax law necessary for compliance. Russia should avoid complexity in tax legislation and regulations . Mechanical adoption of the complex tax laws found in many Western countries should be avoided.

Satisfactory Definition of Taxable Profits/Income

The measurement of profits (income) for tax purposes should include a deduction for all reasonable and necessary expenses. This is necessary to facilitate economic transparency, to avoid creating an environment which lacks appropriate incentives for investment, and to assure foreign tax credits in other countries.

Evaluation of Proposed Legislation

It is important that the proposed legislation be available for preliminary analysis, discussion, and comment by all taxpayers.

Tax Rates

The overall level of taxation should be reasonable so that the tax system does not discourage investment. The members of the Tax Foundation delegation appreciate the need to control budget deficits and the difficulty of reducing public expenditures (including subsidies to state enterprises).

Double Taxation

The problems of applying Russian taxation on worldwide income of foreign citizens resident in Russia should be studied to ensure that double taxation is avoided.

Training, Education and Exchange of Information

Continued cooperation, dialogue, and information sharing between private sector investors and policy makers from the

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Jack A. Barbanel	*Chairman* East-West Trade and Commerce Group

Other members of the Tax Foundation Delegation to Moscow:

Mr George W. Reardon	*Director of Taxes* Archer Daniels Midland Company
Mr Steven J. Willoughy	*Tax Manager* Arthur Andersen & Co.
Ms Clyde Tyree Crook	*International Tax Manager* Baker Hughes Incorporated
Mr William Atkin	*Partner* Baker & McKenzie
Mr Marlen E. Lawson	*International Tax Manager* Bechtel Group, Inc.
Ms Linda Senat	*Senior Tax Adviser* British Gas, PLC
Mr David K. Tomney	*Vice President and Senior Tax Counsel* Citibank USA
Mr Eric Hopkinson	*Tax Counsel* Conoco Incorporated
Mr Richard Lewis	*Senior Manager & Director, Taxes* Ernst & Young
Mr Byron Ratliff	*Partner* Price Waterhouse

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Ministry of Finance, and the State Tax Service of the Russian Federation would be desirable. Contingent on funding, the Tax Foundation stands ready to assist the Russian Federation in these efforts. The parties will explore jointly the feasibility of establishing a training program for Russian tax administrators and possibly also for tax and finance policy makers from the Ministry of Finance. The objective of this program would be to train Russian personnel in principles of free market economics and tax policy; advanced business practices; accounting and finance; and computer technology as it relates to tax collection. The program could include business men and women to ensure that the curriculum is practically oriented, and not simply theoretical.

Conclusion

We, the undersigned, are fully committed to continued cooperation and educational programs to help advance the long-term tax policy goals of the Russian Federation outlined above. The Tax Foundation, working in cooperation with its members and other interested parties, will consult with the tax authorities of the Russian Federation in designing and implementing a tax system and will seek opportunities for further cooperation with the Russian signatories.

Signed in duplicate in Moscow, 24 March 1993. This memorandum of understanding is prepared in the English and Russian languages, both being equally valid.

[See footnote 2 for the list of signatories.]

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UNITED STATES/ISRAEL:

NEW INCOME TAX TREATY

AN ANALYSIS AND PROGNOSIS

Leif Weizman

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Contents

I. Introduction
II. Highlights of the Treaty
A. General structure
B. Scope of the treaty
C. Taxation of income
D. Withholding taxes
E. Capital gains
F. Limitation on benefits
G. Relief from double taxation
H. Non-discrimination
I. Administrative provisions
III. Conclusion

I. INTRODUCTION

For more than 30 years the US and Israeli governments have been trying to find common grounds in order to conclude an income tax treaty. These efforts reached a climax in 1965 when the two countries signed the first income tax treaty. Because the 1965 proposed treaty contained a tax sparing provision it failed ratification in the US Senate. In 1975 the two countries agreed on a new treaty; however, since the 1975 proposed treaty was signed before the 1977 US model income tax convention, the treaty did not contain some of the features of the US model, which have become mandatory in newer US treaties. Consequently, on 30 May 1980, the two countries agreed to the first protocol to the 1975 treaty. The United States did not ratify the treaty, and there were objections made to the treaty by both countries. A second protocol was signed which contains more substantial amendments to the original treaty, and given the scope of amendments to the original treaty, a consolidated treaty was put forward for signature. Based on the 1975 treaty and amended by the first and second protocols, the treaty was signed by the two countries on 26 January 1993.

II. HIGHLIGHTS OF THE TREATY

A. *General structure*

The structure of the treaty does not follow the format commonly found in the 1981 US (Draft), the 1980 UN, the 1977 or 1992 OECD model income tax conventions (see Table I). The treaty lacks a personal scope provision similar to Article 1 of the models. It contains introductory provisions dealing with the scope of the treaty and definitions, as well as a provision dealing with the sourcing of income not found in the models (Articles 1-5). The provisions concerning the taxation rights of the source and residence country also differ from the models (Articles 6-24). Unlike the models, the treaty only covers the taxation of income – a provision concerning taxation of capital similar to Article 22 of the model treaties is not found in the treaty. Relief from double taxation in the state of residence is provided for in Article 26, and the treaty contains a number of special provisions, including limitations on benefits (Article 25), non-discrimination, mutual agreement procedure and exchange of information (Articles 27-29).

B. *Scope of the treaty*

1. Taxes covered

The scope of the convention is limited as compared to the OECD and US model treaties. The OECD model provides that taxes levied at all levels of government are included under the treaty, whereas the US/Israel treaty limits US taxes to federal taxes, excluding state taxes;[1] this provision is taken from the US model and is commonly found in US treaties (the only exception is the US/UK treaty). The treaty contains an additional limitation in that the federal social security taxes (FICA or SECA taxes) are not covered, and since the United States and Israel have not signed a separate totalization agreement on social security taxes, Israeli nationals residing temporarily in the United States are subject to social security tax (however, any social security payments received are exempt from taxation in both countries).[2] The treaty also allows the United States to impose its personal holding company tax[3] and accumulated earnings tax[4] without regard to any provision of the treaty.[5]

1. Art. 1(1)(a).
2. Art. 22.
3. IRC Secs. 541-47.
4. IRC Secs. 531-37.
5. Art. 6(5). However, under the treaty an Israeli corporation is exempt from the personal holding company tax unless a US resident or citizen owns, directly or indirectly (within the meaning of IRC Sec. 544), 10% or more in value of the outstanding stock of the corporation at any time during the taxable year, and the corporation will be exempt from the accumulated earnings tax unless 25% of the voting stock of such a corporation is owned by US residents or citizens.

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Table 1
Treaty Structure

Art. 1:	Taxes Covered.
Art. 2:	General Definitions.
Art. 3:	Fiscal Residence.
Art. 4:	Source of Income.
Art. 5:	Permanent Establishment.
Art. 6:	General Rules of Taxation.
Art. 7:	Income from Real Property.
Art. 8:	Business Profits.
Art. 9:	Shipping and Air Transport.
Art. 10:	Grants.
Art. 11:	Related Persons.
Art. 12:	Dividends.
Art. 13:	Interest.
Art. 14:	Royalties.
Art. 14A:	Branch Tax.
Art. 15:	Capital Gains Tax.
Art. 15A:	Charitable Contributions.
Art. 16:	Independent Personal Services.
Art. 17:	Dependent Personal Services.
Art. 18:	Public Entertainers.
Art. 19:	Amounts Received from Furnishing Personal Services of Others.
Art. 20:	Private Pensions and Annuities.
Art. 21:	Social Security Payments.
Art. 22:	Governmental Functions.
Art. 23:	Teachers.
Art. 24:	Students and Trainees.
Art. 25:	Limitation on Benefits.
Art. 26:	Relief from Double Taxation.
Art. 27:	Non-Discrimination.
Art. 28:	Mutual Agreement Procedure.
Art. 29:	Exchange of Information.
Art. 30:	Diplomatic and Counselor Officers.
Art. 31:	Entry into Force.
Art. 32:	Termination.

The treaty provides that all Israeli income taxes are covered,[6] including taxes imposed by the Income Tax Ordinance, the Land Appreciation Tax Law, the Income Tax Law (adjustments for inflation) and "all other taxes on income administered by the Government of Israel (including, but not limited to, the profit tax on banking institutions and insurance companies and the income tax components of a compulsory loan)".[7] The most significant differences from the original treaty are the exclusion of capital gains taxes, and that the tax on "involuntary defense loan" has since been repealed, which will reduce the importance of the inclusion of taxes on compulsory loans.

2. Geographic scope

Article 2 contains the geographic scope of the convention. The term "United States" means the 50 states and the District of Columbia, but none of the US possessions or territories. The treaty defines the geographic scope to cover the territorial sea, the seabed and subsoil of the submarine areas adjacent to the coast over which the United States and Israel respectively "exercise[s] sovereign rights, in accordance with international law",[8] a provision which has some importance for Israel and the territorial disputes in the Middle East.

Israel does not generally apply its legislation to Judea, Samaria or Gaza. Instead, the legislation which was in force in these territories when they were occupied by Israel is applied in the territories in accordance with international public law. Thus neither Israel nor the United States will consider these territories to be covered by the treaty.[9] In contrast, Israel annexed East-Jerusalem (1967) and the Golan Heights (1981) after the 1967 war, and presently exercises what is viewed as "sovereign rights in accordance with international law" over these areas. Consequently, Israel will consider residents in East-Jerusalem and the Golan Heights to fall within the scope of the treaty. Whether this is also the case for the United States is more questionable. The United States is among the countries which do not recognize Jerusalem as the capital of Israel, but the United States has maintained that recognition of Jerusalem as the capital awaits a comprehensive settlement of the disputed territories. The United States could be forced to make a decision on this issue.[10]

3. Personal scope

A significant difference from the models and most US treaties is the lack of a personal scope provision similar to Article 1 of the US or OECD models. Consequently, the treaty does not contain a provision similar to Article 1(3) of the US model, which allows the United States to impose taxation based on citizenship, a provision which is contained in all US tax treaties.[11] The treaty does, however, allow the

6. Art. 1(1)(b).
7. Israel generally imposes its taxes on income and capital gains on a territorial basis regardless of the status of the individual recipient. Israel's Income Tax Ordinance (New Version) (ITO) 5721-1961 as amended (hereinafter referred to as "ITO") provides in Sec. 2 that "income tax shall be paid...on the income of any person accrued in or received in Israel". The ITO defines the term "income" broadly, to include interest, dividends, gains or profits from employment, pensions, annuities and income derived from any dwelling house.
The limited territorial scope of the Israeli tax system as determined under ITO Sec. 3 is extended by Sec. 5 which provides inter alia, that "...any profits or gain produced by a person from a business the control and management of which are exercised in Israel or from a vocation which he is generally carries on in Israel" is deemed to be income sourced in Israel, and as such subject to Israeli taxation. This provision deems certain income derived outside Israel to be Israeli-source income, an inclusion which limits the territorial basis of Israeli taxation.
8. Art. 2(1)(a)(ii), 2(1)(b)(ii).
9. If part of the territories were to become part of Israel, it would raise a question as to whether the treaty would be extended automatically to the new territories. The issue is not similar to the Chinese takeover of Hong Kong in 1997, where questions could be raised as to the territorial scope of Chinese tax treaties after 1997. See Weizman, "The Territorial Scope of Tax Treaties: Emerging Problems and the Chinese Case", 17 *Tax Planning International Review* (No. 6 1990), at 24. Such a territorial change would be similar to the West German takeover of East Germany, discussed in Prokisch & Rodi, "Double Taxation Conventions after Reunification", 31 *European Taxation* (September 1991), at 263, and given the size of the territory, it is most likely that the succession would lead to automatic extension.
10. The problem would typically arise if a company resident in East Jerusalem or the Golan Heights is engaged in business activities in the United States. The company would claim that in determining whether income is taxable in the United States, the IRC, and especially its broad definition of a permanent establishment (PE) ("US trade or business"), and its use of the force of attraction doctrine to allocate income to a PE, should not be applied. Instead, the company would claim treaty protection, and argue that the question must be determined under the provision dealing with PE (Arts. 5 and 8). A decision on the tax issue would, in effect, force the United States to make a decision on a very politically sensitive issue.
11. The United States subjects its citizens and residents to taxation on a worldwide basis. IRC 1986, as amended, Secs. 1(a), 11(a) and 61(a). US citizens and residents are taxed on worldwide income regardless of whether the income is earned in a foreign jurisdiction, and regardless of whether the taxpayer is residing in that jurisdiction when the income was derived.

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United States to tax its citizens on their worldwide income.[12] The provision allowing taxation based on citizenship is found in Article 6(3) ("general rules of taxation"), which provides that "a Contracting State may tax...its citizens as if this Convention had not come into effect".[13] The provision further contains the so called "lingering" citizenship rule under which the term "citizenship" is deemed to include an individual who has relinquished his citizenship during the ten-year period following such loss of citizenship if the principal purpose was tax avoidance.[14]

The treaty's lack of a personal scope provision similar to Article 1 of the models may be significant, because it could bring into question whether the scope of the treaty is limited to persons who are resident in one or both contracting states. There is little doubt that the United States will follow Rev. Rul. 72-378,[15] where interest payments made by a US bank on a loan to a UK branch of a Swiss bank were subject to US withholding tax on interest, and the US bank was unable to claim protection under the Swiss treaty. This is in accordance with the generally accepted view under which the scope is limited to persons of the contracting states. In a recent case the English High Court questioned this principle.[16] In this case, London branches of banks resident in West Germany and Brazil received interest from corporations in the United States. The court refused to deny the treaty benefits to branches of corporations not resident in third country states because the treaty did not contain a provision similar to Article 1 of the OECD model.[17] However, this decision appears to be contrary to Article 34 of the Vienna Convention on the Law of Treaties, which provides that the treaty does not "create either obligations or rights for a third state without its consent". It is also contrary to the 1977 OECD Commentary to Article 24, paragraphs 54 and 55 which was (based on the 1992 OECD report entitled "Triangular Cases") replaced by the 1992 OECD Commentary. However, the new credit system under Article 24 of the 1992 OECD Commentary (cf. paragraphs 51-54) does clearly assume that the treaty benefits do not extend to third country residents. It therefore appears that *Commerzbank* is not correct and consequently it should not be assumed that it will be followed in Israel even though it is a common law jurisdiction.

4. Residency

Article 3 provides that taxation under the convention is generally based on residency. The term "residence" is based on "fiscal residence", where residency is assigned to the state in which the taxpayer has the greater personal ties. Article 3(1) is different from the models. This provision defines the term "resident" of Israel and the United States respectively, and includes corporations and any person resident under the state's law, but in the case of a partnership, estate or trust only to the extent that the income derived under the state's tax law is subject to taxation as a resident either in the hands of the respective entity or its partners or beneficiaries. Thus US partnerships, estates and trusts or their partners or beneficiaries are considered residents for treaty purposes so long as they are subject to US taxation. The treaty also contains a special rule for US citizens and aliens holding a "green card" who are considered US residents only if they have a substantial presence, permanent home or habitual abode in the United States.[18]

If an individual is considered a resident of both contracting states[19] residency is determined under Article 3(2), which is a tiebreaker provision similar to the models, and it contains the following criteria for determining the residency of individuals: (1) permanent home; (2) center of vital interests; (3) habitual abode; (4) citizenship; and (5) if (1)-(4) are not applicable then the issue is to be decided according to the competent authority procedure. The provision contains a special rule under which a person who is an *oleh* (new immigrant) as defined in Section 35 of the Israeli Income Tax Ordinance is deemed to be treated as an Israeli resident.[20]

12. Art. 6(3) does not limit the taxation based on citizenship to the United States as is the case under most US treaties. Israel is also allowed to imposed taxation on its citizens under the treaty, and may decide to do so in the future. In fact, the Israeli Commissioner of Income Tax recently announced that a recommendation to tax Israeli citizens on worldwide income is being considered.

13. Certain provisions are excluded from the scope: grants (Art. 10), charitable contributions (Art. 15A), private pensions and annuities (Art. 20(2)-(3)), social security payments (Art. 21), relief from double taxation (Art. 26), non-discrimination (Art. 27), mutual agreement procedure (Art. 28), and benefits available to US residents, provided they are not US citizens or have US immigrant status as follows: governmental functions (Art. 22), students and trainees (Art. 24) and diplomatic and consular officers (Art. 30).

14. The lingering citizenship rule is taken from the US model Art. 1(3) and has the IRC as its source, i.e. Sec. 877.

15. 1972-2 C.B. 662.

16. *IRC v. Commerzbank AG*; *IRC v. Banco do Brazil*, [1990] S.T.C. 285.

17. *Id.* at 301-302.

18. Art. 3(1)(c). This rule appears to be contrary to the lawful permanent residence (green card) test under the objective residence definition, which provides that a person is a resident of the United States if he at any time during the calendar year is a lawful permanent resident. The criteria is not conclusive, and previous Treasury Regulations which provided that a person with lawful permanent residence would be deemed a US resident, was struck down in *Schumacher*, 32 BTA 1242 (1935), on the ground that an irrebuttable presumption was not favoured. Instead, Treas. Reg. § 1.871-2(b) creates a presumption of residency, which is controlling "in the absence of exceptional circumstances".

19. Residency in the United States is based on either an objective or subjective definition. The objective definition is linked to two tests: lawful permanent residence (green card) or substantial presence. The latter is automatically satisfied if the alien is present in the United States for 183 days or more, or can be satisfied if the alien spends less than 183 days in the United States, and "spends significant amounts of time in the United States", a term determined under a special formula. The subjective definition is, as the term indicates, subjective. It is based on the degree of attachment to the United States, and a series of factors are included in the determination of residency.
Similarly, residence in Israel for individuals is defined under the ITO, as "..an individual who resides in Israel except for temporary absences that seem reasonable to the Assessing Officer and do not contradict that individual's claim to be an Israeli resident". This definition is not inclusive. As a general rule a person will be considered a resident in Israel if he spends more than 183 days in any tax year (the tax year is from 1 January to 31 December). In addition, residency may be determined under subjective criteria, and guidelines enumerate a number of factors to be considered in determining residency. The most important factor is generally the physical presence of the taxpayer and his family, and all factors indicating where the centre of the taxpayer's life is situated.
The new final regulations under IRC Sec. 7701(b) are discussed in Rothschild & Schinner, "Determining Residency for Federal Income Tax Purposes, an Introductory Note", 47 *Bulletin for International Fiscal Documentation* (February 1993), at 84.

20. Art. 3(2)(a). ITO Sec. 35(d) extends to the term "oleh" as it provides that "a person who holds an oleh's visa or an oleh's certificate under the Law of Return 5710-1950, or a person entitled to said visa or certificate and who holds a visa and permit of temporary residence under the Entry into Israel Law 5712-1952, and a person who belongs to a category of persons for whom the Minister of Finance has prescribed that they will be treated as olim". Generally, persons who are allowed immigration to Israel under the Law of Return are Jews or persons with a Jewish father or grandparent.

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While the tiebreaker provision has reduced the potential for double residency (and thereby double taxation), the treaty does not provide measures to prevent double residency for companies.[21] This question is therefore left to the competent authorities to solve on a case-by-case basis, and it may well cause problems as the United States and Israel apply very different rules for determining the residency of companies.[22]

5. Permanent establishment

The permanent establishment (PE) provision found in Article 5 is broader than the OECD and US models.[23] Article 5(1) is in substance identical to the two models, while Article 5(2) has a broader scope. Different from the models is the inclusion of the following as a "fixed place of business" under (d)-(j): a warehouse, a farm or plantation, a store or other sales outlet, and most importantly, the maintenance of substantial equipment or machinery for a period of more than six months. The treaty does not, however, include "a place of management", as found in the models. The scope of the building site provision is similarly broader in the sense that the period is reduced from 12 to six months which is in accordance with the UN model.

The exclusion provision found in Article 5(3) is also different from the models. While (a)-(d) are identical to the models, (e) is not found in the models. It provides that "[t]he maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a prepatory or auxiliary character, for the resident", does not constitute a PE. This provision seems to have the 1977 OECD Commentary as its source, and does not appear to be of major significance. Similarly, (f)-(g), which are not found in the models, merely mirror the equipment provision[24] and the building site provision.

Article 5(4) is not found in either of the models. It provides that a resident of a contracting state who sells goods in the other contracting state will be deemed to have a PE if the goods were subject to substantial processing in that contracting state (whether or not purchased in there), or were purchased in that contracting state and not subjected to substantial processing outside that state. Again, the scope of the provision is broader than the OECD and US models.

Article 5(5) and (6) contains the definition of a dependent and independent agent as a PE. These definitions are almost identical to the models, and the slightly different wording does not alter the scope of the models. Article 5(7) contains a provision not found in the models, providing that a PE does not exist merely because a resident sells merchandise displayed at a fair or convention in the other contracting state. Article 5(8) is similar to Article 5(7) of the models, but whereas the models refer to "controlled company", the treaty merely refers to "relation".

Article 5(9) is a new invention, providing that the PE principles apply not only to residents of the contracting states, but also to non-residents in determining whether they have a PE in the contracting states; and not only to the contracting states, but also to determine whether residents have a PE outside the contracting states. These principles are to be applied, however, "only for purposes of this Convention", and the provisions appear to be geared towards allocation of income.

C. *Taxation of income*

1. General rules

Article 6 dealing with "General Rules on Taxation" is not found in the models. The general rule is contained in Article 6(1), which provides that "[a] resident of one of the Contracting States may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income subject to any limitations set forth in this Convention". The sourcing of income is to be determined under Article 4, a provision not found in the models. The purpose of Article 4 is to avoid a potential for sourcing conflicts.[25] Whereas the sourcing rules under the treaty are contained in a specific provision, the models have placed them in different articles (e.g. dividends, interest, royalties, capital gains), and the treaty also includes other types of income the competent authorities are able to "agree to the same determination of the source of particular items of income". The treaty also contains special rules with respect to the source of income from the rental of tangible personal property, the disposition of intangible or tangible personal property, performance of personal services and business profits attributable to PEs.[26]

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21. In contrast, Art. 3(3) contains a provision different from the models. It applies only to non-individuals, and provides that until the competent authorities have made a determination, the person will not be treated as a resident of any state except for purposes of Art. 26 (relief from double taxation), Art. 27 (non-discrimination), Art. 31 (entry into force), and for payments by such a person covered by Art. 12(2) (dividends), Art. 13(2)-(3) (interest) and Art. 14(1)(b) (royalties).

22. In the United States, IRC Sec. 7701(a) provides that the characterization of a corporation as foreign or domestic is based on the place of creation and organization, and a domestic corporation is one organized in the United States (defined as the 50 states and the District of Colombia). In contrast, ITO Sec. 1 provides the following definition of a "resident in Israel" as applied to a "body of persons": "(1) a body registered in Israel, its principal activity being in Israel, but if it is registered as a foreign company it shall be considered a resident of Israel only if so requested; if such a request has been submitted, it cannot be withdrawn before three years have passed, unless the Minister of Finance so permitted; (2) any body of persons the control and management of whose business are exercised in Israel".
Until 1978, the residency of corporations was determined exclusively under the principles laid down in Sec. 1(2). The purpose of Sec. 1(1) was to discourage Israeli companies from locating control and management outside Israel, while conducting trade or business in Israel as non-resident companies. Sec. 1(2) contains the English principles under which residency of companies is determined on the basis of the location of the corporate body which exercises the company's policy functions, typically the location of the board of directors. Application of these principles are a source of controversy surrounding double residency of corporations, and it is regrettable that the issues are not resolved under tax treaties, particularly where, as is the case here, the contracting states follow very different theories (incorporation vs. management and control).

23. The PE provisions in US treaties generally provide protection against the broader determination under US domestic law ("US trade or business"), e.g. IRC Sec. 864(b), as well as the application of the force of attraction doctrine, e.g. IRC Sec. 862(c)(2). In contrast, an Israeli PE is taxable only on income "accruing in, derived from or received in Israel", and the treaty does not provide any protection for the US taxpayer.

24. Art. 5(2)(j) and 5(2)(i).

25. Art. 4 of the treaty is equivalent to Art. 16 of the US/Japan treaty. This provision is not commonly found in tax treaties. It is, however, sometimes found in US treaties even though the provision is not contained in the US model. The issue is discussed in *Income Tax Treaties* (Bischel (ed.)) (New York: Practising Law Institute 1978), at 30-32.

26. Art. 4(5)-(8).

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2. Real property

Article 7(1) provides that income from real property is taxable in the situs country.[27] Article 7(2) is similar to the US model as it applies paragraph (1) to income derived from the direct use, letting or use in any other form of real property. A major difference is contained in Article 7(3)(a), which provides that gains derived by a resident of Israel from the disposition of a US real property interest may be taxed by the United States, and Article 7(3)(b), which similarly provides that gains derived by a resident of the United States from the disposition of a comparable interest in real property in Israel may be taxed by Israel. The term "comparable right" include rights in a legal entity, which under Israeli domestic law are considered a disposition of rights in real property. The provision is intended to conform to the "FIRPTA" legislation adopted by the United States in 1980,[28] legislation which caused a storm of criticism, as it was an override of most US tax treaties.[29] These rules make it more favourable for Israelis to own US real property directly. This may, however, be unfavourable in case of death as it may lead to a maximum 55 percent US estate tax (tax phases down to 50 percent for deceased who die after 1993).[30] This problem has typically been solved by mortgaging the real property or by interposing an entity which qualifies as a corporation for US tax purposes.

3. Business profits

The business profits provision in Article 8 is similar to the OECD and US models. The only substantive difference is the inclusion of a provision that the US tax on insurance premiums paid to foreign insurers will not be imposed on insurance or reinsurance premiums which are the receipts of a business of insurance carried on by a resident of Israel whether or not that business is carried on through a PE in the United States.[31] The main effect is to make Israeli insurance companies more competitive in insuring risks of their Israeli clients with respect to property with a US situs.

Article 11 provides that in cases where the profits between related enterprises are adjusted, the other contracting state is obliged to make a corresponding adjustment, provided the first adjustment is based on the arm's length standard. The inclusion of a corresponding or correlative adjustment clause is generally not found in Israeli treaties, and while the inclusion may be seen as an improvement, the treaty contains measures only to avoid economic double taxation (Article 25), while it lacks measures to avoid the legal double taxation that will arise if the contracting states are unable to agree on what is to be considered arm's length consideration. More importantly, the treaty's mutual agreement procedure (Article 28) does not provide for such disagreements to be solved by compulsory arbitration between the competent authorities.[32]

4. Shipping and air transport

Whereas the OECD and UN model treaties provide that profits from the operation of ships or aircraft are taxable only in the state where the place of effective management of the enterprise is situated, and the US model treaty provides for such profits to be taxable in the state where the enterprise is organized, Article 9(1) of the new treaty provides that profits are taxable only in the state from where the shipping and air transport profits are derived. The difference is significant since profits are not always derived from the state where the place of management is situated. Given the different approach adopted under the treaty, Article 9 does not include a provision similar to Article 8(2)-(4) of the OECD and UN (alternative A) models. Instead, the treaty's Article 9(2) contains a provision which is similar to Article 8(2)-(3) of the US model, and includes income derived from rental of ships or aircraft, income incidental to income falling under paragraph (1), and income derived from the use, maintenance and lease of containers, trailers or related equipment.

5. Grants

Israeli tax law provides special tax incentives to promote foreign investments, and the treaty contains a special provision for dealing with these incentives. Article 10 provides that if Israel has made a qualifying grant to a US resident, then the resident may choose either to include or exclude the grant in his gross income. A qualifying grant is one approved by Israel for investment promotion in Israel,[33] but does not

27. Israeli taxpayers are still allowed to make the annual net basis election with respect to US real property income. The election is provided under IRC Sec. 871(d)(1), and allows non-residents to treat income derived from real property as if effectively connected with a US trade or business. If the taxpayer makes the net basis election, a deduction is allowed for related expenses (e.g. depreciation and interest), while the 30% withholding tax on gross income is not applicable. Israeli residents deriving income or capital gains from US real property are exempt from taxation in Israel, unless they are gains from the sale of shares in a corporation which holds real property.

28. IRC Sec. 897.

29. Sec. 1125(c) of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") expressly provided that it would apply without regard to any tax treaty relief after a five year delay, which was intended to allow the United States time to renegotiate the treaties which were being overridden. However, the delay led to no treaty amendments which would allow the United States to impose its tax on shares in companies holding real property, and the treaty override was left to stand.
The question of treaty override has been addressed in some recent treaties, e.g. the 1989 US–Spanish treaty, where the protocol provides for consultation on the negotiation of modifications to the treaty if and when there are "substantial changes in the domestic legislation", and the 1992 US–Mexico treaty, where the consultation requirement in Art. 20 of the protocol is made more firm.

30. IRC Sec. 2001(c)(1) and (2)(D).

31. Art. 8(8).

32. The lack of such a resolution measure may be significant as the United States is applying still more strict intercompany pricing rules. See Weizman, "Transnational Compliance with Intercompany Pricing: The Case of the United States and Korea", *Intertax* (1992), at 544; Weizman, "US Transfer Pricing: Grim Prospects for Multinational Companies", 3 *International Company and Commercial Law Review*, (1992), at 163; Weizman, "US Transfer Pricing: Grim Prospects for Multinational Companies", 9 *Oil & Gas Taxation and Law Review*, (1992), at 282; and Weizman, "Transfer pricing: dystre udsigter for multinationale selskaber", 48 *Skattepolitisk Oversigt* (1992), at 194.

33. A qualifying grant is granted under Law for the Encouragement of Capital 5719-1959, Sec. 40B, which allows grants to be given to: (1) a company which has a share capital; (2) a cooperative society which has a share capital; (3) a registered partnership with limited liability of the capital of which at least 95% of the capital belongs to a company, or cooperative society, and which owns an approved enterprise, being an industrial enterprise or industrial building. Also entitled to the grant are owners of approved enterprises or recognized enterprises which have acquired as property of the enterprise any Israeli-made machinery or equipment mentioned in Sec. 62(a) of the Law. The amount of grant is a percentage of the original cost of the property of the enterprise or of the industrial building and of the expenditure incurred by the owner of the enterprise with respect to land. Grants generally vary according to the geographic zone in which the enterprise is located.

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Table 2
US Investor

	Corporate Investor		Individual Investor	
	Regular IS Corp.	Approved Enterpr.	Regular IS Corp.	Approved Enterpr.
No Remittance:				
Profits before tax	100.00	100.00	100.00	100.00
IS corporarate tax	40.00	10.00	40.00	10.00
Profits after tax	60.00	90.00	60.00	90.00
Full Remittance:				
Profits before tax	100.00	100.00	100.00	100.00
IS corporate tax	40.00	10.00	40.00	10.00
Profits after tax	60.00	90.00	60.00	90.00
IS withholding tax on dividends (25%)	15.00	13.50	15.00	13.50
Total IS taxes	55.00	23.50	55.00	23.50
Total net dividend	45.00	76.50	45.00	76.50
US corporate tax on dividends (34%)	34.00	34.00		
Less US tax credit	(34.00)	(23.50)		
Total US corporate tax	0.00	10.50		
Plus individual income tax on dividends distributed from US corporation to individual (28%)	12.60	20.46	16.80	25.20
Less US tax credit			(15.00)	(13.50)
Total US taxes	12.60	28.98	1.80	11.70
Total taxes	57.60	52.48	56.80	35.20
Net remittance to investor	42.40	47.52	43.20	64.80

Table 3
Israeli Investor

	No treaty		Treaty	
	Corporation	Individual	Corporation	Individual
Profits before tax	100.00	100.00	100.00	100.00
US state income tax (9%)	(9.00)	(9.00)	(9.00)	(9.00)
Profits after state tax	91.00	91.00	91.00	91.00
US federal income tax (34%)	30.94	30.94	30.94	30.94
Profits after US income taxes	60.06	60.06	60.06	60.06
US withholding tax on dividends (30%/12.5%)	18.01	18.01	7.50	7.50
Net distribution	42.05	42.05	52.56	52.56
IS corporate tax on dividends	0.00		0.00	
IS income tax of shareholder (25%)	10.51		13.14	
IS individual income tax on dividends (25%)	10.51		13.14	
Less IS tax credit	(10.51)	(10.51)	(7.50)	(7.50)
Net profit	42.05	42.05	46.92	46.92
Total tax burden:				
No remittance	39.94	39.94	39.94	39.94
Full Remittance	57.95	57.95	53.08	53.08

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include any amount which in whole or part, directly or indirectly: (1) is in consideration for services rendered or to be rendered, or for the sale of goods; (2) is measured in any manner by the amount of profits or tax liability; or (3) is taxed by Israel. If the resident chooses to exclude the amount, then it will be treated as a contribution to capital which the resident is deemed to have made to the Israeli corporation. The resident's basis in the Israeli stock is not increased by the deemed contribution, and the basis of the property of the Israeli corporation will be reduced by the amount of the deemed contribution. The effect of Article 10 is to prevent the US resident from escaping taxation, and it allows the resident receiving a qualifying grant only to defer his tax liability.

The grant provided under the treaty is different from the tax sparing credit (or matching credit), which is sometimes granted to countries which – like Israel – offer tax holidays or reduced tax rates to encourage capital and investment. This idea was developed in the United States in the 1950s, and tax sparing was included in a number of US treaties in the 1960s. Among these treaties was the proposed US/Israel treaty of 1965, which was greeted by the Foreign Relations Committee with the general hostility against the tax sparing credit, and the treaty was never reported out by the Committee. The Senate's view is that tax sparing creates a bias in favour of foreign investment over domestic investment, while developing countries believe that the industrialized country is collecting the tax "spared", which will destroy the purpose of the unilateral measures to stimulate investment. This is demonstrated in Tables 2 and 3.

6. Charitable contributions

Another controversial provision relates to the special treatment of charitable contributions. A provision was included in the first protocol of 1980, which provided for the deductibility of charitable contributions by US persons to Israeli charities and vice versa; the deduction was limited to 25 percent of Israeli source income. This provision was greeted with sharp criticism by the Senate when the treaty and first protocol were considered in 1981. The Senate stopped short of making reservation to the provision. The provision has not been deleted from the treaty but is contained in Article 15A of the consolidated treaty which provides for the same 25 percent limitation. This provision should not, however, be expected to meet the hostility which it previously encountered, as similar provisions since then have been accepted by the Senate without congressional concern (and is similarly included in the new proposed 1992 US-Mexico treaty).

7. Personal services

Article 17 dealing with dependent personal services is almost identical to the US model. The similarities do not extend to independent personal services. Article 16 provides that income derived by an individual who is a resident of one of the contracting states from the performance of personal services in the other state in an independent capacity is generally taxed only by the country of residency. An exception to this rule is provided for income derived by an individual who is a resident of one of the contracting states from the performance of independent personal services in the other state, which may be taxed if the individual is present in that other state for a period or periods aggregating 183 days or more in the taxable year. In addition, the treaty's Article 19 is not found in any of the models. Under Article 19 consideration received for the furnishing of personal services is not taxable as business profits under Article 8 of the treaty, a rule which is subject to certain limitations.

Table 4
Withholding Taxes

	Israel		*United States*	
	No Treaty	Treaty	No Treaty	Treaty
Dividends				
Portfolio investment	25%	25%	30%	25%
Substantial holding	25%	12.5/15%	30%	12.5%
Branch profits tax			30%	5/12.5%
REIT			30%	25/30%
RIC			30%	25%
Interest	25/45%	17.5%	30%	17.5%
Royalties	25/40%	10%	30%	10%

D. *Withholding taxes* (see Table 4)

1. Dividends

(a) *General tax structure*

The corporate tax systems applied in the United States and Israel are different. Corporate taxation in the United States is based on the classical system, and the corporation and shareholders are each subject to a separate level of taxation, whereas Israeli corporate taxation is based on a "double tier" system. The 1990 Israeli tax reform eliminated the corporate income tax on distributed profits to take effect from 1 January 1992,[34] and a corporation will only have to pay the 40 percent corporate income tax rate on undistributed profits,[35] whereas shareholders are subject to a flat 25 percent tax on dividends[36] (the rates may be reduced as low as 10 percent for corporations, and 15 percent for shareholders if the company is an approved enterprise). Both tax systems provide relief for intercompany distributions. In the United States a corporation may deduct 70 percent of the dividends received from a taxable domestic corporation,[37] and affiliated corporations may elect to deduct 100 percent of dividends received from members of the affiliated group (at least 80 percent ownership).[38] In Israel intercompany dividends are free of corporate taxation in the hands of the recipient corporation.[39] The corporate tax systems applied by the United States and Israel should no longer cause the disparity that may result when the classical and imputation systems clash, a confrontation

34. See Lapidoth, "The 1990 Israeli Tax Reform", 44 *Bulletin for International Fiscal Documentation* (December 1990), at 609.
35. ITO Sec. 126(a).
36. ITO Sec. 125B.
37. IRC Sec. 243(a).
38. IRC Sec. 243(b).
39. ITO Sec. 126(b).

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which is typically unfavourable to the country applying the classical system.

(b) *Withholding on Israeli-source income*

The treaty rules on dividends are different from the models. The treaty does not provide for any definition of the term "dividends" similar to Article 10(3) of the OECD and US models. Thus for treaty purposes the term will be determined exclusively in accordance with domestic tax law. In addition, Israeli tax law generally provides for a withholding tax of 25 percent on dividends paid by Israeli corporations to foreign shareholders,[40] a rate which is reduced to 15 percent for profits from an approved enterprise.[41] The treaty applies the general distinction between dividends on intercompany shareholding and dividends on portfolio shareholding. The Israeli withholding tax under the treaty is 25 percent with respect to portfolio shareholding (i.e. no reduction of withholding tax).[42] The treaty does provide for a special rate for substantial holdings, i.e. a special rate of 12.5 percent is generally applicable to the US shareholder if the paying corporation is not entitled to the special tax rate applicable to approved enterprises under Israel's Encouragement of Capital Investments Law (1959), and only if: (1) the recipient US corporation owns at least 10 percent of the outstanding shares of the voting stock; and (2) not more than 25 percent of the gross income of the paying corporation consists of interest or dividends (subject to certain limitations).[43] If the US corporation is the recipient of a dividend from income derived during any period for which the corporation is entitled to the reduced tax rate applicable to an approved enterprise under Israel's Encouragement Capital Investments Law (1959), then the withholding tax rate is reduced to 15 percent if the corporation meets the above conditions. In addition, the reduced withholding tax rate will not be applied to dividends paid by corporations whose income is taxed under Sections 64 (certain house property companies) and 64A (certain family companies) of the Israeli Income Tax Ordinance , or in substantially the same manner. In such cases, the income will be treated as if it were business profits taxable under Article 8.

(c) *Withholding on US-source income*

US tax law generally provides for a 30 percent withholding tax on dividends paid by US corporations to foreign shareholders.[44]. The treaty applies the same distinction between dividends on intercompany shareholdings and dividends on portfolio shareholdings as is applied to Israeli-source income. As a result withholding taxes are reduced to 25 percent for portfolio shareholdings, and a special rate of 12.5 percent is provided for substantial holdings, provided that: (1) the recipient Israeli corporation owns at least 10 percent of the outstanding shares of the voting stock; and (2) not more than 25 percent of the gross income of the paying corporation consists of interest or dividends (subject to certain limitations).

A special exception is provided for dividends received from a US Regulated Investment Company (RIC)[45] or Real Estate Investment Trust (REIT).[46] These two types of companies are exempt from corporate taxation under US tax law, and this could create a loophole because of the exemption of intercompany dividends provided under Israeli tax law. To prevent this, Article 12(3) provides that distributions from a RIC are subject to the 25 percent US withholding tax rate provided for portfolio shareholdings. Distributions from a REIT are likewise subject to the 25 percent withholding tax rate, provided the resident holds less than a 10 percent interest in the REIT. If the shareholding of the REIT is 10 percent or more, distributions will be subject to the full 30 percent US withholding tax rate.[47]

(d) *Branch tax*

In 1986, the United States enacted the branch profits tax under Tax Reform Act of 1986. The branch profits tax was adopted as IRC Section 884, which imposes a branch profits tax and a branch interest tax in lieu of the 30 percent US withholding tax on dividends. The branch profits tax was intended to equalize the tax treatment of US branches with the tax treatment of US subsidiaries of foreign corporations. Prior to 1986, foreign corporations engaged in a US trade or business were not subject to the 30 percent withholding tax on dividends and interest paid to foreign recipients unless more than 50 percent of the payor's gross income for the preceding three years was effectively connected with a US trade or business. However, repatriation of earnings of a US subsidiary to its foreign shareholder was subject to the 30 percent withholding tax unless less than 20 percent of corporate earnings were US-source income ("80/20 corporations"). Therefore, branches were treated more favourably than subsidiaries of foreign corporations, and the branch profits tax was intended to equalize the treatment of branches and subsidiaries.

The branch profits tax was subject to a storm of criticism as it was seen as an override of most US treaties. It was a measure

40. ITO Sec. 125B.

41. In addition to the lowered tax rate on dividends, the regular corporate tax rate of 40% is similarly reduced to 25%. Furthermore, an approved enterprise having foreign ownership may be subject to an even lower corporate tax rate: (1) foreign ownership less than 49% results in a 25% tax rate; (2) 49% or more but less than 74% results in a 20% tax rate; (3) 74% or more but less than 90% results in a 15% tax rate; and (4) 90% or more results in a 10% corporate tax rate. The general corporate tax rate of 40% has recently been reduced by 1% starting from this fiscal year, and will be reduced by 1% in subsequent years until the tax rate reaches 36%.

42. Art. 12(1)(a).

43. Art. 12(2)(b).

44. IRC Sec. 871(a)(1)(A).

45. IRC Secs. 851-860. Certain investment companies, which are classified for tax purposes as corporations, may elect to be taxed on a flow-through basis. The investment company must maintain a diversified portfolio and 90% of its gross income must be derived from dividends, interest and gains from the sale of stock or securities. If the company qualifies as a RIC, all distributed income is taxed only to the shareholders, while the company is taxed only on its undistributed income.

46. IRC Secs. 856-860. A company which qualifies as a REIT is also subject to taxation on a flow-through basis. The company must satisfy a number of requirements, most importantly that the company is widely held, that 75% of the gross income is derived from passive real estate activities, and that 95% of the taxable income is distributed as dividends.

47. The United States may generally not impose a 30% withholding tax on income which is protected under a treaty. The reason is that US residents are subject only to a 28% tax rate (which increases to 33% and then again decreases to 28%), and a 30% withholding tax on income such as dividends would be discriminatory, and therefore a violation of the treaty's prohibition against discriminatory treatment. See Arnold, (Canadian Tax Foundation, 1991), at 237.

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which even the United States perceives to be discriminatory, and contained as such an override of the non-discrimination provision in US treaties.[48]

The treaty with Israel includes and permits the imposition of the branch profits tax, and provides a necessary exception to the non-discrimination provision. However, the 30 percent branch profits tax rate is reduced under Article 14A of the treaty to 12.5 percent or 5 percent. Article 14A provides that a corporation which is a resident of a contracting state "may be subject in the other Contracting State to a tax in addition to the tax allowable under the other provisions of this Convention". In the case of the United States, the treaty provides that the branch tax may be imposed only on:

- the "dividend equivalent amount" of the profits effectively connected with a US trade or business or taxable under Article 7 (real property) or Article 15 (capital gains), and this branch tax may not exceed 12.5 percent; or
- the excess of interest deductible in the United States in computing the profits of the corporation that are taxable in the United States and attributable to a PE or taxable under Article 7 (real property) or Article 15 (capital gains), and this branch tax may not exceed 5 percent.[49]

In the case of Israel, Article 14A(2)(b) provides that: "tax may be imposed only on the amounts sufficient to provide that a branch in Israel of a US corporation...is taxed in a manner comparable to a similarly situated Israeli corporation and its United States shareholder".

2. Interest

The Israeli withholding tax rate on interest is generally 25 or 45 percent,[50] whereas the US withholding tax rate is 30 percent.[51] Article 13 has adopted a split jurisdiction concept for purposes of taxing interest income similar to the OECD and UN models. In contrast, Article 11 of the US model provides for a reciprocal exemption. While the OECD and UN models provide that interest income may be taxed in the residence country of the creditor, and the country of source may impose a withholding rate not exceeding 10 percent, the treaty allows the country of source to impose a withholding rate not exceeding 17.5 percent.[52] In addition, the treaty provides for a special election which allows residents to elect to have interest income taxed as if the income were business profits taxable under Article 8 of the treaty.[53]

3. Royalties

Israel imposes a general 25 or 40 percent withholding tax rate on royalties,[54] whereas the US withholding tax rate is 30 percent.[55] While most tax treaties, including Article 12 of the OECD and US models, provide that royalties derived from within a treaty country by a resident or corporation of the other contracting state are exempt from taxation in the country of source, Article 14(1) has adopted a rule similar to Article 12(2) of the UN model, which allows the country of source to impose a withholding tax not exceeding 10 percent of the gross amount of a copyright or film royalty and 15 percent of the gross amount of an industrial royalty. The term "industrial royalty" is defined to include the right to use patents, designs, models, plans, secret processes or formulae, trade marks or similar property rights.[56]

E. *Capital gains*

The treaty's provision on capital gains is different from any of the models, and the reason is only in part due to differences between related provisions. The treaty provides that capital gains are taxable only in the country of residence, unless: (1) the gain is taxable under Article 7 (real property); (2) the gain is taxable under Article 8(6) (business profits); (3) the resident is present in the other contracting state for a period aggregating 183 days or more during the taxable year; or (4) the gain is derived by a resident from the disposition of stock in a corporation of the other contracting state, provided the resident owned 10 percent or more of the voting power of the corporation within the year prior to the sale. Article 15(2) provides an exception to (4) in cases where the transferor and the transferee are residents of the same state; the transferee's basis in the asset is determined by reference to the transferor's basis; and either corporation or a common parent resident in the same state owns, directly or indirectly, 80 percent of the voting power or value of the other corporation. In such a case the amount of gain taxable in the other state will be limited to the value of cash or other property received by the transferor. An exception applies if the contracting state in which the transferror is resident subjects a greater amount of gain to taxation, in which case the other contracting state will be allowed to tax the gain in accordance with its domestic law.

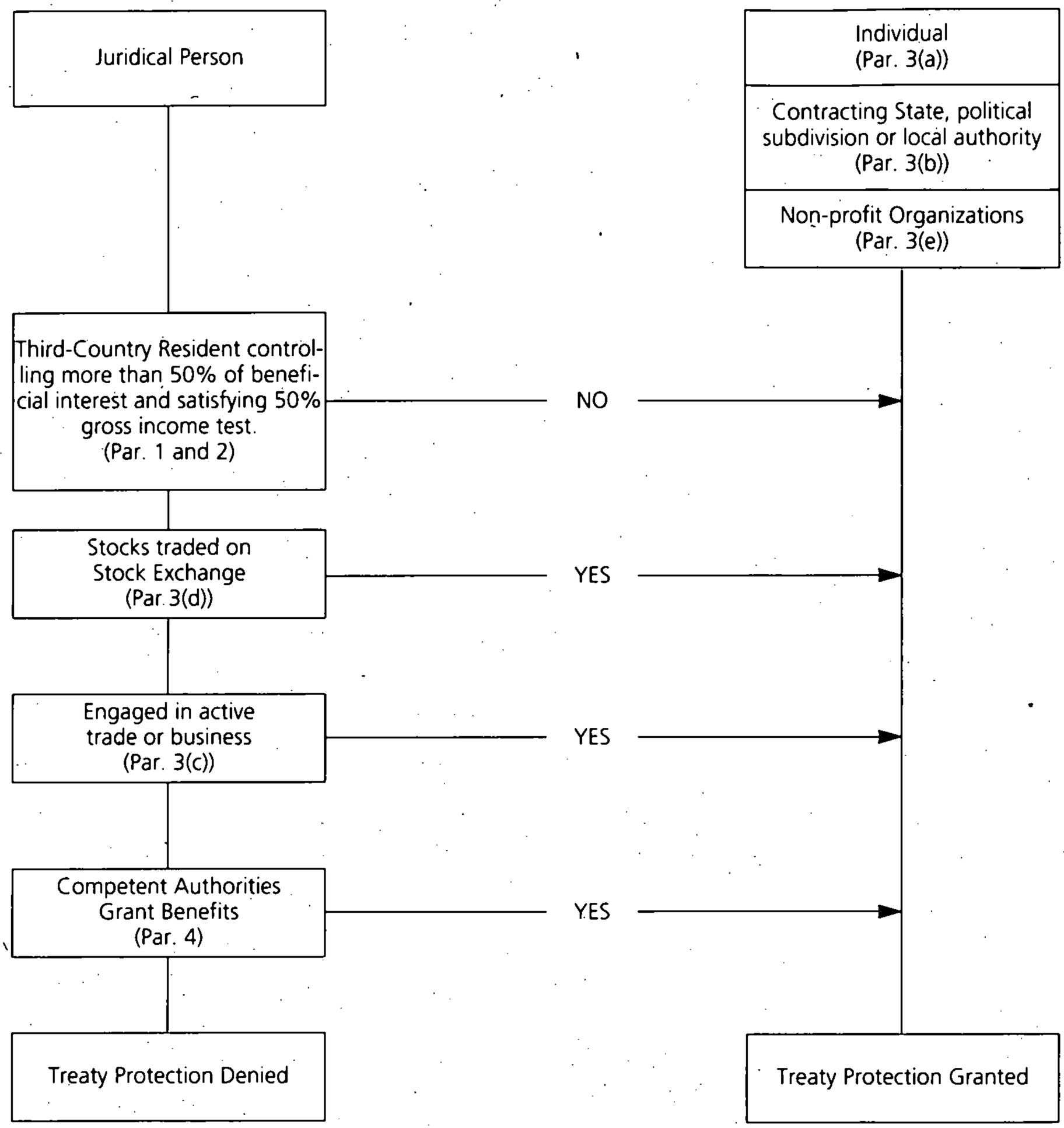
F. *Limitation on benefits (see Table 5)*

The limitation on benefits provision contained in Article 25 of the treaty is taken from the US model. The approach contained in Article 25, however, is different from Article 16 of the US model, and reflects current US anti-treaty shopping policies. Firstly, Article 25 operates with a 50 percent beneficial third-country ownership for denial of benefits under the treaty, whereas the similar percentage in the US model is 75 percent. Secondly, Article 25 provides two additional exceptions for third-country investors who are engaged in a so called "active conduct of a trade or business",[57] and for shares which are regularly traded on a recognized stock exchange.[58] The first exception allows benefits for third-country investments in non-profit organizations which are generally exempted from taxation under domestic law, provided that

48. See Notice 87-56, 1987-2 C.B. 367.
49. Art. 14A(2)(a)(i)-(ii).
50. ITO Sec. 161.
51. IRC Sec. 871(a)(1)(A).
52. Art. 13(2)(a).
53. Art. 13(2)(b).
54. ITO Sec. 170, Income Tax (Withholding on Authors Remuneration) Regulations, 1964-5718; Income Tax (Withholding from Remuneration of Artists, Examiners of Tests, Lecturers, and the Suppliers of Office Services) Regulations, 1967-5721; Income Tax (Withholding from Insurance Commission) Regulations, 1964-5718.
55. IRC Sec. 871(a)(1)(A).
56. Art. 14(2)(b).
57. US model Art. 16(3)(c).
58. US model Art. 16(3)(d).

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Table 5
Limitation on Benefits (Article 25)



more than 50 percent of the beneficiaries, members or participants are persons entitled to the benefits under the treaty.[59] The second exception provides that "a person that is not entitled to the benefits of the Convention pursuant to the preceding provisions of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines".[60]

G. Relief from double taxation

Since the United States and Israel apply the credit method to relieve double taxation under domestic law, it is not surprising that this is the approach adopted under the treaty. Article 26(1) has adopted the method applied in the United States to relieve double taxation. Thus the direct and indirect tax credit method is applied. The foreign tax credit in the United States is limited in a number of ways. Firstly, the foreign taxes must be income taxes as defined under domestic tax law. Secondly, the foreign tax credit is limited to the proportion of the US tax which the source income bears to total US taxable income in a taxable year; and finally, the foreign tax credit is limited by the allocation of income to a specific "basket" of income. These limitations are applied under the treaty.

Article 26(1) provides that the United States will allow a citizen or resident of the United States a credit against the US tax liability on the appropriate amount of taxes paid or accrued to Israel. In the case of a US corporation owning at

59. Art. 25(3)(e).
60. Art. 25(4)(a).

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least 10 percent of the voting stock of an Israeli corporation from which it receives dividends in any taxable year, credit will also be allowed for the appropriate amount of taxes paid or accrued to Israel by the Israeli corporation paying such dividends with respect to the profits out of which such dividends are paid. The credit granted is similar to the credit provided under IRC Section 902, and the treaty does not generally provide any benefits not already available under the IRC with respect to the crediting of Israeli taxes.

Relief from double taxation is provided under Israeli tax law under a credit method similar to the one applied by the United States, and like the United States, Israel imposes an overall limitation on creditable taxes. Israel will accordingly credit US taxes in accordance with the principles under Article 26(1).[61] In addition, Article 26(2) provides a special rule which is related to the US taxation of its citizens. If a US citizen is a resident of Israel, then with respect to items of income that are exempt from US taxation, or are subject to a reduced rate of US taxation when derived by a resident of Israel who is not a US citizen, Israel will allow as a credit against Israeli tax, credit for foreign tax (only the tax paid, if any) that the United States may impose under the treaty, and for purposes of computing US tax liability.[62] The United States will allow as a credit against US tax the income tax paid to Israel after the credit, and the credit will not reduce that portion of the US tax that is creditable against Israeli tax, and for the purpose of relieving double taxation in the United States, items of income will be deemed to arise in Israel to the extent necessary to avoid double taxation.[63]

H. *Non-discrimination*

Article 27 contains a non-discrimination provision which differs from most treaties. Like the models, the requirement is not limited to the taxes covered by the treaty,[64] the non-discrimination provision is generally limited to citizens ("nationals"), and PEs,[65] and companies controlled by a resident of the contracting states are protected.[66] The treaty does not contain provisions like Article 24(3) of the OECD model applying the requirement to stateless persons resident in a contracting state, or like Article 24(5) applying the requirement to interest, royalties and disbursements paid by an enterprise in one contracting state to a resident of the other contracting state, which must be deductible in calculating the taxable profits under the same conditions as if they had been paid to a resident of the same contracting state as the enterprise. In addition, the treaty's Article 27(4) differs from the models, as it provides that "[n]othing in this Article shall be construed as preventing either Contracting State from imposing the tax described in Article 14A (branch tax)", a provision which will allow the United States to impose its branch profits tax despite any claim of discriminatory tax treatment.

I. *Administrative provisions*

One objection to the original 1975 treaty was the scope of the exchange of information provision, and it is somewhat surprising that the second amendment includes the provision contained in the original treaty. Article 29(1) provides, as do the models, that the competent authorities will exchange such information as is necessary to carry out the provisions of the treaty, and to prevent fraud or fiscal evasion, and that any information exchanged will be treated as secret and will only be disclosed to authorities involved in assessment, collection or administration of taxes subject to the treaty. Article 29(2) provides the general exceptions to exchange of information:

- to carry out administrative measures at variance with the laws or the administrative practice of that or of the other contracting state;
- to supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other contracting state;
- to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process or information, the disclosure of which would be contrary to public policy. Article 29 does not, however, contain provisions similar to Article 26(3)-(6) of the US model.

Article 28 is similar to the mutual agreement procedure provided under Article 25 of the models. Article 28(1) is similar to the US model,[67] and provides similarly that the competent authorities, upon the request of the taxpayer, will try to reach an agreement with the competent authority of the other contracting state in order to avoid taxation not in accordance with the convention. The number of issues suggested for agreement is limited under Article 28(2) to:

- attribution of income to a PE;
- allocation of income, deductions, credits and allowances between related persons;
- determination of source of income;
- characterization of income;
- exchange of information. Article 28(3) is similar to the US model,[68] and Article 28(4) provides that taxes will be imposed or refunded in accordance with any agreement between the competent authorities and "notwithstanding any procedural rule (including statutes of limitations) applicable under the law of either Contracting State".

Despite the presence of a competent authority procedure, it is by no means a guarantee that disagreements between tax authorities will be solved to the benefit of the taxpayer. While the United States in a recent treaty agreed to allow disagreements between the competent authorities to be settled through arbitration, it is regrettable that the treaty with Israel does not contain any arbitration procedure.[69]

61. Art. 26(3).
62. Art. 26(2)(a)-(b).
63. Art. 26(2)(c).
64. Art. 1(3).
65. Art. 27(2).
66. Art. 27(3).
67. US model, Art. 25(1)-(2).
68. Art. 25(4).
69. The 1989 US treaty with Germany contains a special provision concerning the mutual agreement procedure (Art. 25) which allows the contracting states to have their disputes submitted to arbitration (para. 5). However, arbitration is not compulsory as it requires that the competent authorities "agree", and it requires full exhaustion of remedies, which will make it a slow and expensive process. In addition, the procedure cannot be initiated by the taxpayer. The US government has since indicated that arbitration procedures will not be included in future US

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III. CONCLUSION

A tax treaty between the United States and Israel is long overdue. The treaty will harmonize conflicting international tax rules, and the overlapping tax jurisdiction claimed under the domestic laws of the two countries. The result is to ensure a fiscal predictability and certainty which will encourage economic relations between the two countries. While tax treaties generally are perceived to prevent double taxation, the fact is that treaties merely reduce the possibility of double taxation, and the extent to which this is achieved depends entirely on the treaty in question. The measures for the avoidance of double taxation could have been improved substantially. Firstly, the treaty places an undue reliance on the competent authorities to resolve any conflict that may arise under the treaty. Secondly, the treaty lacks a provision dealing with the increasingly important issue of treaty override, and this is especially important with respect to US treaties, since the US government for more than a decade has been overriding its bilateral obligations by unilateral measures. Thirdly, the treaty is significantly different from the model treaties. It lacks provisions regarding personal scope, directors' fees, miscellaneous income, taxation of capital, territorial extension, and the denial of treaty protection for certain residents may well have a negative impact on bona fide investments, especially investments by third-country residents. The most important shortfall of the treaty could perhaps be seen as its failure to accommodate the tax incentives provided under Israeli tax law. The reduction of Israeli tax rates for approved enterprises below US tax rates does not benefit the investor as much as the US Treasury, and the lack of a tax sparing provision will not only discourage the very investments which the incentives are intended to encourage, because Israeli tax treaties with industrialized countries generally provide for tax sparing, it will make it more difficult for US multinationals to compete.

treaties. It is, therefore, not surprising that the treaty with Israel does not provide for an arbitration procedure.

However, the new proposed US–Mexico treaty contains an arbitration provision, and while this treaty, like the US-German treaty, provides for an entirely voluntary arbitration procedure, the treaty does suggest that arbitration is considered appropriate if the competent authorities cannot agree. The arbitration provision in the Mexico treaty will not become effective until it is made effective through an exchange of diplomatic notes. This delayed effective date reflects the general IRS reluctance to cede control over the competent authority procedure. Given recent US treaty policies on this issue – and the treaty override issue – the new US model is being awaited with anticipation.

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Kluwer, Deventer.

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- Algemene wetgeving inzake douane
  releases 243-245
- Belastingheffing bij invoer
  release 435
- Gecombineerde nomenclatuur
  release 76
- Tarief van invoerrechten
  release 95

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 356 and 357
Kluwer, Deventer.

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releases 420-422
Kluwer, Deventer.

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Kluwer, Deventer.

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release 160
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NEDERLANDSE WETBOEKEN
releases 241 and 242
Kluwer, Deventer.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
releases 134 and 135
Gouda Quint/D. Brouwer, Arnhem.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  release 66
- AOW/AWW
  releases 60 and 61
- Coord. SV/Premieheffing
  release 20
- Heffing over uitkeringen en loon
  release 36

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEF-RECHTELIJKE WETTEN
release 283
Kluwer, Deventer.

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- Inkomstenbelasting 1964
  releases 850-855
- Investeringsregelingen
  release 154
- Loonbelasting
  releases 535 and 536
- Omzetbelasting
  releases 221-226
- Successiewet 1956
  releases 161-164
- Vennootschapsbelasting 1969
  release 294
- Vermogensbelasting 1964
  releases 148-151

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, release 2
B, releases 7-11
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Prentice Hall Inc., Englewood Cliffs.

CUMULATIVE INDEX – 1993 Nos. 1-6

I. ARTICLES

Canada:
Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Reseach Incentives 255

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Denmark:
Bente Moll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

Finland:
Kari S. Tikka:
Fundamental Tax Reform: 25 Percent Rate on Capital Income and Corporate Income 348

France:
Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Hong Kong:
Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283

Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

G.K. Kawatra:
1993/94 Budget 294

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

Ken Messere:
Recent Tax Revenue Developments in OECD Countries and Some Policy Implications 323

John Prebble:
100 Years of Income Tax 59

Stanley C. Ruchelman:
US Tax Considerations in International Derivative Products 235

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

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Japan:
Alum Bati:
Taxation of Dividends and Interest 202

Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Singapore:
Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

United States:
Stephen A. Mihaly:
How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the Best Method Rule of the New Section 482 Regulations 307

Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

Bruce Zagaris:
The US–Netherlands Income Tax Treaty: Tax Collection Assistance and Evidence-Gathering 342

Wim Wijnen:
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

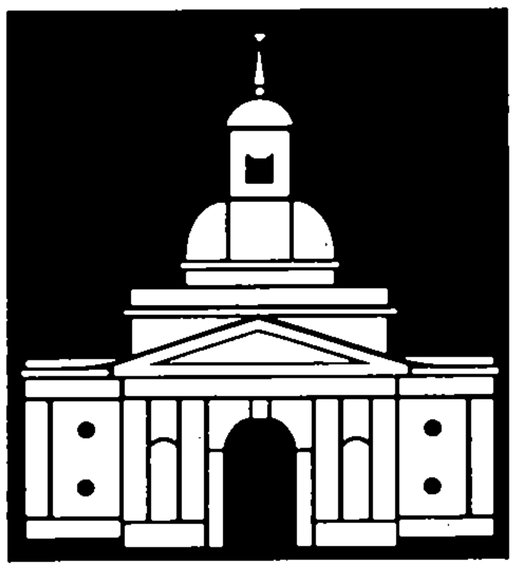
III. IFA NEWS 44, 96, 219, 254

IV. CONFERENCE DIARY 39, 149, 285, 347

V. BIBLIOGRAPHY

- Books 49, 100, 150, 226, 297, 354
- Loose-leaf services 51, 103, 154, 231, 302
- List of addresses of the major publishing houses appearing in the Bibliography 53

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CONTENTS

VOL. 47 NO. 9 **SEPTEMBER 1993**

1993 IFA CONGRESS IN FLORENCE	471	*Karl Beusch*
ITALY WELCOMES FURTHER EC HARMONIZATION	474	*Augusto Fantozzi* The process of corporate tax harmonization in the EC has thus far conferred significant benefits on Italian enterprises. This article examines the Ruding Committee Report and the Response of the EC Commission to the Report in the Italian context.
IMPLEMENTATION OF THE EC MERGER DIRECTIVE	480	*Guglielmo Maisto* Italy implemented the merger directive in December 1992 via a Legislative Decree. The new provisions significantly alter the domestic tax regime applicable to corporate reorganizations, and they offer a welcome clarification of certain civil law issues involving international mergers and divisions. However, the provisions in the Decree give rise to some rather significant discrepancies between the regimes applicable to domestic and cross border reorganizations, and under certain circumstances EC reorganizations appear to be less favourably treated than non-EC international reorganizations.
IMPLEMENTATION OF THE PARENT-SUBSIDIARY DIRECTIVE	493	*Siegfried Mayr* In 1992 the Italian government was authorized to issue a Legislative Decree necessary to implement the parent-subsidiary directive – the relevant decree was issued on 6 March 1993. This article summarizes the taxation of cross border dividends before the directive was implemented, and then examines the new measures dealing with the tax treatment of such dividends.
THE TAX ON THE NET WORTH OF ENTERPRISES	496	*Paolo Ludovici* One of the recent measures aimed at reducing Italy's huge budget deficit is a tax on the net worth of enterprises. Mr Ludovici describes the main features of the new tax, including the instructions provided in the Ministry of Finance's Implementing Decree of 7 January 1993 and Circular No. 7 of April 1993.
TAX TREATMENT OF FINANCIAL INSTRUMENTS IN ITALY	502	*Simona Bellettini* Many statutes and administrative measures affecting the securities market in Italy have been adopted over the last ten years – the process has recently intensified in order to keep up with more developed financial markets. This article summarizes the general rules of Italian tax law which are relevant to financial instruments and then overviews the income tax and VAT aspects of derivative products.

WHAT'S NEW FROM IBFD?

A Guide to the European VAT Directives:

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Transfer Pricing Strategy in a Global Economy

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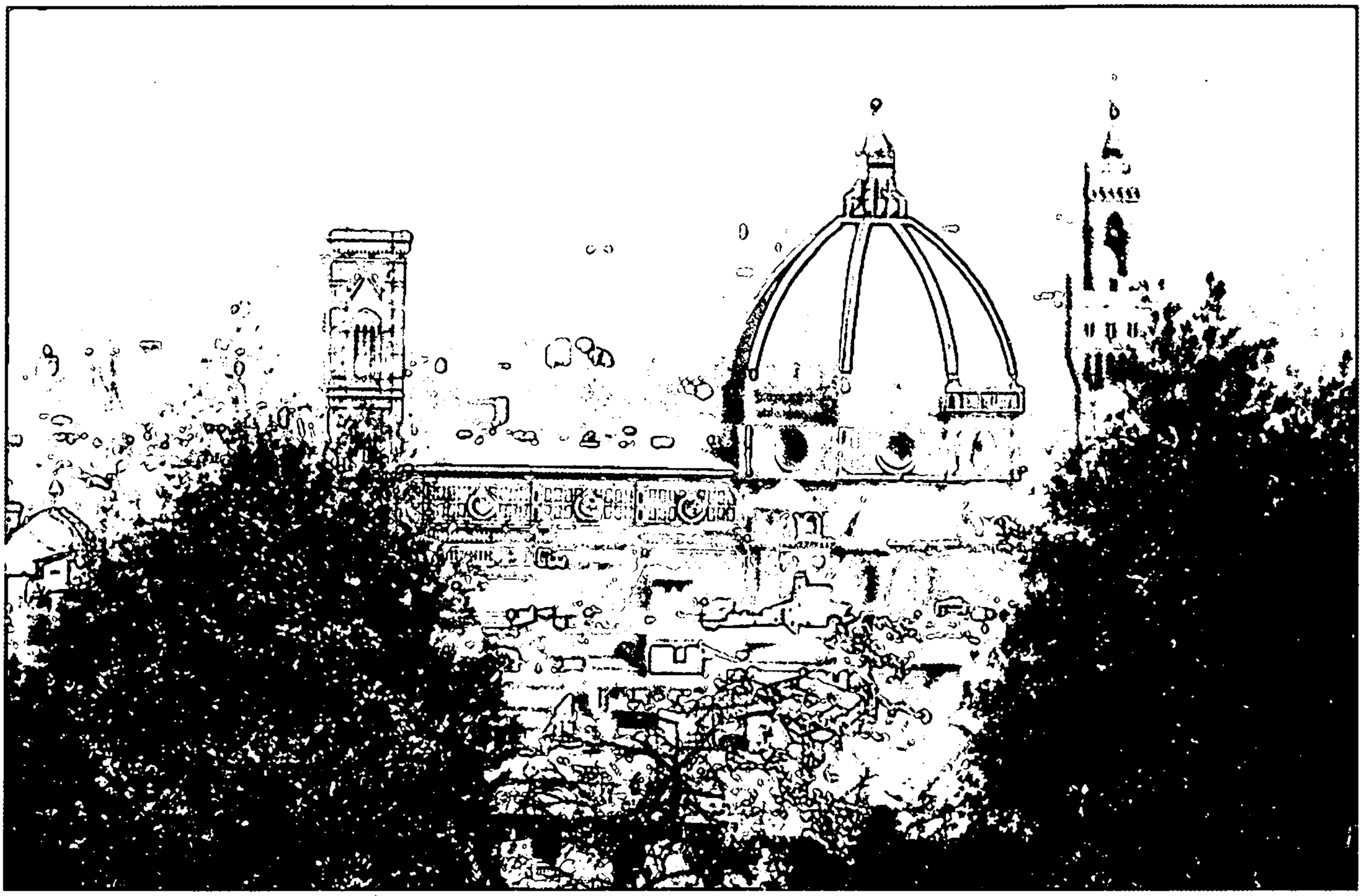
Tax News Service
Now Weekly!

TAXATION OF ITALIAN – BASED FLOWS OF INTEREST AND ROYALTIES IN AN INTERNATIONAL CONTEXT	510	*Guiseppe Marino* A general concern has arisen about how taxation may influence inward and outward direct investment flows, the ways in which revenue from international transactions is shared between countries and new possibilities for tax avoidance. An examination of these issues requires an analysis of the domestic tax regime and how this regime interacts with tax treaties.
TAX INCENTIVES IN ITALY	516	*Andrea Manzitti* Mr Manzitti looks at the evolution of tax incentives in Italy, describes the main incentives and offers some thoughts on possible future developments.
TAX AVOIDANCE: THE ITALIAN EXPERIENCE	522	*Bruno Gangemi* This article reviews the history of tax avoidance measures in Italy, including the recommendation made by the tax reform committee in 1963 and which the Parliament repudiated the commission's recommendation, the use of the Civil Code to counter avoidance and recent developments (implementation of EC directives).
TAX TREATY DEVELOPMENTS	529	*Andrea Manganelli* After examining the interaction of Italian tax treaty policy with domestic law provisions, this article focuses on key provisions of four recently signed treaties with EC partners, explaining how deviations from the OECD model reflect an important evolution of the relationship between the Italian tax system and other tax systems.
IFA NEWS	473	
BIBLIOGRAPHY		
– Books	535	
– Loose-leaf services	540	
CONFERENCE DIARY	492	
CUMULATIVE INDEX	542	

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1993 IFA Congress in Florence

Karl Beusch



Panoramic View of Florence

Italy was the first host country for an IFA Congress outside the Netherlands when the Congress convened in Rome in 1948. After again being held in Rome in 1956 and exactly ten years ago in Venice, now we meet in Florence, capital city of Tuscany and centre of cultural life with worldwide recognition.

As this is my last IFA Congress as your president, I am delighted that the scientific programme will be the peak of the agenda. Both Subject I and Subject II are of fundamental importance and current interest.

Subject I, "Interpretation of Double Taxation Conventions", tackles the fundamental question about the application of double tax treaties. The purpose of these treaties is the avoidance of double taxation and the prevention of fiscal evasion. A necessary condition to achieve these goals is an identical interpretation of the provisions by the respective tax authorities and courts of the contracting states. How to reach this concept of "common interpretation" will be one of the major topics to be discussed. In this context some countries have readopted the primacy of domestic tax law which is detrimental to uniform international principles.

Subject II, "Non-discrimination rules in international taxation", is also fundamental. The principle of non-discrimination is governed by rules contained in domestic law as well as in international, supranational, bilateral or multilateral conventions. I expect the resolution to suggest how to shape the non-discrimination principle in a better and more complete manner.

With regard to the Working Sessions of the two main Subjects, I would like to draw your attention to a procedural change for the discussion by the panel and the participants from the floor, and the voting procedures of the congress resolutions' respective résumés. As the new procedure is implemented on a trial basis only, the participants are kindly invited to cooperate and contribute to the discussions.

The number of seminars is once again increased – Florence offers six. Seminar A, "Harmonization of corporate taxes in the EC", will focus on the goals of the five EC corporate tax measures adopted prior to 1 January 1993, i.e. in particular realizing neutrality of competition and avoiding distortion in order to improve the productivity and competitiveness of EC-based enterprises.

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Comparing the situation in various jurisdictions, Seminar B, "Taxation of employee fringe benefits", investigates the different methods to tax employee fringe benefits, such as inclusion in the employee's income, denial of a deduction to the employer and imposing a fringe benefits tax on the employer.

"Environmental taxes and charges", the subject of Seminar C, are coming into effect in more and more countries in order to limit negative environmental effects. The seminar will overview what kind of taxes and charges have been introduced and summarize the experiences to date of "eco-taxes".

Seminar D, "Corporate tax on distributions (equalization tax)", looks at methods of avoiding economic double taxation by lowering the tax rate on dividends distributed or by granting imputation credits. Possible undue benefits for shareholders are countered by specific adjustments, i.e. the so-called "equalization tax".

Seminar E, "Resolution of tax treaty conflicts by arbitration", describes the arbitration clauses in tax matters which have been included in recent treaties and discusses the principal and practical problems of the arbitration procedure.

Finally, Seminar F, "Italian tax treatment of new financial instruments", gives an overview of the accounting and tax treatment of financial products such as futures, options and other forward exchange and interest rate contracts under Italian law.

The social programme offers not only the opportunity to experience a unique accumulation of historical places and magnificent works of art, but also requires a tough choice – four different settings are offered for the Gala Dinner. In any case your choice will be perfect and I am personally looking forward to meeting the IFA-family again.

Welcome to the 1993 IFA Congress in Florence!

SUBJECTS AND SEMINARS OF THE 1993 IFA CONGRESS

SUBJECT I
Interpretation of double taxation conventions
General Reporters:
Prof. Dr. Klaus Vogel (Germany)
Dr. Rainer Prokisch (Germany)
Discussion Leader:
David A. Ward Q.C. (Canada)
Chairman:
Prof. Avv. Victor Uckmar (Italy)
Secretary:
Dr. Massimo Agostini (Italy)

TEMA I
Interpretación de los convenios de doble imposición
Ponentes Generales:
Prof. Dr. Klaus Vogel (Alemania)
Dr. Rainer Prokisch (Alemania)
Presidente de Debates:
David A. Ward Q.C. (Canadá)
Presidente:
Prof. Avv. Victor Uckmar (Italia)
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Dr. Massimo Agostini (Italia)

SUJET I
Interprétation des conventions de double imposition
Rapporteurs Généraux:
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Dr. Rainer Prokisch (Allemagne)
Modérateur:
David A. Ward Q.C. (Canada)
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THEMA I
Die Auslegung von Doppelbesteuerungsabkommen
Generalberichterstatter:
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Dr. Rainer Prokisch (Deutschland)
Diskussionsleiter:
David A. Ward Q.C. (Kanada)
Vorsitzender:
Prof. Avv. Victor Uckmar (Italien)
Sekretär:
Dr. Massimo Agostini (Italien)

SUBJECT II
Non-discrimination rules in international taxation
General reporter:
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Discussion Leader:
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Chairman:
Prof. Ignace Claeys Bouuaert (Belgium)
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TEMA II
Reglas de no discriminación en la imposición internacional
Ponente General:
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SUJET II
Règles de non-discrimination en matière d'imposition internationale
Rapporteur Général:
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Modérateur:
John F. Avery Jones CBE (Royaume-Uni)
Président:
Prof. Ignace Claeys Bouuaert (Belgique)
Secrétaire:
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THEMA II
Diskriminierungsverbote im internationalen Steuerrecht
Generalberichterstatter:
Prof. Avv. Pietro Adonnino (Italien)
Diskussionsleiter:
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Vorsitzender:
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Sekretär
Dr. Simone Fiorito (Italien)

SEMINAR A
Harmonization of corporate taxes in the EC
Chairman:
Hubert M.A.L. Hamaekers (Netherlands)

SEMINARIO A
Armonización de los impuestos societarios en la CE
Presidente:
Hubert M.A.L. Hamaekers (Holanda)

SEMINAIRE A
Harmonisation des impôts sur les sociétés dans la CE
Président:
Hubert M.A.L. Hamaekers (Pays-Bas)

SEMINAR A
Die Harmonisierung des Körperschaftsteuerrechts in der EG
Vorsitzender:
Hubert M.A.L. Hamaekers (Niederlande)

SEMINAR B
Taxation of employee fringe benefits

Chairman:
Rick Krever (Australia)

SEMINARIO B
Imposición de beneficios adicionales a las remuneraciones por servicios personales ('fringe benefits')
Presidente:
Rick Krever (Australia)

SEMINAIRE B
L'imposition des avantages en nature des salariés

Président:
Rick Krever (Australie)

SEMINAR B
Die Besteuerung der Zusatzvergütungen von Arbeitnehmern
Vorsitzender:
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SEMINAR C

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SEMINARIO C

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SEMINAR D

Corporate tax on distributions (equalization tax)

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SEMINARIO D

Impuestos sobre sociedades en las distribuciones (impuesto de egualización)
Presidente:
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SEMINAIRE D

Impôt sur les distributions (Précompte)

Président:
Dr. Massimo Pagani (Italie)

SEMINAR D

Körperschaftsteuer auf Dividenden ('Ausgleichsteuer')

Vorsitzender:
Dr. Massimo Pagani (Italien)

SEMINAR E

Resolution of tax treaty conflicts by arbitration

Chairman:
Prof. Gustav Lindencrona (Sweden)

SEMINARIO E

Resolución de los conflictos de los tratados fiscales mediante arbitraje

Presidente:
Prof. Gustav Lindencrona (Suecia)

SEMINAIRE E

La résolution par l'arbitrage des conflits relatifs aux conventions fiscales
Président:
Prof. Gustav Lidencrona (Suède)

SEMINAR E

Lösung abkommensrechtlicher Konflikte durch Schiedsverfahren

Vorsitzender:
Prof. Gustav Lindencrona (Schweden)

SEMINAR F

Italian tax treatment of new financial instruments
Chairman:
Prof. Avv. Giulio Tremonti (Italy)

SEMINARIO F

Tratamineto tributario en Italia de los nuevos instrumentos fiscales
Presidente:
Prof. Avv. Giulio Tremonti (Italia)

SEMINAIRE F

Régime fiscal des nouveaux instruments financiers en Italie
Président:
Prof. Avv. Giulio Tremonti (Italie)

SEMINAR F

Die italienische Besteuerung neuer Finanzierungsinstrumente
Vorsitzender:
Prof. Avv. Giulio Tremonti (Italien)

IFA NEWS

FRENCH BRANCH

In a study meeting to be held on 17 November 1993, Mr Michel Noemie will speak on tax aspects of capital reductions linked to a disinvestment in public companies or partnerships.

KOREAN BRANCH

The annual seminar, to be held in December, will consist of a panel presentation and a talk by a government official regarding recent developments in international tax.

SWISS BRANCH

The Swiss branch will be hosting a joint meeting with the US branch 30 September – 1 October. Subjects discussed include recent developments in Swiss and US taxation, treaty shopping and limitations on inbound debt financing.

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ITALY WELCOMES FURTHER EC HARMONIZATION

Augusto Fantozzi

Augusto Fantozzi is a professor of tax law at the University La Sapienza in Rome. He is also founder-partner of Studio Legale e Tributario Fantozzi-Biscozzi, and of STI-Studio Tributario Internazionale-Fantozzi-Uckmar.

Contents

I. Introduction

II. Recent Developments in the EC Policy of Corporate Tax Harmonization
- A. Overview of the Ruding Committee recommendations and the Commission's response
- B. Recommendations to harmonize corporate taxes

III. Conclusion

I. ITALY

Italy is one of the original six signatories to the Treaty of Rome, which provided the impetus to the institution of the European Communities. Since then, Italy has fulfilled its commitment to the evolution of the community of states. The Treaty of Maastricht, the most recent step in a 35-year process, was promptly ratified by the Italian Parliament. However, with respect to the adoption of tax measures issued at the Community level, Italy has not been the most diligent member state, particularly in the case of directives concerning direct and indirect taxes. However, after the recent implementation of the EC directives in the field of direct and indirect taxes, the Italian tax system is now awaiting adoption of new harmonizing measures.

The compulsory adoption of EC directives in the tax area has offered a solution to problems relating to the fiscal aspects of international economic activities, an area particularly afflicted by weak aspects of the Italian tax system. For example, Italian tax legislation does not provide favourable conditions for foreign investment in Italy, nor does it provide advantageous rules for profits from Italian investments abroad.

The few measures adopted at the EC level have increased the level of competitiveness of certain features of the Italian tax system, (e.g. tax regime for inbound dividends) and certain long-standing problems have been resolved by implementation of the EC directives. Any expectation of further improvement in the Italian rules governing transnational economic operations should be analyzed in light of future developments in the process of corporate tax harmonization.[1]

This article examines two important documents issued at the EC level in 1992, i.e. the Ruding Committee Report and the Response of the EC Commission to the Report. Portions of those documents that more directly address issues which are relevant from an Italian perspective will be examined in detail.

II. RECENT DEVELOPMENTS IN THE EC POLICY OF CORPORATE TAX HARMONIZATION

The process of harmonizing of corporate tax systems in the EC has developed enormously in the last three years. Since the Commission published its 1990 document, "Guidelines for Corporate Taxation,"[2] renouncing its ambitions of full corporate tax harmonization in the member states, the first steps towards harmonization have been taken. The adoption of the parent-subsidiary directive, the merger directive and the 1990 arbitration convention represent an historical event in the harmonization process.

In the Guidelines, the Commission outlined the fundamental principle of subsidiarity, i.e. harmonization will be realized through intervention at the Community level only insofar as serious distortions are not removed by the harmonizing effects that economic integration will have on the tax systems, or by separate action on the part of member states.

The first evidence of the introduction of the principle of subsidiarity was the withdrawal of the proposed 1975 Directive,[3] in which the imputation system was presented as the harmonized method for the elimination of double taxation on dividend flows, and which imposed a minimum and a maximum limit for corporate tax rates. Further evidence of the Commission's new approach was the abandonment of the 1988 draft proposal on the determination of profits of undertakings, which aimed to harmonize national rules on the determination of the taxable base. Under the new approach, the Commission intends to focus on harmonization of the rules governing tax aspects of transnational operations, rather than on intervention in national legislation which governs domestic economic events.[4] The Guidelines recommend-

1. This process will be discussed in Seminar A of the 1993 IFA Congress, so reference should be made to the results of the panel members' discussion.
2. SEC(90)601 of 2 April 1990.
3. COM75(392) final.
4. The same consideration is also expressed in point 38 of the Commission's latest communication.

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ed immediate adoption of the parent-subsidiary directive and the merger directive. The recommendation was taken up by the Council in July 1990, and the march towards harmonization began. The accomplishment of such result demonstrates that as of 1990, the Commission more astutely interpreted the Council's reluctance to relinquish too much sovereignty of the member states in direct tax matters. In this respect, the importance of fiscal policy as a means to reinforce the economic policy of each member state should never be neglected.[5]

An analysis of the Ruding Report and the Commission's reactions to the Report should be undertaken in view of the new position outlined in the Guidelines. The Ruding Committee's investigation was announced in the Guidelines, and the response of the Commission is expressly defined as a "communication ... further to the Guidelines presented on 20 April 1990".

The Commission's reactions to the Ruding Committee recommendations which are likely to cause significant changes in domestic legislation governing internal taxation were rather cool. However, the Commission warmly welcomed recommendations which deal with aspects of domestic legislation which regulate cross-border transactions.[6]

A. *Overview of the Ruding Committee recommendations and the response of the Commission*

Unlike the systems of other member states, the Italian system has benefited greatly from the introduction of EC measures in fiscal matters. Thus further harmonization would be certainly welcomed.

However, full implementation of the measures suggested by the Ruding Committee would create other problems primarily related to Italy's particular financial situation, which because of the pressing need for an increase in tax revenue, does not allow any flexibility of fiscal policy. The recommendations discussed here are those aimed at reducing double taxation of transnational flows of income and recommendations concerning further harmonization of corporate income tax.

1. Elimination of double taxation of cross-border income flows

The elimination of obstacles to the development of European-wide economic activities is one of the most important purposes of the tax harmonization policy followed by the European Commission. The creation of the European Common Market could not be realized without the establishment of economic conditions similar to those of an internal market. Therefore, all factors which contribute to make transnational investments more burdensome than domestic investments should in principle be removed.

In the tax area, obstacles which impede the creation of a common market usually consist of discriminatory treatment of foreign- source income as compared to income derived from domestic sources. Many obstacles for corporate taxpayers have been removed through the adoption of the parent-subsidiary directive. However, application of the directive is limited to instances where certain conditions – which are in some respects restrictive – are met. One specific recommendation of the Ruding Committee addresses the elimination of double taxation on cross-border income flows when the country of residence of the recipient provides for an imputation system in the domestic context. This recommendation, in the Ruding Committee's opinion, should help to solve the problems of transnational investments when the income derived therefrom, being exempt in the hands of the recipient, is subject to equalization taxes upon redistribution.

The prompt adoption of the other two directives presently under discussion in the European Council, i.e. the interest and royalties directive and the directive for the taking into account of losses of permanent establishments ("PEs") and subsidiaries situated in other member states, has been suggested by the Ruding Committee in order to facilitate intra-Community financing and licensing operations and to promote the creation of productive activities in other member states.[7] The implications of adoption of these proposals are commented on below.

(a) *Tax treatment of income earned abroad*

The elimination of double taxation on cross-border income flows is significantly related to the elimination of double taxation of foreign-source profits. An unresolved dilemma is whether the classical system or an imputation system should be adopted throughout the EC as a harmonized system. In those member states which provide for a full or limited imputation regime and an exemption system governs foreign-source income, the redistribution of exempt foreign-source income on the part of resident companies raises problems of equalization taxes.[8] Equalization taxes aim to equalize the tax credit granted to resident shareholders of the distributing company. The imposition of equalization taxes constitutes double taxation, since the profits originally taxed in the hands of the foreign company are subject to an additional burden when redistributed by the resident company.

This issue was specifically addressed by the Ruding Committee through a recommendation which could significantly affect the Italian tax system. The Committee recommended

5. The same conclusions may be drawn taking into account the process of conclusion of the arbitration convention. The purpose of the convention, i.e. elimination of double taxation resulting from uncoordinated application of transfer pricing adjustments, was originally to be achieved by a directive. The proposed directive presented to the Council on 29 November 1976 (COM(76)711 final) never obtained the Council's approval. The text was transposed into a multilateral convention, which was signed on the basis of Art. 220 of the Treaty of Rome. By adopting a convention rather than a directive, the member states have prevented the EC Court of Justice from gaining authority in this area. The member states apparently deemed such a transfer of authority from a national body to an EC body too rigorous.
6. I will assume that only the proposed measures which have been agreed to by the Commission are likely to be implemented in the near future. Therefore, only those measures will be discussed from an Italian perspective.
7. The effects of the losses directive on the creation of new productive activities in other member states could be extremely favourable inasmuch as it would permit the recovery at the level of the parent company or the head office of the start-up losses which normally arise in the event of newly created activities.
8. Some form of equalization tax is levied by Italy, France and Germany.

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that those states which, like Italy, apply equalization taxes on the distribution of profits earned in another member state should be required, on a reciprocal basis, to allow such tax to be reduced by corporate income tax paid in the other member state in respect of dividends remitted by a subsidiary, or profits earned by a PE.[9]

The reciprocity principle has already been adopted in Italian tax treaty policy; see for example, the new treaties with France, Germany, the United Kingdom and the Netherlands.[10] Under the UK and French treaties Italy grants a repayment of the underlying tax credit on dividends distributed to French or UK shareholders. Under the UK treaty the benefit reciprocally granted is limited to the repayment of the tax credit. Under the French treaty, if the equalization tax has been effectively paid by the Italian company, and the French shareholder is not entitled to the full tax credit refund, the equalization tax may be refunded as an alternative to payment of the tax credit. These conditions have been agreed upon on a reciprocal basis so that Italian shareholders obtain the same benefit.

The German and Dutch treaties only provide for a refund of the equalization tax. Neither Germany nor the Netherlands was able to recognize any payment of the underlying tax credit to Italian shareholders, and the only benefit granted to Dutch and German shareholders is a refund of the equalization tax.

To fully implement the Committee's recommendation, the current tax regime applicable to dividends paid to an Italian company by its EC resident subsidiary, and the regime applicable to profits that such company has produced abroad through a PE, should be almost completely revised. However, due to contradictory measures recently adopted with respect to the treatment of business income flowing from abroad, the current situation appears quite confused.[11]

For example, the legislation implementing the parent-subsidiary directive introduced a 95 percent exemption for dividends received by Italian parent companies from their EC resident subsidiaries, no equalization tax being due upon redistribution. This situation is different from the one described by the Ruding Committee since no equalization tax is levied. However, no double taxation occurs, and there is no need to implement the Committee's recommendation. It should also be noted that the treatment of dividends received from EC resident subsidiaries is different from the system adopted to avoid double taxation on intercompany flows of dividends in a domestic context, where an imputation system fully avoids double taxation.

In different circumstances, double taxation would not be solved by the measures suggested by the Committee. When the benefits of the parent-subsidiary directive are not available (for example, because of an insufficient participation or because the one year holding period is not met), only a partial exemption is granted with a partial levy of the equalization tax. In particular, dividends received by Italian companies from non-resident associated companies (holding more than 10 percent of the voting rights in the case of quoted companies, more than 20 percent in other cases) are 60 percent exempt, 40 percent being taxable. The equalization tax levied on redistribution of such dividends is approximately 8 percent of the dividends received. In this situation, the advised solution would eliminate the double taxation that arises upon the levy of the equalization tax. Unfortunately, it would not help to abolish the double taxation which amounts to the tax due on the 40 percent of the dividends which do not benefit from the exemption.

When neither the parent-subsidiary directive nor the partial exemption applies, pure double taxation occurs; for example, when dividends are received by enterprises which do not have a corporate structure or by companies which do not hold the requisite participation necessary to benefit from the partial exemption. In these cases dividends received are fully taxable in the hands of the recipient, and no equalization tax is due. Thus, the recommendation of the Ruding Committee would not produce any positive result.

These problems, however, could be resolved by adoption of provisions aimed to substantially reduce the participation threshold as prescribed by the parent-subsidiary directive and by extending the directive's application to all enterprises subject to income tax. These measures are also suggested by the Ruding Committee.

With respect to profits realized abroad by a PE of an Italian company situated in another member state, the current situation is different from the one described by the Ruding Committee, as domestic legislation and Italian tax treaties provide for an ordinary foreign tax credit method, and therefore double taxation is generally avoided. In these cases, no equalization tax is levied, as the PE's profits do not benefit from an exemption when Italy is the country of residence of the head office.

(b) *Draft directive for taking into account losses of PEs and subsidiaries situated in other member states*

European economic integration is another objective to be accomplished for the realization of the Common Market, i.e. EC-resident enterprises should be able to operate in the European context under the same conditions under which they

9. See the Ruding Report, Conclusions and Recommendations, Part III, Policy recommendations.
10. All of these treaties, with the exception of the Netherlands treaty, are effective.
11. Newly introduced measures include:
- legislative decree No. 136 of 6 March 1992 implementing the parent-subsidiary directive;
- Art. 11(14) of Law 413 of 30 December 1991 (the 1992 Finance Act), which denies the 60% exemption from IRPEG for profits from foreign associatd companies which have their fiscal residence in a tax haven;
- foreign PE's profits are traditionally treated under an ordinary foreign tax credit regime;
- profits from EC resident subsidiaries can benefit from a 95% exemption from IRPEG and from a full exemption from equalization tax (ITC Art. 96 bis);
- profits from foreign associated companies (particiation greater than 20% of the voting rights and 10% in the case of quoted companies) are only subject to IRPEG up to 40% of their total amount but are subject to equalization tax (ITC Art. 96(1);
- profits from foreign associated companies resident in a tax haven are fully subject to IRPEG but not to equalization tax (ITC Art. 96(1)bis);
- profits from foreign associated companies are fully subject to IRPEG but not to equalization tax ITC Art. 56).

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operate in a single state. Currently, the location of an enterprise's units in a foreign country usually gives rise to initial losses, and in some cases the attempt to expand to foreign markets fails.

The possibility of recovering foreign losses at the level of the head office or at the level of the controlling company would assist in obtaining a positive result. To this end, on 6 December 1990 the Commission submitted to the Council a proposal for a directive for taking into account the losses of PEs and subsidiaries situated in other member states.[12] The Commission stressed the importance of rapid approval of the directive in the Guidelines, and the Ruding Committee concurred. The matter was not covered in the Response of the Commission.

No official documents have been issued by the Council, but "rumours" from Brussels confirm that the proposal has been divided into two directives, i.e. one concerning PEs and the other concerning subsidiaries. Such a division would aim to facilitate prompt adoption of the proposed directive's provisions concerning losses suffered by PEs. The provisions of the official draft which relate to the losses of subsidiaries would, in fact, constitute the main obstacle to adoption of the directive.

The approval of the directive only with respect to losses of PEs would not create significant changes in the Italian legislation. The proposal provides for two methods which can be adopted by the member states, i.e. the credit method or the method of deducting losses and reincorporating subsequent profits. The explanatory notes to the directive clearly state that those countries which already adopt the credit method would probably maintain such method, while those countries which adopt the exemption method should implement the deduction and reincorporation method.

The system presently applicable in Italy with respect to the income of foreign PEs' provides for a credit method, although it is limited to corporate income ("IRPEG"). For the purposes of local income tax ("ILOR"), the exemption system applies.[13]

The tax courts have consistently held that as the profits of PEs which are situated abroad are exempt from ILOR, then losses suffered by such PEs should not be taken into account in determining the taxable base for ILOR purposes. In this respect, it is worth noting that Article 3 of the directive, which lists the taxes to which the enterprises of member states must be subject in order to benefit from the directive, does not mention ILOR, but only IRPEG and the individual income tax ("IRPEF").

The absence of ILOR from the list might imply that, as far as Italy is concerned, the obligations provided by the directive are limited to IRPEG and IRPEF and do not encompass ILOR. Thus, the current regime would be in line with the directive's provisions which deal with losses of foreign PEs, and implementation of the provisions contained therein would be unnecessary.

Substantial changes should be introduced if the draft directive dealing with losses is approved in its present official version, i.e. including losses of foreign subsidiaries. The same holds true with respect to the Ruding Committee's recommendation of full horizontal and vertical offsetting of losses within groups of enterprises at the national level. These major changes would be necessary in Italy due to the absence of provisions allowing groups of companies to consolidate their accounts for tax purposes.

In the absence of group relief, losses of domestic and foreign subsidiaries are usually taken into account by resident head group companies by devaluing their participation in the subsidiaries' capital. Such devaluation achieves the purpose in an effective way only with respect to participation in companies with capital represented by shares. In these cases, it is possible to benefit from the system of evaluation of participations in non-quoted shares under ITC Article 61(3)(c), which provides that in the event of a decrease in the value of the participation, the new value should be determined taking into account the capital losses resulting from a comparison of the last balance sheet approved by the issuing company with the last balance sheet approved prior to the purchase of the participation. If losses have been incurred by the subsidiary, such losses would be normally covered by a reduction of capital or a diminution of reserves. In both cases the result is a decrease in the net asset worth of the company, which would allow the capital loss to emerge upon a comparison of the two balance sheets. Thus, a sort of deduction of losses of subsidiaries is permitted.

On this point, some concern has been expressed with respect to participation in non-resident corporations, since the tax authorities have frequently expressed doubts about the truthfulness of the balance sheet of companies resident outside of Italy. These doubts, however, should not affect the situation where the Italian company holds shares in a company resident in the EC, as the implementation of the fourth company law EC directive (78/660-EC) in all member states has harmonized the principle for drawing up the profit and loss account and the balance sheet throughout the Community.

Some problems may arise, however, when the participation is in companies with capital represented by quotas or similar instruments rather than by shares. In this case, the only provision which can help Italian companies is ITC Article 66(3), which allows the deduction of an extraordinary loss when the loss of one or more goods which belong to the enterprise is ascertained on the basis of certain and precise evidence. In the case of non-in-share participations, the loss can be certainly and precisely determined only in the event of a reduction of the capital of the company to nil, with its subsequent reconstitution; the participation can be considered as lost. With respect to participations in EC resident companies, some problems arise in Dutch BVs or German GmbHs, the capital of which cannot be reduced to nil, but only to the legal minimum.

(c) *Interest/royalty draft directive*

The proposed directive on a common system of taxation applicable to interest and royalty payments made between

12. COM(90)595 final.
13. See ITC, Arts. 115 and 117.

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parent companies and subsidiaries in different member states was presented by the Commission to the Council on 6 December 1990.[14] Its adoption would serve the creation of a Common Market having the characteristics of a domestic market where the transactions between companies of different member states are not subject to less favourable tax conditions than those applicable to the same transactions carried out between companies in the same member state. Apart from the more favourable financial implications derived from abolition of withholding taxes on cross-border payments of interest and royalties, the actual benefit which might derive from adoption of the directive depends on the foreign tax credit regime in effect in the member state of residence of the company which receives the payment. Where such credit system is effectively elaborated, the withholding taxes levied in the country of the paying company may generally be recovered by the recipient company.

Major benefits may be derived by the paying company inasmuch as the amount of interest and royalties due under the financing or licensing contract is determined net of withholding taxes levied at source.

With respect to the implications of adoption of the directive, some concern may be expressed for the decrease in revenue which is likely to result. The current withholding tax rate in domestic legislation on interest and royalties paid to non-residents is, respectively, 30 percent and 21 percent. The rate is usually reduced by double tax treaties, although the reduction is rather limited compared to withholding tax rates applicable (domestically or under the treaties) in other member states. The withholding tax rate on interest in treaties with other member states is 15 percent, and for royalties, Italian treaty policy has generally preferred the insertion of a 5 percent withholding tax provision, although the 1977 OECD model provides for a zero rated withholding tax. Therefore, complete abolition of withholding taxes on such payments to non-residents would decrease Italy's tax revenue.

B. *Recommendations to harmonize corporate taxes*

Among the recommendations of the Ruding Committee relating to the harmonization of corporate taxes, one draws immediate attention, i.e. not only minimum and maximum rates are necessary, but also minimum standards need to be set for determination of the taxable base. This is a logical conclusion, since distortions cannot be avoided only by a band of rates if the tax base varies significantly from member state to member state. However, it will be difficult to determine the minimum standards for the tax base, and at what point the line with "drastic harmonization" should be drawn. Member states will probably perceive this as the final step towards full harmonization of corporate tax despite the subsidiarity principle, which was reiterated as a valid principle by the Ruding Committee.

In fact, the Commission has coldly reacted to most of the Ruding Committee suggestions to harmonize corporate tax systems. In its communication of 26 June 1992 the Commission expressed firm reservations on the recommendations concerning the harmonization of the tax base. The reservations were based on the following:

- differences in tax base rules generally have relatively little impact on the divergences in the cost of capital between the different member states;
- most of the proposed harmonization measures would have the effect of reducing the corporate tax base, which, all other things being equal, would necessitate an increase in rates;

Only a few of the Ruding Committee's suggestions were considered desirable by the Commission, i.e. those relating to the definition of taxable profits, the carry-over of foreign losses, the deductibility of pension contributions paid by or for expatriate workers and the deductibility of insurance premiums.

1. Measures for the introduction of a minimum and maximum tax corporate tax rate

As far as the creation of a uniform band of tax rates for the entire Community is concerned, major problems would arise in Italy if the Ruding Committee's suggestion to introduce a 40 percent maximum rate for corporation tax was followed. In this respect, the Ruding Committee's recommendation was probably the result of the convergence demonstrated by other member states for a reduction of the corporate income tax rates. An opposing position has been adopted by Italy, where the latest news is that the aggregate of IRPEG and ILOR has increased the burden on corporate profits from 47.8 to 52.2 percent in the last year. Again, the particular financial situation facing the Government does not allow any flexibility. In addition, the need to meet economic and financial requirements set out in the Treaty of Maastricht exacerbates the situation.

No problems should arise if the minimum 30 percent tax rate was introduced, provided that tax incentives hitherto allowed by the Community are safeguarded. To promote the development of Southern Italy, a total exemption from IRPEG for a period of ten years is granted to companies established in the Mezzogiorno area after 29 March 1986. The exemption is applicable from the date of incorporation of the company, and the incentive is maintained for equalization tax purposes, which is usually levied when the company's income has been subject to reduced taxation. ITC Article 106(2) provides that the equalization tax does not apply to companies which benefit from the above incentive.

2. Specific measures for harmonization of the tax base

The Commission made favourable comments about certain recommendations of the Ruding Committee concerning measures to be adopted with respect to determination of the tax base. It is therefore worth noting the current Italian position as the measures are likely to be implemented in the near future.

(a) *Definition of taxable profits*

The rules for determining taxable profits should under no circumstances be more favourable than rules governing the calculation of profits for accounting purposes. Italy already con-

14. COM(90)571 final.

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forms to this principle. Under Italian law taxable business income is based on the result shown by the profit and loss account, as adjusted by the provisions of the ITC. Such adjustments usually increase taxable income, if compared to business income computed according to accounting rules. Hidden incentives do not exist, and they are not likely to be introduced.

(b) *Carry-over of losses*

The carry-over of losses should be harmonized throughout the EC according to the rules set forth in the 1984 proposed directive, as amended in 1985.[15] This proposal provides that if the undertakings of a member state draw up, for tax purposes, annual accounts consisting of a balance sheet and a profit and loss account, and the result of such computation is a loss, such undertakings should be allowed to carry back their losses for three years or carry them forward for an unlimited period of time.

Adoption of the proposed directive would be welcomed by Italian enterprises, as currently the only provisions of the ITC which deal with business losses (Articles 8(3) and 102) provide that, for IRPEF or IRPEG purposes, losses derived from business activities may be carried forward for five years insofar as they cannot be set off against net taxable profits of each year.

The adoption of the 1984 directive would put the Italian legislation in line with the regimes applicable in most other member states. However, some concern may be expressed as the carry-back of losses would determine the necessity of a refund of taxes already paid in previous years. Refund procedures in Italy are particularly time-consuming, and a carry-forward procedure, if it can be utilized in the year after the losses were incurred, may be financially more convenient for the enterprise.

3. Deductibility of contributions paid to foreign pension funds by or for expatriate workers

It is suggested that the Commission take steps to ensure that contributions to pension schemes paid by or on behalf of expatriate workers are deductible for tax purposes, regardless of where the pension fund is situated.

The ITC does not appear to contain any specific provisions prohibiting such a deduction, i.e. the deduction is allowed provided the negative item of income represented by the contributions paid are related to the activities of the enterprise. This condition should be considered as fulfilled when the beneficiary of the pension is an employee of the enterprise.

When the deductibility of contributions paid by the employee is at issue, the rules set out in ITS Articles 10 and 48 provide that in general, a deduction is allowed since no distinction is made between Italian or foreign funds.[16]

III. CONCLUSION

The process of corporate tax harmonization in the EC has thus far conferred significant benefits on Italian enterprises. Over the last few years the EC Commission has emphasized the necessity for a more realistic and concrete approach, pursuing less ambitious aims with a greater degree of decision. After the adoption of the merger directive, the parent-subsidiary directive and the arbitration convention, further discussion has commenced which hopefully will lead to the adoption of the other two outstanding proposals, i.e. the losses directive and the interest and royalties directive.

Further harmonization cannot be easily forecasted, as the views of the Ruding Report and the Commission are significantly different. The few measures which the Committee of experts and the EC Commission have agreed upon are the most likely to be introduced in the near future, and should not create too many problems as far as their impact on the Italian tax system is concerned.

However, further extension of the scope of harmonization would grant to the Italian system the possibility of being in line with the high standards of other member states, and would therefore be certainly welcomed.

15. COM(84)404 final.

16. This interpretation was confirmed by the tax authorities in Ministerial Circular No. 19/3595 of 1979 and by the decision of the Central Tax Court No. 3975 of 11 May 1988. A decision of the Central Tax Court (No. 247 of 15 January 1991), in which the deduction was not allowed, was based on the restrictions to the cross-borders transfers of currency. These restrictions were subsequently abolished in observance of EC regulations, and therefore problems in this respect have been finally solved.

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IMPLEMENTATION OF THE EC MERGER DIRECTIVE

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Contents

I. Introduction
II. The Cross Border Merger
  A. Civil law provisions applicable to mergers in general
  B. Civil law regime applicable to international mergers
  C. Tax regime
III. EC Cross Border Division
  A. Civil law provisions applicable to divisions
  B. Tax regime
IV. Exchange of Shares
  A. Definition
  B. Tax regime
V. Transfer of Assets
  A. Definition
  B. Tax regime
  C. Contribution by an Italian company of the foreign PE
VI. Contribution of an Italian PE by a Non-resident Company to Another Non-resident Company
VII. Anti-abuse Provisions

I. INTRODUCTION

Directive 434/90/EEC of 23 July 1990, concerning the common system of taxation applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different member states (hereinafter "the Directive") was implemented in Italy through Legislative Decree No. 544 of 30 December 1992 (hereinafter "the Decree").[1] The new provisions constitute, on the one hand, a significant change in the internal tax regime applicable to corporate reorganizations whilst, on the other hand, they afford a welcome clarification of some underlying civil law issues regarding the legal possibility to execute international mergers and/or divisions. The provisions contained in the Decree give rise to significant discrepancies between the regime applicable to domestic and cross border reorganizations. Moreover, under certain circumstances, EC reorganizations seem to be even less favourably treated than non-EC international ones, which continue to be governed by the provisions applicable to domestic reorganizations.

This article describes the provisions contained in the Decree and outlines and discusses the above-mentioned discrepancies.

II. THE CROSS BORDER MERGER

A. *Civil law provisions applicable to mergers in general*

Mergers are governed by Articles 2501-2504 sexies of the Civil Code (some of these provisions were introduced through Legislative Decree No. 22 of 16 January 1991 to implement Directive 78/855/EEC of 9 October 1978).[2] No definition of merger is given by the Civil Code. However, a definition of merger has been elaborated by scholars[3] to include the situation where two or more companies join their structure and their assets without losing their legal personalities, even though a new entity is created in the process.

Two types of merger can be envisaged:

- the *merger by the formation of a new company*, defined by Directive 78/855/EEC as an operation whereby two or more companies are wound up without going into liquidation and transfer all of their assets and liabilities to a company that they set up, in exchange for the issue to their shareholders of shares in the new company and a cash payment, if any, not exceeding 10 percent of the nominal value of the shares so issued; and
- the *merger by acquisition*, defined by Directive 78/855/EEC as an operation whereby two or more companies are wound up without going into liquidation and transfer to another company all their assets and liabilities, in exchange for the issue to the shareholders of the company or companies being acquired of shares in the receiving company and a cash payment, if any, not exceeding 10 percent of the nominal value of the shares so issued.

B. *Civil law regime applicable to international mergers*

The civil law regime applicable to international mergers is not expressly governed by the Civil Code; in the past scholars have debated the legal possibility to execute international mergers considering the situation where a foreign incorporated company acquires an Italian company and where an Italian incorporated company acquires a foreign company.

1. Published in the *Official Gazette* No. 9 of 13 January 1993.
2. For a more detailed analysis see Maisto & Miscali, *Business Law Guide to Italy* (CCH Europe, 1992).
3. Simonetto, "Trasformazione e fusione delle società. Società costituite all'estero", in *Commentario Scialoja-Branca* (Bologna-Roma, 1976); Santagata, *La fusione tra società* (Naples, 1964); Spano, "Problemi insoluti in tema di fusione fra società", in *La riforma delle società di capitali in Italia. Studi e dibattiti, Atti del Covegno internazionale di studio sulla riforma delle società per azioni* (Milan, 1968), Vol. II; Sacerdoti, "Impresa multinazionale come gruppo di società", in *Giur. comm.* (1988), at 75; Santamaria, "La fusione di societ soggette a leggi regolatrici diverse sul progetto preliminare di convenzione della Comunità economica europea", in *Riv. Soc.*(1968), at 582.

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According to prevailing literature, the legitimacy of cross border mergers is based on:

- Article 16 of the Provisions on the Law in General according to which "aliens enjoy the civil rights attributed to citizens on condition of reciprocity and subject to the provisions contained in special statutes". This provision also applies to foreign corporate entities;
- Articles 2506 et seq. of the Italian Civil Code which recognizes the possibility for foreign corporate entities to operate within the Italian legal system;
- the non-existence of any express provision which precludes the cross border merger.

Scholars have taken the view that international mergers are possible even where the company to be acquired has its seat in Italy,[4] although it has been affirmed that such transactions were only possible so long as the foreign company was subject to Italian company law rules.[5] In any event, it is commonly agreed that shareholders of the company to be acquired are entitled to withdraw from the (acquired) company.[6] This would make the merger more difficult in certain situations, namely where the acquiring company does not own the entire capital of the acquired company.

In conclusion, cross border mergers are not prohibited under Italian civil law although it may be required that the company resulting from the merger (e.g. the acquiring company) be subject to Italian law after the merger has taken place. If this theory is correct cross border mergers could be subject to some limitations.

C. *Tax regime*

Three different tax regimes for mergers can be envisaged as a result of the implementation of Directive 434/90/EEC:

- regime for domestic mergers;
- regime for international mergers not covered by the special EC regime;
- regime for international mergers covered by the special EC regime (hereinafter referred to as "EC mergers").

1. Domestic mergers

Tax rules on mergers, other than EC mergers, are found in Consolidated Tax Act ("CTA") Article 123, which provides that the merger does not give rise to the realization or distribution of capital gains or losses on the assets of the merged companies, including inventories and goodwill (principle of neutrality).

In computing the taxable income of the acquiring company, the merger surplus entered in the balance sheet as a result of the share exchange ratio or the cancellation of the shares in the acquired companies owned by other companies taking part in the merger, is not taken into account. Additionally, no account is taken of the merger deficit entered in the balance sheet as a result of the share exchange ratio, provided such deficit does not result in a revaluation of the assets of the acquired company. On the contrary, the merger deficit resulting from cancellation of the shares in the acquired company owned by the acquiring company can be used for a tax-free revaluation of the assets of the acquired company (up to their market value), including goodwill.[7] Subsequent capital gains or losses as well as depreciation are calculated on the revalued amount.

Losses generated by the companies taking part in the merger (which can be carried forward for five years for IRPEG purposes only) can be used by the acquiring company subject to the following limitations:

(1) the profit and loss account of the company whose losses can be carried forward relating to the fiscal year prior to the resolution of merger must show revenues as mentioned in Article 2425-bis, first part no. 1 of the Civil Code, and expenses for subordinate labour higher than 40 percent of the average of the two previous years;
(2) if the test described under (1) above is satisfied, available losses to carry forward cannot exceed:
   - the net book value as shown in the last approved financial statement (or, if lower, in the interim financial statement required in merger procedures by Article 2501-ter of the Civil Code) of the company, the losses of which are carried forward without taking into account any equity contribution made during the 24-month period prior to the date of said statement;
   - if the shares or quotas of the corporation, the losses of which have to be carried forward, were owned by the acquiring company or another company involved in the merger, the losses cannot in any event be carried forward up to the amount of the devaluation of said shares or quotas taken by such company from which such shares or quotas have been purchased after the occurrence of the losses and before the merger;
   - lastly, carried forward losses cannot exceed the amount of tax-free capital gains realized as a consequence of the merger deficit.

Moreover, provisions or reserves subject to tax deferral entered in the balance sheet of the acquired company have to be included in the income of the acquiring company if and to the extent they are not entered in the balance sheet of the acquiring company.[8]

The merger will not give rise to any gain or loss for the shareholders of the acquired company, provided no cash payments are made by the acquiring company. The tax basis of the shares of the acquired company is carried over to the shares of the acquiring company allotted as a result of the merger.

4. Marziale, "La fusione delle società nella disciplina comunitaria" in *Le Società* (1986), at 980; Simonetto, *supra* note 3, at 376.
5. In particular, see Simonetto *supra* note 3 who takes the view that such merger is recognized when the foreign acquiring company is subject to Italian company rules. Such view has also been adopted by the Court of Appeal of Milan; see Decree 7 May 1974 in *Riv. Not.* (1975), III, at 584.
6. See Santamaria *supra* note 3, at 584.
7. The revaluation is allowed up to the difference of the tax basis for the company which owns the shares of the company being acquired, which are cancelled as a result of the merger, and the net book value of the company being acquired.
8. This provision does not apply to reserves which are taxed only in the case of distributions if the merger gives rise to a merger surplus or to a merger deficit resulting from the exchange ratio. However, in such a case, an amount equal to the amount of such reserves will be included in the taxable income of the acquiring company upon distribution of the merger surplus or reduction of the share capital because it is considered excessive.

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2. International non-EC mergers

The recognition and legitimacy of a cross border merger under Italian civil law should lead to the conclusion that international mergers can be effected by applying internal law rules governing mergers.[9] From the civil law viewpoint, the transfer of assets and liabilities from the acquired company to the acquiring company would be recognized so that the acquiring company would take over all such assets and liabilities without interruption. From the tax viewpoint, Article 123 does not include any restriction to its applicability to cross border mergers and does not prevent its application to non-resident taxpayers.[10]

If the assets and liabilities of an Italian acquired company are transferred to an (existing or new) Italian permanent establishment ("PE") of the foreign acquiring company, the continuity of the assets and liabilities would be recognized both for civil law and tax purposes, and Article 123 would apply. Moreover, the merger deficit resulting from cancellation of the shares in the Italian acquired company may be used for a tax-free revaluation of the assets transferred to the PE.

On the contrary, some doubts arise if:
- after the merger the acquiring company does not maintain a PE in Italy showing the assets and liabilities of the acquired company; or
- the Italian acquired company maintained assets outside Italy and such assets do not appear in the books of the Italian PE after the merger.

Under these circumstances, the assets of the acquired company which are not reflected in the books of the PE would cease to be subject to Italian tax rules. It is worth noting, however, that the circumstances under which a gain is realized for tax purposes are expressly mentioned in CTA Articles 53 and 54,[11] which do not appear to include the situation where the assets "leave" the Italian tax jurisdiction. Consequently, no taxable event would occur. It is, however, very likely that the tax authorities would nonetheless take the view that the "departure" of the assets from the Italian tax jurisdiction would amount to a taxable event under the above-mentioned Articles 53 and 54, i.e. the destination of goods to a purpose other than the business purpose of the enterprise (the assets which are no longer tax relevant in Italy would no longer be "used" for the purpose of the Italian enterprise, regardless of the fact that they remain used within the conduct of the business of the foreign enterprise). In any event, the "departure" does not necessarily give rise to taxable income, because the real value of the asset may coincide with its book value (perhaps as a result of the imputation of the merger deficit).

The same conclusion outlined above for application of Article 123 to cross border mergers should apply to mergers where an Italian company is acquiring a foreign company. In particular, a tax-free revaluation of the assets of the acquired company, up to the merger deficit, is also allowed.

3. EC mergers

(a) *Definition of EC cross border merger*

The mergers governed by the Decree include both the merger by the formation of a new company and the merger by acquisition; in the latter case no requirement is set forth regarding the number of shares of the acquired company to be held by the acquiring company at the time the merger takes place.

Based on Article 2(a) of the Directive, the Decree provides that the merger cannot give rise to a payment in cash greater than 10 percent of the par value of the securities issued by the acquiring company and received by the shareholder of the acquired company.[12]

The Decree applies to mergers in which companies from two or more
member states are involved. Such companies will be the merged companies, i.e.:
- in case of merger by acquisition, both the acquiring and the acquired companies;
- in case of a merger by formation of a new company, the companies being dissolved. In this respect, the residence and the legal status of the newly formed company appear to be immaterial.[13]

The legal status and fiscal residence of the shareholders of the merged companies is immaterial. At least one of the companies taking part in the merger must be a company resident in Italy; however, the Decree also considers the case of a merger between non-resident companies, which involves a PE situated in Italy.[14]

The Decree does not allow non-eligible companies to take part in the merger: a merger between two companies of two different member states and a non-eligible company (being an EC company not complying with the requirements set forth by the Decree or a non-EC company) is not regarded as a qualified EC merger. On the contrary, the Decree does not exclude or limit the scope of the special EC regime where a third eligible company is involved and such company is resident in the same member state where one of the other companies is resident. In this case, the EC regime fully applies to all companies taking part in the merger.

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9. CTA Art. 123.
10. Art. 123 is included in CTA Title IV, which sets out "common provisions", i.e. provisions applicable to all entities covered by the CTA itself.
11. Pursuant to CTA Art. 53, goods which are inventory and shares give rise to gross revenue upon sale for consideration, contribution to the capital of other companies, receipt of indemnities as reimbursement for loss or damage, if destined for the personal use of the entrepreneur or his relatives, upon distribution to the shareholders and if destined for purposes other than business purposes. Pursuant to CTA Art. 54, assets, other than goods which are inventory and shares, give rise to capital gains upon a sale for consideration, contribution to the capital of other companies, receipt of indemnities as reimbursement for loss or damage, if destined for the personal use of the entrepreneur or his relatives, upon distribution to shareholders, if destined for purposes other than business purposes or upon an increase of the book value of such assets.
12. The Decree refers only to the "par value of the securities" without taking into consideration the "accounting par value" which is referred to by the Directive. This concept is unknown in Italian civil law (the "accounting par value" was included in the Directive at the insistence of countries, such as Belgium, which have companies whose participation is not represented by a par value. See Thommes, "Commentary on the Merger Directive", in *Commentary on the EC Direct Tax Measures and Member States Implementation* (Amsterdam: International Bureau of Fiscal Documentation, 1991), at para. 19 referring to Belgian "Parts sociales" and German "Kuxe").
13. On the contrary, the Directive also applies where only one of the merged companies is an eligible company, the other being the newly formed company.
14. Decree Art. 1(d).

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(b) *Eligible companies*

The requirements that non-resident companies must meet in order to benefit from the special regime are set out in Article 3 of the Directive. The "subject to tax" requirement mandates that the companies involved in the eligible transactions must be subject to one of the taxes listed in Annex B to the Decree (the same as those described in Article 3 of the Directive), without the possibility of an option of being exempt. The "subject to tax" requirement is the same as the requirement in Article 2 of Directive 435/90/EEC (the parent-subsidiary directive). However, the Italian decree implementing the parent-subsidiary directive contains a more specific description of the "subject to tax" requirement where it affirms that companies benefiting from exemptions limited in time or having a territorial application are covered by the EC regime.[15]

In my opinion, the clearer definition of the "subject to tax" requirement can also be adopted for the merger directive, because it merely represents the interpretation of the Italian Government to the requirement set forth by the Directive.[16] Thus there would be no doubt that companies benefiting from the territorial exemption in the South of Italy fall within the scope of the European regime; accordingly, companies set up in Madeira which benefit from the corporate tax exemption up to the year 2011 are also eligible. However, under no circumstances would Luxembourg holding companies set up in accordance with Law of 31 July 1929 and Grand duchy Regulation of 17 December 1938 be eligible as they are not subject to or temporarily exempted from direct taxes.

As to companies resident in Italy, there exist some discrepancies between the Decree and the Directive. For example:

(1) With respect to the legal form of companies resident in Italy, Article 1, paragraph 1(a) of the Decree provides that the special regime is also applicable to cooperative companies and mutual insurance companies.[17] These forms, however, are not expressly included in the Annex to the Directive; as a consequence, it may be questioned whether they can be qualified as eligible companies by the tax legislation of the other EC countries.

(2) The Decree does not expressly consider the case where a company incorporated outside Italy is deemed to be resident in Italy for tax purposes (because its administrative seat or main purpose of business is located in Italy) and intends to benefit from the special regime granted by the Decree. Two scenarios can be envisaged:

   (a) the Decree applies only where the resident company has been set up in Italy. This interpretation would be contrary to the Directive and must be rejected;

   (b) the Decree applies to any company resident in Italy regardless of its legal form, and regardless of the fact that the company is not in one of the forms listed in the Annex to the Directive. In my opinion, this is the correct interpretation, supported by the wording of the delegation law and the CTA,[18] and by the Legislative Decree which implemented Directive 435/90/EEC.[19] Thus a company incorporated, for example, in China but deemed to be resident in Italy for tax purposes can benefit from the special regime set out by the Decree.

(3) The Decree does not require that a company resident in Italy according to Italian tax law not be considered resident outside the EC under the terms of a double taxation agreement concluded with a third state.

(4) The Decree does not consider the case where a company incorporated in Italy is deemed to be resident in another EC member state pursuant to a double taxation treaty. This would prevent application of the Decree in a merger where two companies incorporated in Italy are involved, one of which has its treaty residence in another member state.[20]

(c) *Tax neutrality of the merger*

The Decree does not expressly provide that the EC merger does not give rise to the realization or distribution of capital gains or losses on the assets of the merged companies, including inventories and goodwill (the principle of neutrality affirmed in Article 4, paragraph 1 of the Directive and in CTA Article 123, paragraph 1). This result is considered an automatic consequence of the merger itself, which need not be expressly set out in the Decree. However, based on the Directive, Article 2, paragraph 7 of the Decree jeopardizes the principle of neutrality where an Italian company is acquired by a non-resident company as long as the assets of the Italian acquired company are not attributable to or connected with an Italian PE of the acquiring company.[21]

In particular, the Decree expressly provides that items of the business which are transferred as a result of a merger become taxable if they do not form part of the PE resulting from the merger or if such items are subsequently transferred or taken away from such a PE. This rule appears to close a loophole contained in the CTA which did not expressly provide for the taxability of latent gains of assets attributable to a PE in Italy of a non-resident taxpayer, where such assets are transferred to the head office. The loophole is now eliminated but only in

15. Legislative Decree No. 136 of 6 March 1993.

16. The Delegation Law does not contain any definition of "subject to tax" in Art. 34 (relating to Directive 434/90/EEC) or in Art. 35 (relating to Directive 453/90/EEC). As a result, both Directives had to be applied pursuant to the provisions of the Directive, without any extension being allowed (Art. 2(f) of the Delegation Law). Since the Directives set forth the same requirement, in my opinion, the interpretation of the requirement will be the same in both implementing decrees.

17. The other eligible companies are joint stock companies (excluding SICAVs), limited partnerships with shares, limited liability companies and public and private entities referred to in CTA Art. 87, para. 1(b), i.e. entities resident in Italy for tax purposes, having as their exclusive or main purpose the carrying out of business activities (it should be noted that on the contrary the Directive does not set forth any specific requirement as to the purpose of such entities, provided they carry out a business activity.

18. CTA Art. 87, para. 1(a) only mentions the legal forms typical of companies set up in Italy. However, companies set up abroad but resident in Italy for tax purposes are also within the scope of CTA Art. 87, para. 1(a); if this were not the case such companies would not have been subject to tax in Italy. The Delegation Law also mentions exclusively the legal forms typical of companies set up in Italy. Such a law, however, should be interpreted to include companies set up abroad. Thus the extension of the subjective scope of the special regime to companies not taking one the legal forms listed in the Annex to the Directive is based on the Delegation Law itself.

19. Legislative Decree No. 136 of 6 March 1993.

20. This issue is common to all transactions covered by the Decree.

21. Italian tax law does not contain a definition of PE, but case law and administrative practices refer to the OECD definition.

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respect of mergers covered by the Directive so that the EC regime appears to present a less favourable treatment compared to other non-EC qualified cross border mergers.

It is not clear which criterion will be applied in determining whether or not the single assets are attributable to the PE; in other words, it is doubtful whether the entry of the assets into the PE's balance sheet would be sufficient for such assets being considered attributable to the PE. In my opinion, such "accounting criterion" may not be sufficient; the Decree often refers to an effective connection, which if interpreted according to the OECD commentary, requires that those assets be economically linked to the PE, i.e. be associated with its activity.[22]

(d) *Revaluation of the assets as a consequence of the merger deficit*

Under Article 2, paragraph 1, the higher value of the assets of the acquired company entered in the balance sheet of the acquiring company as a consequence of the merger deficit (if any) need not be included in taxable income but will not be recognized for tax purposes.[23]

It should be pointed out that Article 2 makes reference to the "merger deficit" without specifying that such deficit will result from the cancellation of the shares in the acquired company. Consequently, the deficit resulting from the exchange ratio can also be used to increase the book value of the assets of the acquired company. This constitutes a significant difference compared with the tax regime applicable to domestic and non-EC international mergers.

Article 2 of the Decree, however, provides that increases in value of the assets owned by the acquired company are not taxable as such, provided such assets are "effectively connected with a PE situated in the territory of the State or abroad, existing at the date in which the merger is effected or resulting from the merger itself". It is difficult to understand the reason for this requirement in this context, and to determine the circumstances where such requirement is not met. The only circumstance appears to be where:

- the acquired non-resident company only owns domestic (non-Italian) situs assets; and
- after the merger these assets do not constitute a PE of the Italian resident acquiring company; and
- the head offices of the acquired company and the acquiring company (to which such assets respectively relate prior to the merger and after the merger) are not considered PEs within the meaning of the Decree.

I am of the opinion, that in light of the above, in the context of Article 2, paragraph 1 of the Decree, the "effectively connected" requirement is always met.

(e) *Value for tax purposes of the assets transferred as a consequence of the merger*

Pursuant to Article 2, paragraphs 1 and 2 of the Decree the assets transferred to the acquiring company as a result of the merger maintain the same value for tax purposes that such assets had prior to the merger. If the acquiring company increases the book value because of the imputation of the merger deficit, a table will be attached to the tax return, showing the difference between the book value and the tax basis of each asset.

The value for tax purposes is the value recognized for Italian tax purposes (if the foreign acquired company has a PE in Italy or if the acquired company is resident in Italy) as well as the value recognized in applying the taxes of the state where the acquired company was a resident.[24] It is not clear what value should be taken into account where an Italian resident company acquires the Italian-situs assets of a foreign company (other than the assets relating to a PE situated in Italy) and some of these assets have two different bases, i.e. one for application of Italian taxes and the other for application of foreign taxes. This circumstance may be common for participations in Italian companies or Italian-situs real property and could depend on different evaluation rules for tax purposes[25] as well as on special reorganizations effected by the foreign company.[26]

This situation is not covered by the Directive, which only applies to assets which are either connected with an after-merger PE of the acquiring company in the state of the acquired company (Article 4) or with a pre-merger PE of the acquired company in the state of the acquiring company (Article 10). The Directive, indeed, allows the states of both the acquiring and the acquired company to tax the capital

22. This issue has been dealt with in more detail by the US Internal Revenue Service in Regulation §1.864-3, where, with reference to fixed or determinable income and capital gains, both the "asset-use test" and the "business activities test" are described. As for the asset-use test, the Regulation specifies that [§4(c)(4)] "due regard shall be given to whether or not the asset, or the income, gain or loss, is accounted for through the trade or business conducted in the United States, that is whether or not the asset, or the income, gain or loss, is carried on the books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of an item reflects the consistent application of generally accepted principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer".
It should be noted that the accounting criterion was adopted by the 1969 proposed merger directive (Art. 4, lett. b)), but was rejected in the final version of the directive.

23. It is therefore clear that there is a discrepancy between the tax regime applicable to domestic mergers versus the regime applicable to EC mergers which seems to be less favourably treated. Furthermore, if the view is taken that a cross border merger can take place without tax consequences through the application of CTA Art. 123 (i.e. according to the rules which basically govern domestic mergers), the conclusion can be reached that a cross border merger between an Italian acquiring company and a foreign non-EC acquired company is more favourably treated than an EC-qualified cross border merger.
Pursuant to Art. 2, para. 2, last sentence of the Decree, such provision (regarding the non-taxability of the revaluation of the assets as a consequence of the merger deficit) applies where the acquiring company is a company resident in Italy as well as where the acquiring company is a company not resident in Italy. In practice, however, this provision does not apply to non-resident acquiring companies because the increase in value of the assets of the Italian PEs resulting from foreign balance sheets is in any case immaterial for Italian tax purposes.

24. The value for tax purposes in the state where the asset is situated should be immaterial.

25. For instance, because of tax-free revaluations allowed by foreign countries, of extraordinary revaluations effected to offset losses (if allowed) or of different accounting rules as to the expenses to be capitalized.

26. For instance, where a foreign company having a PE in Italy has been merged into another foreign company and the latter company has increased the value for tax purposes of the assets connected with the PE as a result of the merger deficit.

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gains related to the assets which are not connected with either of the above-mentioned PEs.

As a result, the issue should be resolved exclusively on the basis of Italian legislation, which is not at all clear.[27] It seems reasonable, however, to give priority to the value that the assets under examination had for Italian tax purposes prior to the merger, regardless of the fact that such value is higher[28] or lower[29] than the value for application of foreign taxes. An official interpretation by the tax authorities would obviously be welcome.[30]

(f) *Merger of companies with PEs*

Special issues arise when one of the companies taking part in the merger has a PE abroad:

(1) *Italian acquired company with PE in the state where the acquiring company is resident*

In this case, according to Article 2, paragraph 3 of the Decree (which is based on Article 10, paragraph 2 of the Directive), the PE will be considered as if it had been disposed of at its market value, but a tax deduction will be allowed equal to the tax that (in the absence of Directive 434/90/EEC) would have been charged by the state where the PE is located.[31] Needless to say, the determination of the taxable gains in the two countries may result in different amounts as a consequence of different tax bases and, in some circumstances, of different criteria in determining the market value. Moreover, the state where the PE is located would have exempted such gains even if the Directive had not been applicable. If Article 10, paragraph 2 of the Directive and Article 2, paragraph 3 of the Decree are interpreted literally, no tax deduction would be granted in such circumstance.

(2) *Italian acquired company with PE in a third EC state*

The regime described under (1) would apply.

(3) *Italian acquired company with PE outside the EC*

Under a literal interpretation of Article 2, paragraph 3 of the Decree, the regime as described in (1) would be applicable. In my opinion, however, no deduction will be granted with respect to the tax that the state where the PE is located would have applied in the absence of the Directive: the Directive does not apply to non-EC countries, so only taxes actually paid in the non-EC countries can be credited against the tax due on the deemed disposal of the PE. As this credit would be a real foreign tax credit, the deduction will be granted only for purposes of IRPEG.

(4) *Foreign acquired company with PE in Italy*

This case has already been dealt with above: the Italian acquiring company will receive the assets connected with the PE having the same tax value. It should be mentioned that the transfer of the PE by the acquired company would have not been taxed in Italy even in the absence of the Directive; thus care should be taken in determining whether the acquired company can benefit from the tax deduction allowed by Article 10, paragraph 2 of the Directive.[32]

(5) *Foreign acquired company with PE in a third EC state*

This case is not specifically dealt with in the Directive. As far as the Directive is concerned, the last sentence of Article 2, paragraph 1 appears to be applicable in this case; thus the value for tax purposes of the PE for the acquiring company appears to be the same value recognized for tax purposes in the state of the acquired company. However, if the state where the acquired company was a resident applies Article 10, paragraph 2 of the Directive (which grants the right to tax the capital gains arising from the transfer), the value for Italian tax purposes should be the fair market value of the PE, i.e. the value which is taken into account by the state of the acquired company in computing the taxable income pursuant to the above-mentioned provision of the Directive.[33]

(6) *Foreign acquired company with PE outside the EC*

This case is not dealt with by Article 10 of the Directive. In principle, the member state of the acquired company has the right to include in the taxable income of the acquired company the difference between the market value of the assets of the PE and their value for tax purposes. As far as Italy is concerned, however, the regime described under (5) applies.

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27. According to Italian legislation, the transfer of the Italian-situs asset to the Italian-resident acquiring company does not give rise to any taxable income for the acquired company. Thus if the state of the acquired company decides to impose the tax upon such transfer, no allowance could be given for taxes that would have been paid in Italy (the deemed tax credit only applies in case of a transfer of PEs).

28. According to Italian legislation, the taxable income is determined as the commercial income, adjusted to take into account the specific criteria set out in the CTA. There is no special criterion which can be applied in the case under examination (unless the last sentence of Art. 2, para. 1 is deemed to be applicable by way of analogy). Thus in principle upon disposition of the isolated asset, there would be no difference between the amount of commercial profits and the amount of tax profits; in the absence of an ad hoc criterion, it is still doubtful whether the higher value can be taken into account.

29. As mentioned in the previous note, in principle upon disposition of the isolated asset, there would be no difference between the amount of commercial profits and the amount of tax profits; in the absence of an ad hoc criterion it is doubtful whether the tax authorities can claim an upward adjustment of taxable profits. In my view, the tax authorities can not argue that capital gain will be deemed to have been realized at the time the asset is entered in the balance sheet at the higher value, inasmuch as the value in the acquiring company's balance sheet is the same as that entered in the acquired company's balance sheet.

30. Another issue to be taken into account is the determination of the value for tax purposes of assets which in the case of disposal did not give rise to a taxable gain in the country of residence of the acquired company (e.g. shares where the participation exemption is also applicable to capital gains) or in the country of residence of the acquiring company (e.g. Italian-situs real property owned by the acquired company by more than five years, which, in the case of disposal, had been tax-exempt in Italy).

31. It is doubtful whether such deduction would be granted against ILOR as well, because in some circumstances these gains are included in taxable income for purposes of ILOR, i.e. when the PE does not have separate accounting and management. ILOR is not listed in Art. 3(c) of the Directive or in Annex B attached to the Decree, and according to Italian tax law the foreign tax credit is granted only with respect to IRPEG. In my opinion, excluding ILOR from the scope of the deduction provision would be contrary to the spirit of the Directive as set forth in the preamble; however, it is likely that such exclusion will be affirmed by the tax authorities.

32. It should be noted that the applicability of foreign taxes does not allow a step-up in basis of the assets connected with the PE.

33. Art. 10, para. 2 is mainly applicable in the member states which use the credit method in taxing income of the PE. With respect to states which use the exemption method, the value for tax purposes should be the fair market value at the date of the transfer; in this way the value of the PE for Italian tax purposes would be made independent from the method adopted in the member state of the acquired company.

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(7) *Merger between non-resident companies where the acquired company has a PE in Italy*

In this case, there would be no taxation in Italy, but the assets of the PE maintain their pre-merger value for tax purposes.

(g) *Merger of companies with foreign-situs assets not connected with PEs*

Neither the Directive nor the Decree expressly take into account the tax regime applicable to the difference between the real values of foreign-situs assets not constituting a PE (and not connected with either a pre-merger PE of the acquired company or with a post-merger PE of the acquiring company situated in the member state of the acquired company) and their values for tax purposes. The following scenarios can be envisaged:

(1) *The acquired company is a resident in Italy*

In this case, the solution depends on the connection of the foreign-situs asset with the PE situated in Italy which comes into existence after the merger has taken place. If the asset is related to such a PE, no taxation arises in Italy; otherwise it would be considered as disposed of at its market value and taxed accordingly. The problem is whether the connection is to be determined on an actual basis (i.e. operative connection) or whether it is sufficient that the foreign-situs asset results from the accounting books of the PE. As mentioned above, an operative connection is required (the Decree in fact requires that assets be "effectively" connected with the PE).

(2) *The acquiring company is a resident in Italy*

This case would not give rise to substantial issues from an Italian tax perspective. It should be mentioned, however, that if the state where the acquired company is a resident applies the tax on the difference between the real value and the tax value of the asset being transferred, the tax value of the asset for the acquiring company will be the real value.[34]

(3) *Neither the acquiring nor the acquired companies are resident in Italy and the asset is located in Italy*

In this case, according to Italian tax law no taxation would arise in Italy (even if the asset is not connected with a PE in the state of the acquired company).

(h) *Provisions or reserves subject to tax deferral*

Pursuant to Article 3 of the Decree (based on Article 5 of the Directive), provisions or reserves subject to tax deferral entered in the balance sheet of the acquired company must be included in the income of the acquiring company if and to the extent they are not entered in the accounting books of the PE situated in Italy of the acquiring company.

(i) *Carry-forward of losses from previous years*

Pursuant to Article 4 of the Decree (based on Article 6 of the Directive), losses generated by the Italian resident acquired company can be used by the foreign acquiring company under the limitations set out in CTA Article 123, paragraph 5 in proportion to the difference between the assets and liabilities effectively connected with the PE in Italy and up to such difference.

(j) *Allotment of shares to the shareholders of the acquired company*

Consistent with the general principle governing domestic mergers, the allotment of shares representing the capital of the acquiring company to a shareholder of the acquired company in exchange for shares representing the capital of the latter company, does not give rise to any taxation in the hands of that shareholder.[35]

The value for tax purposes of the cancelled shares will constitute the tax basis of the shares received by that shareholder. Cash payments must be included in the taxable income of the recipient shareholders. The wording of the Decree does not seem to allow a different interpretation: the gross amount of the cash payment will be taxable, so the tax basis of the shares received will be exactly equal to the tax basis of the shares cancelled, as if no payment had been made.

This result is illogical since it could lead to a tax value of the shares received being even higher than the market value of the shares themselves. Such would be the case of a merger between two companies (A and B) each having a share capital (and net worth) of 100, wholly constituted by cash. Assuming that each company is owned by one shareholder (respectively, X and Y) having a participation of the value of 100, after the merger by acquisition of B by A, Y would receive shares in A for 90 and a cash payment for 10. If the gross amount of the cash payment is taxed, the value of the shares received will remain 100. In this case, the shareholder will evaluate the participation for tax purposes as 100, while the actual value of such participation is 90. Moreover, according to Italian tax law, the cash payment should not be deemed consideration for the disposal of the shares but should fall within the category of income from capital, as income from participation in companies.[36] Thus such income, being fully taxable, will be considered as distributed profit even if the company does not have any profit to distribute.

Due to such qualification, it can be affirmed that if a cash payment is made by a company resident in Italy:

- the company which makes such a cash payment should apply the dividend withholding tax;
- EC companies, which can be considered as parent companies of the acquiring company (after the merger has been effected), should be exempted from the dividend withholding tax;

34. The taxation, if any, in the state where such asset is located is immaterial in determining the value for tax purposes of such asset under Italian law. However, in such a case the tax basis of that asset in the third state for the acquiring company will be the value on the basis of which the capital gains had been determined.
35. Decree Art. 2, para. 5; Directive Art. 8, para. 1.
36. Such income is referred to in CTA Art. 44, the application of which in case of cash payments is expressly affirmed by Legislative Decree No. 543 of 30 December 1992, which sets out the tax regime for domestic divisions (the nature of the cash payment is common among the different transactions).

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- with respect to other persons resident in treaty countries, the withholding tax must not exceed the rate provided for in the dividend article;
- Italian resident recipients (and, under some circumstances, persons resident in France and the United Kingdom) can benefit from the dividend tax credit.

On the contrary, cash payments made by companies not resident in Italy for tax purposes are subject to the following regimes (such payments will always be exempt from ILOR):
- if received by individuals or transparent entities, the payments will be included in full amount in taxable income;
- if received by companies which do not qualify as affiliate companies (e.g. they hold less than 20 percent of the voting rights of the paying company, or 10 percent if the latter is a listed company), the payments will be fully subject to IRPEG;
- if received by companies which qualify as affiliate companies, only 40 percent of such payments will be subject to IRPEG;
- if received by companies which qualify as parent companies, only 5 percent of such payments will be subject to IRPEG.

It is worth noting that all of these issues would not exist if the cash payment had not always been considered as fully taxable. In the above example, for instance, it is clear that the cash payment constitutes a reimbursement of the share capital which should not be taxable. On the contrary, if company B's net worth would have been constituted by 90 share capital and 10 retained earnings, it would have been reasonable to consider the cash payment as paid out of company B's retained earnings.

III. EC CROSS BORDER DIVISION

A. *Civil law provisions applicable to divisions*

The civil law regime of divisions is governed by Articles 2504 septies-2504 decies of the Civil Code, which have been enacted to implement Directive 82/891/EEC of 17 December 1982 ("the Sixth Directive"). As for mergers, Italian law gives no definition of division. However, in line with the provisions of the law, doctrine has defined a division as the operation whereby the net worth of a company is split into parts to be transferred to two or more existing or new corporations.

Three types of division can be envisaged:
- *division by the formation of new companies*, defined by Directive 82/891/EEC as the operation whereby, after being wound up without going into liquidation, a company transfers to more than one newly-formed company all of its assets and liabilities in exchange for the allocation to the shareholders of the company being divided of shares in the recipient companies, and possibly a cash payment not exceeding 10 percent of the nominal value of the shares allocated;
- *division by acquisition*, defined by Directive 82/891/EEC as the operation whereby, after being wound up without going into liquidation, a company transfers to more than one company all of its assets and liabilities in exchange for the allocation to the shareholders of the company being divided of shares in the companies receiving contributions as a result of the division ("recipient companies"), and possibly a cash payment not exceeding 10 percent of the nominal value of the shares allocated;
- *division by acquisition combined with a division by formation of one or more new companies.*

It is worth noting that under Italian law partial divisions are allowed, i.e. divisions where the company being divided does not cease to exist, and only part of its assets is distributed to the recipient(s) company(ies). Moreover, in accordance with Directive 82/891/EEC Italian law permits shares in the recipient companies to be allocated to the shareholders of the company being divided otherwise than in proportion to their rights in the capital of that company (see below). The Civil Code rules on divisions do not expressly govern cross border divisions. However, no rules or principles appear to exclude that this is possible under the existing civil law regime (the legal arguments for supporting the legitimacy of international divisions are primarily the same used in the past to uphold the recognition of cross border mergers).[37]

B. *Tax regime*

As a result of the implementation of Directive 434/90/EEC, three different tax regimes for divisions can be envisaged:
- regime for domestic divisions;
- regime for international divisions not covered by the special EC regime;
- regime for international divisions covered by the special EC regime (hereinafter referred to as "EC divisions").

Such regimes can be combined even in the framework of the same transaction.

1. Domestic divisions

Tax rules concerning divisions, other than EC divisions, are found in CTA Article 123-bis, which was introduced through Legislative Decree No 543 of 30 December 1992, enacted simultaneously with the Legislative Decree implementing the merger directive.

Art 123-bis provides that a division (total or partial) does not give rise to the realization or distribution of capital gains or losses on the assets of the company being divided, including inventories and goodwill (principle of neutrality). In computing the taxable income of the recipient companies, the division surplus entered in the balance sheet as a result of the share exchange ratio or the cancellation of the shares in the divided company owned by the recipient company, is not taken into account. Nor is account taken of the division deficit entered in the balance sheet as a result of the share exchange ratio, provided that such deficit does not result in a revaluation of the assets of the company being divided.

37. See II.B. above.

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On the contrary, the division deficit resulting from the cancellation of the shares in the company being divided owned by the recipient company can be used for a tax-free revaluation of the assets of the former company (up to their market value), including goodwill. Subsequent capital gains or losses as well as depreciation are calculated on the revalued amount.

Losses generated by the companies taking part in the division operation (which can be carried forward for five years for IRPEG purposes) can be used by the companies taking part in the operations subject to the same limitations established in case of merger.[38] Moreover, provisions or reserves subject to tax deferral entered in the balance sheet of the company being divided must be included, in proportion to the net worth of such company received by any recipient company, in the income of the recipient companies if and to the extent they are not entered in the balance sheet of such latter companies.

As to the shareholders of the divided company, the division does not give rise to any gain or loss provided no cash payments are made by the receiving company (or companies). The tax basis of the shares of the divided company is carried over to the shares of the receiving company (or companies) allotted as a result of the division.

Italian tax law therefore affords neutrality to both partial and total divisions but expressly provides that the tax benefits under Legislative Decree No. 543 will not apply to divisions which give rise to a transfer of assets not constituting a branch of activity and to divisions whereby the attribution of the shares of the recipient companies does not maintain the proportionality between the shareholders of the divided company.[39]

It is not clear, however, what benefits the law is referring to: the revaluation of the assets of the divided company in the books of the recipient companies or more extensively the neutrality of the division itself (latent gains attached to the assets of the divided company do not constitute a taxable gain and the shares of the recipient companies assigned to the shareholders of the divided company do not give rise to a taxable event).

2. International non-EC divisions

The tax rules in CTA Article 123-bis do not expressly govern cross border divisions; however, since a cross border division is recognized for civil law purposes, there is no reason to exclude cross border divisions from the scope of the article. This conclusion gives rise to a puzzling situation, and to a situation where the EC regime may be less favourable than the regime applicable to non-EC cross border divisions.

The issues arising in respect of the tax regime of such divisions are the same described above for international non-EC mergers.[40]

3. EC divisions

The divisions governed by the Decree include both the division by the formation of a new company and the division by acquisition (a combination of such types of division is also recognized). Such divisions, however, are total. Moreover, the shares in the recipient companies must be allocated to the shareholders of the company being divided in proportion to their rights in the capital of that company. Consequently, any partial division or division in which the shares of the recipient companies are allocated between the shareholders in a non-proportional way do not fall within the scope of the EC tax regime.

The EC regime is only applicable where the share of the net worth of the divided company to be transferred to each recipient company is constituted by a business or by an independent part of the business. In this respect, the division operation which implies the transfer of a branch of activity to some recipient companies only does not appear to fall within the scope of the Decree.[41]

Based on Article 2(b) of the Directive, the Decree provides that the division cannot give rise to a payment in cash greater than 10 percent of the par value of the securities issued by the recipient companies and received by the shareholders of the divided company. The Decree applies to divisions in which companies from two or more member states are involved. Such companies are the divided company and at least one of the recipient companies; the legal status and fiscal residence of the shareholders of such companies are immaterial. At least one of the companies taking part in the division must be a company resident in Italy. However, the Decree also considers the case of a division between non-resident companies, where a PE situated in Italy is involved.[42]

The Decree specifies that the EC transnational character of the division must be verified for each recipient company. This requirement is not met where both the divided company and one of the recipient companies are resident in Italy. In such a case, the EC regime is applicable only to the portion of the net worth transferred to the recipient company which satisfies the EC transnational character.[43]

With respect to the Italian resident recipient company, the ordinary regime set forth in CTA Article 123 bis applies. Thus within the framework of the same division operation, different tax regimes will be applicable: the EC regime for the portion of the net worth transferred to the non-Italian resident recipient company and the domestic regime for the portion of the net worth transferred to the Italian resident company.

The rules described for cross border mergers also apply in respect of the eligibility requirements for companies taking part in the division, and in respect of the tax regime.

38. See II.C. above. The law clarifies that the provisions dealing with the acquiring companies will be applied with respect to the recipient companies, while the provisions dealing with the acquired companies will be applied with respect to the company being divided.
39. CTA Art. 123-bis, para. 11.
40. See II.D. above.
41. It should be noted that the determination of the existence of a business constitutes an issue of fact, which in the past, with respect to registration tax issues, gave rise to significant problems and to extensive case law.
42. Decree Art. 1(d).
43. This is a significant difference compared to the tax regime of EC mergers which, provided that at least one acquired company is resident in another member state, also applies to the transfer of assets from an Italian resident acquired company to the Italian resident acquiring company.

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IV. EXCHANGE OF SHARES

A. *Definition*

Article 2(d) of the Directive defines an exchange of shares as "an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the latter company, in exchange for their securities, of securities representing the capital of the former company, and, if applicable, a cash payment not exceeding 10 percent of the nominal value, or in the absence of the nominal value, of the accounting par value of the securities issued in exchange".

The Decree also provides a definition of the transactions which fall under the EC regime applicable to the exchange of shares. Article 1, paragraph 1(e) of the Decree refers to "exchanges and contribution of shares or quotas through which one of the persons listed in paragraph a) (e.g. a qualified EC company) acquires or integrates a controlling participation according to Article 2359, paragraph 1, no. 1 of the Civil Code[44] in one of the persons listed in the same letter residing in a different member state, attributing to the participants its own shares or quotas in exchange for those received in exchange or contribution and, if applicable, a cash payment not exceeding 10 percent of the nominal value of the latter shares or quotas, provided that at least one of the participants to the transaction is a resident in the territory of the state or the participation exchanged is connected with a PE in Italy of a person listed in paragraph a)" (e.g. a qualified EC company)".

The Decree therefore appears to give a more precise scope of application to the EC exchange of shares. For example:

- the exchange must result in a company acquiring or integrating control of the voting rights of another company. The first situation arises when the acquiring company does not own any participation prior to the exchange, or when such company already owns some shares or quotas of the acquired company prior to the date when the exchange takes place but such shares or quotas do not constitute a controlling participation. The second situation (integration) includes the situation where the beneficiary company owns the majority of the shares or quotas prior to the exchange of shares – the transaction simply integrates (or reinforces) control;
- the cross border requirement of the transaction is met if both the acquired and the acquiring companies are eligible companies and they are resident of different member states.[45] In this respect, the residence and legal status of the shareholders of the acquired company are immaterial. However, at least one of such shareholders (the participants) must be resident in Italy for tax purposes.[46] If this requirement is met, the EC regime is applicable to any participant, including non-Italian resident participants.[47] On the contrary, if no participant is an Italian resident person, the Decree is not applicable and the ordinary taxation rules will apply. Thus, for instance, the acquisition by a French company of a holding in an Italian limited liability company which is owned by a Dutch company may give rise to taxable income in Italy of the Dutch company: this result is clearly contrary to the Directive, which provides for an unlimited obligation to exempt such gain (i.e. not solely with regard to gains realized in the state of residence of the participant);
- the cross border requirement is also met if the acquired shares are connected with a PE situated in Italy of an eligible non-resident company (participant);
- it is not necessary for the acquiring company to issue new shares, i.e. it is possible to assign existing shares in exchange for the shares or quotas received;
- the exchange can give rise to a cash payment which cannot exceed 10 percent of the par value of the shares or quotas of the acquiring company to be assigned to the shareholders of the acquired company.

B. *Tax regime*

According to domestic tax law, income from the disposal of shares[48] realized by a resident taxpayer is subject to different regimes depending on the status of the taxpayer. If the taxpayer is other than an entrepreneur, the gain falls in the category of miscellaneous income and is taxed at a flat rate of 25 percent. However, in case of a disposal of "small participations" (e.g. participations representing less than 2, 5 or 15 percent of the capital of the company whose shares are sold, depending whether such company is a listed company, a non-listed joint stock company or any other company), the gain is calculated on a percentage of the sale price (or, in case of transfer to the capital of a company, the real value), which for non-listed companies is equal to 7 percent. Moreover, the tax is applicable at the flat rate of 15 percent, so that the actual tax in case of a disposal of small participations in non-listed companies is equal to 1.05 percent of the sale price (or the real value). Such regime is also applicable to non-resident persons (both natural and legal) not having a PE in Italy. However, no tax will be levied by Italy to the charge of non-resident persons upon disposal of shares whose certificates are not physically located in Italy at the time of the disposal.[49]

44. Pursuant to Art. 2359, para. 1, no. 1 of the Civil Code, the following are considered controlled companies: "companies in which another company, by virtue of the shares or quotas held, has the majority required for resolutions of the ordinary shareholders' meeting".
45. See II.E.2. above. It follows that if an Italian company contributes the controlling shareholding of a Swiss resident company to a Dutch company, the regime set forth for an EC exchange of shares would not be applicable.
46. This requirement confirms that an exchange of shares may involve more than one participant. Thus, for instance, the acquiring company might increase its capital and receive from various persons shares which, taken as a whole, constitute a controlling interest in an EC company residing in another member state.
47. For example, if an Italian company, owned by an individual resident in Italy and by a 1929 Luxembourg holding company is acquired by a French company, the EC regime is applicable to the 1929 Luxembourg holding company. If, on the contrary, the Italian company is fully owned by the 1929 Luxembourg holding company, the EC regime will not apply. It is difficult to understand the reason for this different treatment, which does not appear to be allowed by the Directive.
48. Pursuant to CTA Art. 9, para. 5, for income tax purposes, the provisions relating to the transfer for consideration also apply to transfers to the capital of companies. Moreover, in case of such transfers, the gains are determined as the difference between the real value of the shares and their last value for tax purposes.
49. CTA Art. 123, para. 1(f).

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If the taxpayer who disposes of the shares is a resident entrepreneur (including a PE in Italy of a non-resident person), income from the disposal of shares is always included in taxable income and subject to IRPEG and ILOR at the cumulative rate of 52.2 percent. However, if the taxpayer does not have the purpose of purchasing and selling participations in other companies or entities and the participation to be disposed of is not constituted by shares, the taxation of such income can be spread over a maximum period of five years.

If the Decree applies, any income or gain realized by a resident taxpayer does not constitute taxable income, but the value for tax purposes of the participation disposed of is carried over to the shares of the acquiring company received in exchange.[50] It should be noted that:

- the Decree does not require that the shares of the acquiring company be entered in the accounting books of the participant entity at the same value recognized for tax purposes. Such shares can be entered at their real value, so the exchange of shares may give rise to income recognized for civil law purposes only: upon distribution of such income, an equalization tax liability may arise;
- the Decree does not require that the tax basis of the acquired shares for the acquiring company be the same as that recognized for the participants. Thus the value for tax purposes for the acquiring company is the real value of the shares acquired.

If a cash payment is made by the acquiring company, the amount received is fully taxable in the hands of the recipient.[51] If the recipient is an entrepreneur, resident in Italy, the amount received is taxable in the year received or in five years, depending on the business purpose of the recipient and on the legal form of the participated company. The shares received maintain the entire value for tax purposes of the shares disposed of, as if the cash payment had not been made.[52]

If the recipient, a resident of Italy, is other than an entrepreneur, the amount received falls in the category of miscellaneous income and is taxed accordingly.[53] If the recipient is a non-Italian resident, in most cases the cash payment is exempt from Italian tax under the terms of the relevant double tax treaty, if any.

V. TRANSFER OF ASSETS

A. *Definition*

Pursuant to Article 1(c) of the Decree, the provisions contained in the Decree are also applicable to a "contribution of a business or of an independent part of business from one to another person referred to in letter a) (the eligible companies), provided that one of the two persons is resident in Italy for tax purposes". The Decree defines the transfer of assets as the transfer of a business (*azienda*) or of an independent part of a business. Article 2555 of the Civil Code defines the azienda as "an aggregate of property organized by an entrepreneur for the conduct of an enterprise".[54] A going concern is therefore a complex of assets forming an autonomous whole through which the enterprise may be conducted. In this respect the definition is similar to the one contained in Article 2(i) of the Directive, where it refers to "all the assets and liabilities of a division of a company which from an organizational point of view constitute an independent business, that is to say an entity capable of functioning by its own means".[55]

To benefit from the special EC regime, the transfer of assets must take place between eligible companies from two different member states,[56] provided at least one company is a resident in Italy for tax purposes. This requirement is also met where a non-resident company contributes its Italian PE to the capital of an Italian resident company (so called "incorporation of the PE").

B. *Tax regime*

1. Non-EC transfer of assets

Capital gains on the contribution of a business by an Italian resident company are taxed in Italy at ordinary income tax rates (IRPEG and ILOR). Capital gains are computed by deducting the depreciated cost of the business from its real values. Such gains are always taxable, but they may be included, at the taxpayer's option, in their entire amount in the year in which they are realized or in equal instalments in the current and in the following fiscal years, but not exceeding the fourth.[57] Capital gains could be offset against losses carried forward. The acquiring company may calculate

50. Decree Art. 2, para. 5.
51. CTA Art. 2, para. 5.
52. See II.E.10.
53. The tax regime to be applied depends on the amount of the participation disposed of, considering the cash payment as proportionally shared by all shares (or quotas) disposed of. In other words, it is not possible to consider that the cash payment represents the full consideration for the disposal of some shares only (whose amount can be determined in proportion of the ratio between the cash payment and the real value of the shares disposed of).
54. Contracts of sale of a business must be evidenced in writing. The seller has an obligation not to compete with the buyer for a period of five years (Art. 2557 of the Civil Code). Unless otherwise agreed, the buyer succeeds to contracts stipulated for the conduct of the business that are not of a personal nature. However, the third contracting party may withdraw from the contract within three months from the date of notice of the transfer if there is just cause, but in such case the liability of the seller is unaffected. Analogously, the assignment of claims and receivables pertaining to the business is effective against third persons if and when they are notified of the transfer (Art. 2559 of the Civil Code). The seller is not released from debts incurred in the operation of the business prior to the sale, unless it is shown that the creditors consented to such release (Art. 2560 of the Civil Code).
The rules that apply in case of sale of a business also apply in a contribution of a business. The Italian Civil Code does not provide for any specific regulation concerning the contribution of a business, i.e. it is regulated by general provisions on contribution in kind to a company as set forth by Arts. 2342 (contribution) and 2343 (appraisal of contributions in kind).
As to labour law issues, in the case of transfer of a business, employment contracts continue with the buyer, and the employee retains the right arising from the seniority attained by him prior to the transfer (Art. 2112 of the Civil Code). Moreover, the trade union bargaining units of both the seller and the purchaser and the trade associations must be notified of the transfer of a business in which more than 15 persons are employed at least 25 days prior to the date of the agreement.
55. See *supra* note 39.
56. See II.E.2. above.
57. CTA Art. 54, para. 4.

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depreciation on the real value of the assets included in the business received. For the first year, depreciation is reduced by one-half. Anticipated depreciation may be taken only for the first year in an amount equal to the ordinary depreciation; thus for the first year the maximum depreciation to be deducted is equal to the full ordinary amount. Acquired goodwill may be depreciated over five years.[58]

2. EC transfer of assets

Pursuant to Article 2, paragraph 2 of the Decree, the transfer of assets does not give rise to any taxable gain (or loss), provided the value for tax purposes of the business transferred is carried over to the shares received in exchange for the transfer. If the transferor company is resident in Italy (contributing assets other than foreign PEs), the regime is only applicable with respect to the assets which after the transfer will be effectively connected with a PE in Italy of the recipient company.[59]

The Decree, however, does not prevent such shares from being entered in the accounting books of the transferor at their real value at the time of disposal. The difference between the real value and the book value of the assets transferred will be entered in an ad hoc reserve, which is taxable (for IRPEG and ILOR purposes) upon distribution to the shareholders (or upon actual realization of the gain, through the disposal of the shares received).

As far as the recipient company is concerned, the assets included in the business received as a result of the transfer of assets maintains the same value for tax purposes that such assets had prior to the transfer. If the recipient company records such business at its real value, a table is to be attached to the tax return showing the differences between the book value and the tax basis of each asset.[60] Consequently, the same gain may be taxed both in the hands of the transferor company (upon disposal of the shares received) and in the hands of the recipient company (upon disposal of the business received), whilst in the absence of the Directive such gain would have been taxed only once in the hands of the transferor company (this is a typical case of economic double taxation).

No special rules are provided for the tax basis for depreciation, so the ordinary rules should apply.

C. *Contribution by an Italian company of the foreign PE*

If a company resident in Italy contributes to the capital of another EC (non-Italian) company a PE situated in a member state other than Italy, the PE is considered as if it had been disposed of at its market value, but a tax deduction is allowed equal to the tax that (in the absence of Directive 434/90/EEC) would have been charged by the state where the PE is located.[61] The capital gain arising from the deemed disposal of the PE will be exempt from ILOR (provided the PE has separate accounting and management).

In such a case, the tax basis of the shares received in exchange for the transfer of the PE will be increased by an amount equal to the taxable income corresponding to the tax actually due after deduction of the foreign deemed tax (the amount of the tax due will be multiplied by 2.778). If a company resident in Italy contributes to the capital of another EC (non-Italian) company a PE situated outside the EC, Article 2, paragraph 6 of the Decree does not apply. Only taxes actually paid in the non-EC countries may be credited against the tax due upon the deemed disposal of the PE. Moreover, although not specifically affirmed, in this case the value for tax purposes of the shares received in exchange for the transfer of assets should be the real value of such PE, as if no (actual) foreign tax credit had been granted.

VI. CONTRIBUTION OF AN ITALIAN PE BY A NON-RESIDENT COMPANY TO ANOTHER NON-RESIDENT COMPANY

This transaction is specifically covered by Article 1(d) of the Decree. The same regime described under transfer of assets applies.[62]

VII. ANTI-ABUSE PROVISIONS

The Decree does not contain an anti-abuse provision. The lack of anti-abuse provisions is very likely due to a lack of coordination of the provisions contained in the delegating law. Indeed, Article 34 of the delegating law empowered the Government to enact ad hoc rules implementing the Directive,[63] and introduce a tax regime applicable to (domestic) divisions.[64]

The first paragraph of Article 34 did not contemplate an anti-abuse provision while paragraph 2 contained a reference to anti-abuse provisions as follows:

> "non-application or revocation of the tax benefits regarding the mergers, divisions or exchange of shares if such transactions between companies or persons of different member states are effected without valid economic reasons and with the exclusive purpose of obtaining fraudulently a tax saving".

This provision focused on the transactions contemplated by the Directive but was wrongly included in the delegation law regarding domestic divisions. Consequently, the delegation law did not grant any power to the Government to enact anti-abuse provisions connected with the transactions contemplated by the Directive.

The issue now arises as to whether anti-abuse provisions in other statutes may apply to the transactions contemplated by the Directive. In particular, an anti-avoidance provision

58. CTA Art. 68, para. 3.
59. Decree Art. 2, para. 7.
60. As for the determination of the value for tax purposes, see II.E.5.
61. Decree Art. 2, para. 6 which is based on the Directive Art. 10, para. 2.
62. Decree Art. 2, para. 2.
63. Delegating Law Art. 34, para. 1.
64. Delegating Law Art. 34, para. 2.

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which may be applied is Article 10 of Law No. 408 of 28 December 1990, which stipulates that the tax offices have the power to disallow for fiscal purposes the portion of the cost of acquisition of the participation or any other tax advantage obtained in connection with mergers, concentrations, transformations, divisions and capital reductions carried out without valid economic reasons and for the sole purpose of fraudulently obtaining a tax saving. This provision may be deemed to be applicable to the operations falling within the scope of the Directive; indeed, the scope of such provisions is even more stringent than the scope of the EC anti-abuse provision.[65]

65. Directive Art. 11."A member state may refuse to apply or withdraw the benefit of all or any part of the provisions of Titles II, III and IV where it appears that the merger, division, transfer of assets or exchange of shares ... has as its principal objective or as one of its principal objectives tax evasion or tax avoidance; the fact that one of the operations referred to in Article 1 is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives."

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

SEPTEMBER 1993

Interpretation of Tax Treaties, Amsterdam, 13-14 September 1993 (English):
IBFD, International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel. 31-20-626 7726, Fax: 31-20-620 9397.

Treaty shopping workshop, Monte Carlo, 13-14 September 1993 (English):
Elizabeth Husband, ITPA Conference Liaison Office, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-62910, Fax: 44-732-63762.

UK and International Oil and Gas Taxation, London, 16-17 September 1993 (English):
IIR Ltd., 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1DD, England, Tel.: 44-71-412 0141, Fax: 44-71-412 0145.

Tax Effective Management of an International Treasury, London, 27-28 September 1993 (English):
Vicki Ashworth, IBC Financial Focus Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-823-321300, Fax: 44-823-333474.

OCTOBER 1993

47th Annual IFA Conference, Florence, 3-8 October 1993; main subjects: interpretation of double taxation conventions, non-discrimination rules in international taxation (English, French, German, Spanish):
Secretary of the Conference, STRUMENTI, c/o ENIC, via Santa Caterina d'Alessandria 12, 50129 Florence, Italy, Tel.: 39-55-474737, Fax: 39-55-475037.

An Introduction to U.S. International Taxation. London, 11-12 October 1993 (English):
The American Tax Institute in Europe, Falmer Court, London Road, Uckfield, East Sussex, TN22 1HN, England. Tel.: 44-825-760 901, Fax: 44-825-760 903.

Tax Planning in the Changing Environment, London, 14 October 1993 (English):
Michelle Beard, Ernst & Young, Rolls House, 7 Rolls Building, Fetter Lane, London EC4A 1NH, England.

EC Corporate Tax Directives, Amsterdam, 14-15 October 1993 (English):
IBFD, International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The International Tax Implications of NAFTA for European and Asian Companies Investing in Mexico, the US and Canada, London, 25-26 October 1993 (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Taxation Management Techniques, Brussels, 25-26 October (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

Tax-efficient corporate organization, Amsterdam, 27-29 October 1993 (English):
Marion Oakley, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, England, Tel.: 44-71-779 8601, Fax: 44-71-779 8599.

NOVEMBER 1993

Asset Protection Planning/Asset Protection Trusts, New York City, 1-2 November 1993 (English):
International Bussiness Communications USA Conferences, Inc., 225 Turnpike Road, Southborough, MA 01772-1749, U.S.A., Tel.: 508-481 6400, Fax: 508-481 7911.

Offshore Trust Services, New York City, 3-4 November 1993 (English):
International Business Communications USA Conferences Inc., 225 Turnpike Road, Southborough, MA 01722-1749, Tel.: 508-481 6400, Fax: 508-481 7911.

The Legitimate Uses of European Tax Havens, Malta, 29-30 November 1993 (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

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IMPLEMENTATION OF THE PARENT-SUBSIDIARY DIRECTIVE

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Contents

I. Introduction
II. Outbound Dividends
A. Domestic law
B. Tax treaties
III. Inbound Dividends
A. Domestic provisions
B. Tax treaties
IV. The Parent-Subsidiary Directive
A. Entities to which the Decree applies
B. Participation and holding period
C. Transactions to which the Decree applies
D. Outbound dividends
E. Inbound dividends
F. Anti-avoidance provisions
G. Effective date

I. INTRODUCTION

The parent-subsidiary directive[1] requires member states to generally eliminate withholding taxes on profit distributions by a subsidiary to its parent company, and to provide relief from double taxation for the parent either by the credit or the exemption method. Under Law 142 of 19 February 1992 the Italian Government was authorized to issue a Legislative Decree necessary to implement the parent-subsidiary directive. Decree No. 136 was issued on 6 March 1993,[2] and it radically alters the taxation of dividend streams between Italian companies and companies of other EC states.

This article summarizes the taxation of cross border dividends before the directive was implemented, and then examines the new measures dealing with the tax treatment of such dividends.

II. OUTBOUND DIVIDENDS

A. *Domestic law*

Dividends paid by an Italian company to a non-resident shareholder are subject to a final withholding tax of 32.4 percent, unless a tax treaty provides otherwise.[3]

Italy applies an imputation system to eliminate the double taxation of dividends for resident taxpayers who receive dividends from resident companies.[4] Under the imputation credit mechanism, a resident taxpayer is entitled to a dividend tax credit which is equal to 9/16 of the dividend received. The credit corresponds to the corporate income tax paid by the distributing company, and is credited against the taxpayer's final tax liability. A non-resident shareholder, however, may not avail himself of the benefits of the Italian imputation mechanism, although he is entitled to a refund of the tax paid abroad on the dividends received if he provides proper documentation (which must be issued by the tax authorities) that he in fact paid a final tax on the dividends.[5] The refund is equal to two-thirds of the withholding tax levied in Italy, resulting in an effective Italian dividend tax of at least 10.8 percent.

To prevent a resident shareholder from claiming a tax credit in respect of dividends derived from income which was not subject to corporate income tax, or subject to tax at a rate lower than the 36 percent corporate rate, an equalization tax is applied at the company level to equalize the amount actually paid with the shareholder's tax credit. The equalization tax is levied at the rate of 56.25 percent of the excess of the amount distributed to the shareholder from the tax year's earnings over 64 percent of the income declared for purposes of the corporate income tax.[6]

B. *Tax treaties*

The majority of Italy's treaties reduce the withholding tax on outbound dividends to rates ranging from 5 to 25 percent. The only treaty which provides for a complete exemption from tax is the old treaty with the Netherlands; under that treaty a total exemption applies if the Dutch company has a 75 percent holding in the Italian subsidiary.[7]

Under the new treaties with France and the United Kingdom, the imputation tax credit is extended to non-resident shareholders (see below).

III. INBOUND DIVIDENDS

A. *Domestic provisions*

Foreign-source dividends received in Italy are included in the taxable base of Italian residents under the principle of worldwide taxation. The Italian imputation

1. Council Directive 435/90 of 23 July 1990.
2. The directive required member states to implement the provisions before 1 January 1992, so the decree applies retroactively to that date.
3. Income Tax Assessment Code ("ITAC"), Art. 27(3).
4. The imputation system was adopted in 1977. See ITAC Art. 14.
5. An exception to this rule applies to a foreign parent company which has a permanent establishment ("PE") in Italy. In such a case, the dividends form part of the taxable income of the PE, and the PE is entitled to the benefit of the tax credit which it can then pass on to the foreign parent company.
6. ITC Art. 105.
7. A new treaty has been signed but is not yet in force.

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regime does not extend to foreign-source dividends – such dividends are subject to tax in the hands of the Italian recipient, although unilateral tax relief is granted in respect of the foreign withholding tax suffered. However, no indirect foreign tax credit is granted on the foreign corporate profits out of which the dividends were paid. Inbound dividends are taxed differently according to the type of recipient.

In the case of individuals, foreign-source dividends are taxed at the ordinary progressive rates in the hands of the recipient with a tax credit granted as relief for the foreign withholding tax.

In the case of Italian companies, the taxation of foreign-source dividends depends on the extent of the participation in the foreign company.[8] If the participation is at least 20 percent the foreign-source dividend is taxed on only 40 percent of its gross amount, thus exempting 60 percent for purposes of corporate income tax. If the holding is less than 20 percent the foreign-source dividend is fully taxable for corporate income tax purposes (at a flat rate of 36 percent).

Application of the equalization tax is affected when foreign-source dividends are redistributed by an Italian company. As stated above the equalization tax is due in respect of dividends deriving from income which was not subject to corporate income tax in whole or in part in order to balance the shareholder's tax credit granted under the imputation regime. In theory when foreign-source dividends are redistributed the exempt 60 percent should be subject to the equalization tax. However, under ITC Article 96, paragraph 1 such dividends are deemed to be subject to corporate income tax for equalization tax purposes, resulting in an equalization tax liability of only 20.25 percent of gross foreign-source dividend (if no foreign withholding taxes have been imposed).

When dividends are distributed by companies resident in countries having a "preferred tax regime", the 60 percent exclusion does not apply – the dividends are taxed at the 36 percent rate.[9]

B. *Tax treaties*

With very few exceptions (i.e. the Brazilian and German treaties), all of Italy's tax treaties provide for the taxation of inbound dividends. Taxation of only 40 percent of the gross dividend under domestic law may also be applied in respect of dividends flowing from a treaty country if the Italian shareholder is an Italian company which holds at least 20 percent of the foreign company.[10]

IV. THE PARENT-SUBSIDIARY DIRECTIVE

The parent-subsidiary directive provides that when EC parent and subsidiary companies meet certain requirements, dividends paid by a corporation resident in an EC country to a corporation resident in another EC country which owns at least 25 percent of the capital of the distributing company will not be subject to withholding tax in the subsidiary's country of residence. The dividends will also be exempt from tax in the hands of the recipient EC parent company, or be subject to tax with a credit for underlying tax paid by the subsidiary on the distributed income. No minimum holding period is set forth to qualify for the benefits of the directive, although member states may require a minimum holding period of two years.

As mentioned above, Legislative Decree No. 136 of 6 March 1993 implements the provisions of the parent-subsidiary directive on the basis of Law No. 142.

A. *Entities to which the Decree applies*

To qualify for the benefits under the Decree both the parent and subsidiary company must be a company that is listed in the Annex to the directive. Further, both companies must be tax resident in EC member states and must be subject to corporate income tax.

The following companies are targeted by the Decree: joint stock companies, limited liability companies and other public and private companies which have as their exclusive or main purpose the conduct of a business.

A company is resident in Italy for income tax purposes if its legal seat, administrative office or principal object is situated in Italy.

As a general rule, all resident companies are subject to corporate income tax. However, the Decree provides that cases of exemption from corporate income tax which are limited in time and with respect to the territory do not preclude application of the new provisions.[11] Consequently, companies which have their registered office in the south of Italy (Mezzogiorno) which benefit from particular exemptions may be considered among the entities to which the directive applies.

B. *Participation and holding period*

To qualify under the Decree a company must hold at least 25 percent of the capital of a company of another member state, and the parent company must have maintained the requisite holding for an uninterrupted period of at least one year.

C. *Transactions to which the Decree applies*

The provisions only apply to "distributions of profits", a term which encompasses actual dividend distributions, but it excludes profits derived from the liquidation or winding up of the distributing company, as well as amounts attributed to the parent in connection with its holding as a result of tax treaty provisions (e.g. the payment of dividend tax credits, as in the French and UK treaties). The exclusion of the latter implies that such distributions will be subject to withholding tax (as specified in the treaty) when paid from Italy and that they are subject to ordinary taxation in the hands of the Italian parent when received from abroad.

8. ITC Art. 96(1).
9. Such countries are listed in a Ministerial Decree.
10. Because tax treaties allow Italy (as the state of residence of the shareholder) to tax the dividends coming from the other country, the actual taxation is made according to domestic law which, as mentioned, provides for partial exemption in certain cases.
11. Decree Art. 1, para. 2.

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D. *Outbound dividends*

Under the directive, dividends distributed by an Italian subsidiary to an EC resident parent company are exempt from Italian withholding tax, provided the parent company meets the participation and holding requirements mentioned above. Although the directive contains no provisions with respect to refund procedures, the Decree provides that non-resident companies meeting the parent-subsidiary requirements are entitled to a full refund (vs. the two-thirds refund described above) of Italian withholding tax levied on outbound dividends. The Decree further provides that the refund process can be bypassed if the foreign parent company specifically requests the exemption from withholding tax and submits documentation issued by the foreign tax authorities which certifies that all conditions required for application of the directive have been met.[12] The Italian subsidiary must attach such documentation to the withholding agent return.

E. *Inbound dividends*

Italy opted for the exemption method to eliminate economic double taxation; according to this method dividends paid by a qualifying subsidiary are totally exempt from tax.[13] The Decree added a new provision to the ITC (Article 96 bis) which provides that dividends received by an Italian parent are exempt from taxation for 95 percent of their gross amount if both the parent and the subsidiary meet the residency and participation requirements.[14] Taxation of the remaining 5 percent reflects the alternative granted to member states to disallow certain charges relating to the participation.

The Decree also excludes application of the equalization tax that would generally apply upon the distribution of exempt income if the Italian parent redistributes the dividends (exempt for 95 percent) to its shareholders, i.e. the tax credit in the ordinary amount (9/16 of the dividend which matches the IRPEG tax normally applicable to the company profits) is maintained even if the parent has paid the IRPEG on only 5 percent of the dividend received.

The only limitation introduced by the Decree concerns the refund of the tax credit: the tax credit may be fully utilized up to the amount of tax due on total income (including the tax credit in the amount of 9/16 of the dividend). However, an excess tax credit arising because of the dividend tax credit is not refundable, and therefore should be considered as lost. In setting this limit, the Decree only makes reference to personal income taxes, so some doubt exists as to whether it applies to shareholders who are corporate entities, or whether it may be claimed that the dividend follows the ordinary rules so long as it is received by corporate entities, and that the limitation only comes into play when the dividend is redistributed to an individual by the last company in the chain.

Another purpose of the limitation is to prevent residents of states whose treaty with Italy provides for the payment of the tax credit (i.e. treaties with France and the United Kingdom) from obtaining a refund of the tax credit on dividends distributed by Italian companies and deriving from EC subsidiaries (on which the Italian parent has been subject to tax on only 5 percent of its amount). The unclear wording of the law does not allow a conclusion as to whether or not this objective has been achieved.

Capital losses resulting from a profit distribution of an EC subsidiary to an Italian parent company are not deductible in respect of the amount equal to the dividends that were not subject to tax because of the exemption.

F. *Anti-avoidance provisions*

The Decree denies the benefits of the directive in the case of dividends distributed by companies which are directly or indirectly controlled by entities which do not reside in the EC, and which have been organized for the sole or main purpose of benefiting from the exemption.[15]

G. *Effective date*

The provisions have retroactive effect to 1 January 1992. However, Article 3 of the Decree provides the retroactive effect to 1 January 1992 with reference to the date of the resolution to distribute the dividends;[16] thus distributions which took place in the past (but after the date of effect) or which will take place in the future, will only come within the scope of the provisions if the relevant resolution was dated after 1 January 1992.

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12. For a discussion of this issue, see Simona Belletini, "Parent/Subsidiary Finds Home in Italy", *International Tax Review* (April 1993), at 36.
13. The withholding tax levied by Italian banks on inbound dividends which fall within the scope of the directive has also been abolished.
14. Italian PEs of companies resident in other EC countries are also eligible for the 95% exemption provided the residency and participation requirements are met.
15. It should be noted that the anti-avoidance provision has been extended to an Italian parent controlled by an entity residing outside the EC, thus disallowing the 95% exemption on dividends received from EC subsidiaries.
16. The directive itself only makes reference to the distribution and not to the decision to distribute.

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THE TAX ON THE NET WORTH OF ENTERPRISES

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I. INTRODUCTION

One of the extraordinary measures aimed at reducing the astronomical Italian budget deficit was Decree Law No. 394 of 30 September 1992 (hereinafter referred to as "the Decree Law"),[1] which introduced a tax on the net worth of enterprises. The tax, which resembles the tax applicable during 1954-1973[2], is considered a "temporary taxation measure which better fits the goal of increasing revenue within the framework of a policy of tax equalization and harmonious completion of the tax system".[3]

This article describes the main features of the new tax on net worth, including the instructions provided in the Ministry of Finance's Implementing Decree of 7 January 1993 and Circular No. 7 of 21 April 1993.

Contents

I. Introduction
II. Application of the Tax
A. Scope
B. Taxable base
C. Reduction of net taxable worth
D. Determination of the tax
E. Deductibility
F. Allocation of the net worth tax for accounting purposes
III. The Role of Double Taxation Treaties
A. Treaties which include capital taxes
B. Allocation of the right to tax capital
C. Method for avoidance of double taxation on capital
D. Netherlands treaty

II. APPLICATION OF THE TAX

The net worth tax will apply as from the financial year current at 30 September 1992 until the business income tax is revised (currently scheduled to be completed by 30 June 1994), or if the revision is completed earlier, until the financial year current at 30 September 1994.[4] Thus in principle the new tax is applicable to no more than three financial years. It is worth mentioning, however, that although the new tax is initially a temporary emergency measure, it cannot be ruled out that it will be made permanent.

A. *Scope*

The net worth tax is imposed on all entities which carry out (or are deemed to carry out) business activities in Italy and which are subject to tax on business income. In particular, the following taxpayers are subject to the net worth tax:

- resident joint stock companies, limited liability companies, cooperatives and mutual insurance companies.[5] Any activity carried out by these companies is considered a business activity, so their entire net worth is subject to the tax;
- resident state-controlled and private entities (besides companies) which have as their exclusive or main purpose the carrying out of commercial activities. Any activity carried out by these entities is considered a business activity, so their entire net worth is subject to the tax;
- resident state-controlled and private entities which do not have as their exclusive or main purpose the carrying out of commercial activities. However, these entities are only subject to the net worth tax on the share of net worth attributable to business income produced by the entity;[6]
- resident general and limited partnerships. Any activity carried out by these partnerships is considered a business activity, so their entire net worth is subject to the tax;
- resident individual entrepreneurs;
- permanent establishments (PEs) in Italy of non-resident individuals, companies and entities.

The following entities are excluded from the scope of the net worth tax:

- EEIGs since they are not considered taxable persons for personal income tax purposes;[7]
- UCITS, wherever established, which are not considered to be carrying out commercial activities.[8]

B. *Taxable base*

The criteria for determining the taxable base depends on the bookkeeping regime applicable for tax purposes to the taxpayer. According to Decree No. 600 of 29 September 1973, the following regimes are applicable:

1. The Decree Law was converted into law, with modifications, through Law No. 461 of 26 November 1992.
2. Prior to 1973 companies were also subject to a corporation tax equal to 0.75% of the net worth, increased by 15% of the taxable income which exceeded 6% of the net worth (Law No. 603 of 6 August 1954 and Arts. 145-155 of Presidential Decree No. 645 of January 1958
3. See the Ministerial Report on Decree Law No. 394/1992, published in *Il Fisco* (1992), at 8926.
4. Decree Law, Art. 4, para. 1.
5. *Id.* Although not specifically mentioned in the law, companies incorporated abroad but resident in Italy for tax purposes (because their administrative seat or the main purpose of their business is situated in Italy) are subject to the Italian law applicable to joint stock companies. See Italian Civil Code Art. 2507.
6. According to Art. 8, para. 1 of the Implementing Decree, the net worth tax is not due by non-commercial entities which produce business income in the course of relief, health, educational, cultural or sporting activities and which keep separate accounting records for such activities.
7. Art. 11 of Legislative Decree No. 240 of 23 July 1991.
8. Art. 9 of Law No. 77 of 23 March 1983, as amended by Legislative Decree No. 83 of 25 January 1992 and Art. 14 of Legislative Decree No. 84 of 25 January 1992.
Some doubts had arisen about Italian SICAVs established as joint stock companies, which are expressly mentioned in Art. 1 of the Decree Law. These doubts were resolved by the 21 April 1993 Ministry of Finance Circular which stated that such entities do not carry out commercial activities.
In the author's view, the Ministry of Finance's conclusion is correct although based on an erroneous argument. Indeed, Art. 1 of Law Decree No. 394/1992 makes reference to joint stock companies without setting forth as an additional condition that such companies must carry out business activities. The conclusion is correct, however, because the reference to CTA Art.

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- the ordinary bookkeeping regime, which is mandatory for resident companies and entities which have as their exclusive or main purpose the carrying out of commercial activities;[9]
- the simplified bookkeeping regime, which is applicable to partnerships and individual entrepreneurs whose annual turnover does not exceed 1 billion lire (350 million lire for service enterprises).

1. Entities subject to the ordinary bookkeeping regime

For entities required to keep accounting books according to the ordinary regime, the taxable base is equal to the net worth shown in the last approved balance sheet, reduced by profits of the current year.[10] If there is no balance sheet (e.g. in the case of a merger, transformation, division, etc.) or if the balance sheet has not yet been approved by the shareholders meeting, the net worth is determined from the accounting books and entries at the end of the tax period.

The items comprising net worth are specifically listed in Article 2 of the Implementing Decree, which refers to Article 2424 of the Italian Civil Code, the provision which regulates the company assets and liabilities statement. In particular, the following items are mentioned (this list is not intended to be exhaustive):

- subscribed capital or endowment fund. The decree specifies that reference should be made to subscribed capital even if not fully paid-in (the amount owed by shareholders must be shown as a separate item on the assets side). For PEs in Italy the endowment fund consists of the functioning capital allocated to the PE by the home office;[11]
- amounts paid by shareholders (or partners) which do not have to be refunded, and payments to the capital account;
- share premium account and equalizing interest paid by subscribers for new shares or quotas;
- revaluation reserves established pursuant to specific laws;[12]
- legal reserve, statutory reserve, reserves established pursuant to tax amnesty legislation and other reserves and funds, regardless of the tax regime applicable thereto;[13]
- own shares reserve;
- reserves destined for reinvestment pursuant to specific incentive legislation;[14]
- provisions for generic liabilities and charges, e.g. provisions for unscheduled expenses, unspecified risks, fluctuation of the value of business assets and liabilities, renewal of plant and inventory;
- reserves and funds for the self-financing of future investments in business assets;
- merger (or division) surplus;[15]
- profits (and losses) of previous years;
- current year losses, which will be determined without considering the amount of the net worth tax if shown in the loss side of the profits and loss account relating to the same year.[16]

Consistent with the characterization given by accounting principles, provisions for specific liabilities and charges, and reserves and funds for downward adjustments of the book value of business assets[17] are not included in the net worth which comprise the base for computation of the net worth tax. According to Article 2, paragraph 2 of the Implementing Decree, the same exclusion applies to reserves for accelerated depreciation[18] up to the amount of depreciation which will be accounted for civil law purposes in future years.[19]

2. Persons subject to the simplified bookkeeping regime

For persons falling within the scope of the simplified bookkeeping regime, the taxable base is determined as the sum of the following items:

- book value of inventory and works in progress; and
- book value of depreciable business assets net of the depreciation. Both tangible and intangible assets are taken into account for these purposes.

87, para. 1, lett. a) must be interpreted as a reference to joint stock companies *subject to corporate income tax*, whereas SICAVs are not subject to such tax.

9. Taxpayers not mandatorily subject to the ordinary bookkeeping regime may, however, elect to be subject to it.

10. Decree Law, Art. 1, para. 2. As explained below, losses of the current year are taken into account in determining the taxable net worth.

11. Non-resident companies with a PE in Italy are required to keep separate and distinct accounts for purposes of determining income produced by the PE (Art. 14 of Decree Law No. 600 of 29 September 1973). For application of the net worth tax, the "force of attraction" principle (according to which some income is deemed to be attributable to the PE) should not have any effect, i.e. the net worth of the PE should be determined by taking into account only the assets and liabilities actually related to it.

12. The most recent revaluation laws are Law No. 72 of 19 March 1983, Law No. 408 of 29 December 1990 and Law No. 413 of 30 December 1991.

13. There are various types of reserves and funds under the Italian tax system:
- reserves and funds which, upon distribution, do not constitute taxable income for the distributing company but constitute taxable income for the shareholders;
- reserves and funds which, upon distribution, give rise to an equalization tax liability to the charge of the distributing company and constitute taxable income for the shareholders;
- reserves and funds which, upon distribution, do not constitute taxable income for either the distributing company or the shareholders;
- reserves and funds which, upon distribution, are to be included in the taxable income of the distributing company and constitute taxable income (for their net amount) for the shareholders;
- reserves and funds which, regardless of their use (even for covering losses) are included in the taxable income of the company.

The full amount of these reserves and funds is included in the net worth. It should be noted that prior to the enactment of Decree Law No. 513 of 31 December 1992 (now reproduced in Law No. 131 of 28 April 1993) reserves and funds subject to a possible future tax liability had to be considered for 50% of their amount (Art. 1, para. 3 bis, Decree Law No. 394/1992).

14. For example, profits to be reinvested in Valtellina or in the south of Italy (Mezzogiorno).

15. On the contrary, the merger (or division) deficit cannot be considered a negative item of net worth.

16. For accounting purposes, the net worth tax can be shown as a separate item in the profits and loss account or can be deducted directly from the existing net worth.

17. The Ministry of Finance Circular lists, among other things, the following funds and reserves: fund for taxes to be paid; reserve for exchange risks; reserves for personnel severance pay; bad debt fund; reserve for the writing-down of participations; fund for technical depreciation; fund for financial depreciation; technical reserves of insurance companies and entities.

18. According to CTA Art. 67, para. 3, the amount of ordinary depreciation may be increased by way of accelerated depreciation up to two times in the first and the two succeeding fiscal years.

19. Accelerated depreciation does not have to be taken into account for civil law purposes. Thus the depreciation period for tax purposes is shorter than the period for civil law purposes. For civil law purposes, depreciation to be made after completion of the tax depreciation will be computed as a reduction of the reserves for accelerated depreciation.

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However, if a simplified regime taxpayer elects to be subject to the ordinary bookkeeping regime, he may elect to be subject to the net worth tax according to the rules set forth above.[20]

C. *Reduction of taxable net worth*

Article 1, paragraph 4 of the Decree Law provides for a reduction in the taxable base for taxpayers (other than those keeping books according to the simplified regime) which own participations in companies or entities subject to the net worth tax. This provision aims to prevent economic double taxation which would be particularly burdensome in groups of companies having a highly vertical structure. In the absence of this provision the same net worth would be subject to the net worth tax twice, i.e. once at the company level and again in the hands of the shareholder.

1. Participation

Contrary to the practice in most countries, the Decree Law does not set forth any requirement as to the extent of the participation, i.e. the special mechanism applies to any taxable person regardless of the extent of the participation. However, the allowance is granted only if the entity is a taxable person for purposes of the net worth tax. As a result, participations in foreign companies do not in principle give rise to a reduction in the taxable base.[21] Moreover, the allowance is granted only if the taxable base of the participated company or entity is determined as the net worth and not as the sum of the book value of inventory and depreciable assets.

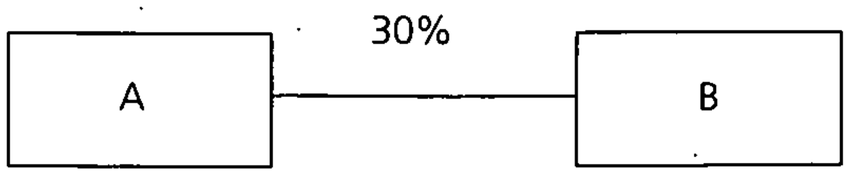
2. Minimum holding period

To benefit from the mechanism for the avoidance of economic double taxation, the participation must be held without interruption for the three month period preceding the end of the tax period. If during the last three months the taxable person purchased other shares or quotas in the participated company or entity, the allowance is granted only with respect to the shares or quotas which fulfil the minimum holding period requirement (so the mechanism is applicable on a share-per-share basis).[22]

3. Amount of the reduction

According to Article 1, paragraph 4 of the Decree Law and Article 6 of the Implementing Decree, the amount of the reduction is determined as the lower of the following amounts:

- the book value of the participation as resulting from the assets side of the balance sheet of the participating company (or from any other accounting book or entry if the balance sheet has not been approved); and
- the net worth value of the participated company. For these purposes, the net worth is determined gross of any reduction granted with respect to the participation held by the participated company, and net of current profits. The net worth results from the balance sheet of the participated company which has been approved prior to the approval of the balance sheet of the participating person.



Case 1
- Net worth of A 1,000
- Book value of the participation in B 400
- Net worth of B (net of current profits) 5,000
- Share of B's net worth attributable to A 1,500
- Reduction in A's net worth 400
- Taxable base 600

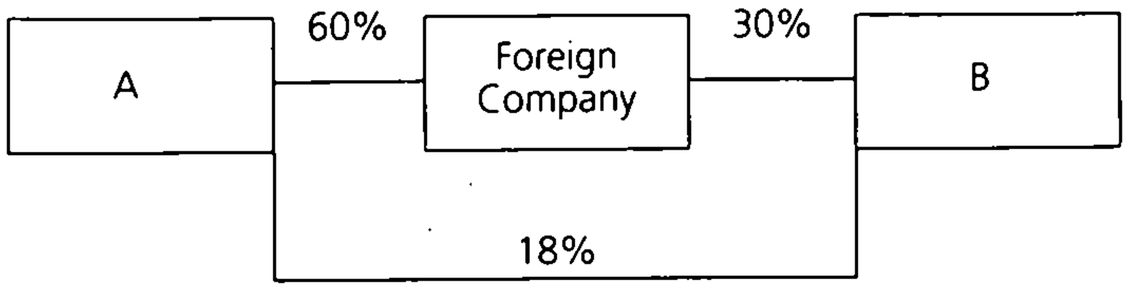
Case 2
- Net worth of A 1,000
- Book value of the participation in B 400
- Net worth of B (net of current profits) 1,000
- Share of B's net worth attributable to A 300
- Reduction in A's net worth 300
- Taxable base 700

4. Reduction for participations in Italian companies held through non-resident companies

The Decree Law takes into account the case where a taxable person[23] holds an indirect participation in an Italian resident company[24] through a non-resident company or entity.[25] In such a case, the law provides that the reduction in the taxable net worth will be determined on the basis of the percentage of indirect holding in the Italian company, up to an amount equal to the book value of the participation in the foreign company. This reduction is granted regardless of the amount and composition of the net worth of the foreign company and regardless of the tiers of indirect holding. Although not specified by the Decree Law, any participation held by foreign entities down to the Italian indirectly-owned company must comply with the minimum three month holding period requirement.

20. Non-business entities may apply for application of the net worth tax only if they keep a separate accounting for the business activities that they carry out.
21. The only exception applies to a participation in a foreign company with a PE in Italy which is subject to the net worth tax. In this case the amount of the reduction will be measured by the PE's net woth.
22. The Ministry of Finance has stated that newly issued shares or quotas subscribed during the three month period within the limits of the option rights attached to shares or quotas complying with the minimum holding period requirement are deemed to be purchased prior to the three month period.
23. The Decree Law does not contain specific requirements as to the legal form of the taxable person which holds a participation in the foreign entity. However, the Implementing Decree provides that the mechanism is applicable only if the taxable person is a company. According to general principles of Italian law, this conflict will be resolved in favour of the Decree Law, which is why reference is generically made to "taxable persons".
24. According to the Decree Law the mechanism is applicable only if the taxable person participates indirectly in the capital of a "company". However, the Implementing Decree extends application of the mechanism to indirect participations in "entities" as well. As stated above, the conflict will be resolved in favour of the Decree Law.
25. As mentioned above the Decree Law does not consider the case where a taxable person participates indirectly in a non-resident entity having a PE in Italy.

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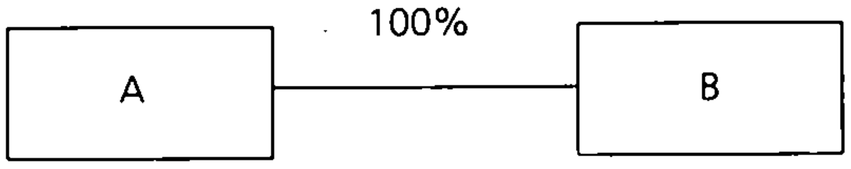
Case 1
- Net worth of A 1,000
- Book value of the participation in the foreign company 400
- Net worth of B (net of current profits) 6,000
- Share of B's net worth attributable to A 1,080
- Reduction in A's net worth 400
- Taxable base 600

Case 2
- Net worth of A 1,000
- Book value of the participation in the foreign company 400
- Net worth of B (net of current profits) 2,000
- Share of B's net worth attributable to A 360
- Reduction in A's net worth 360
- Taxable base 640

D. *Determination of the tax*

1. Rate

The net worth tax is levied at the rate of 0.75 percent.[26] However, if the taxable person benefits from the reduction granted with respect to the (direct or indirect) holding of a participation in an Italian company, the actual amount of tax to be paid cannot be lower than 0.1 percent of the net worth, gross of such reduction. Thus in some cases economic double taxation is not avoided at all. Such circumstance is typical of pure holding companies.



Case
- Net worth of A 1,000
- Book value of the participation in B 1,000
- Net worth of B (net of current profits) 1,000
- Share of B's net worth attributable A 1,000
- Reduction in A's net worth 1,000
- Taxable base 0
- Net worth tax due by B 7.5
- Net worth tax due by A 1.0

No deductions are allowed for capital taxes paid abroad.

2. Cases where the net worth tax is not due

The net worth tax is not due if, at the end of the tax period the taxable person is subject to an insolvency procedure, such as bankruptcy, forced administrative liquidation, extraordinary administration or preventive agreement by transfer of business assets; or if the tax to be paid does not exceed 100,000 lire.

E. *Deductibility*

The net worth tax is not deductible in determining taxable income for individual or corporate income tax purposes.

F. *Allocation of the net worth tax for accounting purposes*

The net worth tax may be considered a negative item of the profits and loss account or as an item to be deducted from existing net worth. The net worth tax may be accounted for as a negative item of the net worth of the period to which the tax relates or the period in which the actual payment is made.[27]

In the absence of any requirement regarding reserves or funds to be charged with the net worth tax, taxpayers may elect to reduce the reserve or fund of their choice. Thus it would be convenient to reduce the amount of reserves or funds which:
- in the event of distribution are to be included in the taxable income of the distributing company; or
- in the event of distribution give rise to an equalization tax liability to the charge of the distributing company.

III. THE ROLE OF DOUBLE TAXATION TREATIES

The role of double taxation treaties has not been adequately taken into account in respect of the economic effects of the net worth tax on enterprises. The issue was not addressed by the Ministerial Circular of 21 April 1993. It is difficult to understand the reasons underlying this omission – in all of Italy's treaties only 20 also apply to capital taxes and their application may significantly affect the scope and impact of the net worth tax on enterprises.[28]

A. *Treaties which include capital taxes*

Following the definition in Article 2, paragraph 2 of the OECD model treaty, capital taxes include both taxes on total capital and taxes on elements of capital. As a result, the net worth tax (which, depending upon circumstances, is applica-

26. If the tax period is other than the normal 12 month period, the rate will be modified accordingly. The equalization on a 12-month basis prevents certain distortions which would otherwise arise in cases of merger (or division) by the formation of new companies. Such effects, however, have not been eliminated in cases of merger by acquisition or division effected through a transfer of assets to existing companies. In these circumstances, the transferee existing companies cannot benefit from a reduction of the rate in proportion to the period during which the assets were the property of the transferor company.
27. Pursuant to Decree Law, Art. 4, para. 2-bis (as amended by Art. 62 of Decree Law No. 131 of 28 April 1993).
28. The treaties are with Argentina, Austria, Bulgaria, China, Denmark, Ecuador, Finland, France, Germany, Greece, Hungary, Israel, Luxembourg, Norway, the Netherlands, Romania, Sri Lanka, Sweden, Switzerland and Yugoslavia.

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ble on the difference between total assets and total liabilities, or only on some assets) must be regarded as a capital tax for purposes of the application of double tax treaties.[29]

B. *Allocation of the right to tax capital*

With the sole exception of the treaty with the Netherlands, all of Italy's treaties which include capital taxes within their scope of application are drafted along the lines of Article 22 of the OECD model convention, with the result that:

(1) capital represented by immovable property may be taxed in the state where the property is situated but such taxability does not prevent taxation in the state where the owner is resident;
(2) capital represented by movable property forming part of the business property of a PE of an enterprise may be taxed in the state where the PE is situated but such taxation does not prevent taxation in the state where the enterprise is resident;
(3) ships and aircraft operating in international traffic and boats engaged in inland waterways transport may be taxed only in the state in which the place of effective management is situated;
(4) all other elements of capital may be taxed only in the state where the enterprise is resident.

The scope of application of the Italian net worth tax on enterprises complies with the allocation rules listed under (1), (2) and (4).[30] In some cases, the net worth tax seems even more favourable for foreign enterprises since immovable property situated in Italy is taxable there only if the property is attributable to a PE situated in Italy. On the contrary, there is a clear conflict with the allocation rule described under (3) above:

- pursuant to Decree Law No. 394/1992, the Italian net worth tax is applicable to shipping enterprises which are resident in Italy for individual or corporate income tax purposes; an enterprise established in Italy is resident regardless of the place where the seat of effective management is situated. As a result, according to domestic tax law, a shipping enterprise established in Italy but effectively managed abroad would nonetheless be fully subject to the net worth tax on its entire net worth;
- a shipping enterprise, even if not resident in Italy for tax purposes, may be subject to the net worth tax on the net worth attributable to a PE situated in Italy. This is clearly contrary to the allocation rule in Italian treaties.

Although not specifically dealt with by the Decree Law, it is indisputable that treaty provision prevails over domestic rules,[31] and that the net worth tax will not apply to shipping enterprises whose place of effective management is not situated in Italy.

C. *Method for avoidance of double taxation on capital*

With the sole exception of the treaties with the Netherlands and France (which make reference to a further agreement between the competent authorities),[32] all of the Italian treaties which include capital taxes within their scope of application provide for the credit method as the method for the avoidance of double taxation on capital. Consequently, if a resident of Italy has capital which, in accordance with the provisions of the applicable treaty, may be taxed in the other contracting state, Italy will allow as a deduction from the tax on the capital an amount equal to the capital tax paid in the other contracting state, provided that such deduction does not exceed that part of the capital tax as computed before the deduction is given, which is attributable to the capital which may be taxed in the other contracting state (ordinary credit method).

Application of the credit method does not require that the objective scope of application of the Italian and the foreign capital tax (e.g. one tax may be applied on net worth, defined as assets minus liabilities, while the other may be applied on gross total assets or only on certain elements of capital) be identified. What is material is that both taxes qualify as capital taxes for purposes of the treaty.

Italian domestic tax law does not take into account the possibility of deducting foreign taxes from the net worth tax actually due; notwithstanding that, the credit must be allowed since treaty provisions prevail over domestic tax law provisions.

Once it is established that the foreign tax credit provision is applicable, the method of computation of the maximum deduction allowed should be determined.[33] According to the ordinary credit method, the deduction cannot exceed that proportion of the Italian net worth tax which the item of capital that may be taxed in the other contracting state bears to the entire capital. For these purposes, in the author's view, this item of capital will be determined net of relevant liabilities, provided that:[34]

- specific liabilities are taken into account in their full amount; and
- generic liabilities (e.g. total liabilities net of specific liabilities attributable to whatever item of capital) are attributed in the same proportion which the item of capital (net of specific liabilities) bears to total assets (net of specific liabilities).[35]

29. Some treaties, in listing the existing taxes covered by the treaty, make reference to net worth tax applied by the other contracting state (see, for instance, the treaty with Luxembourg). It would make no sense not to consider the same treaties applicable to the Italian net worth tax.
30. The sole exception, which is not very common, is dual resident companies which are deemed to be resident of the other contracting state for treaty purposes. See text below regarding shipping companies.
31. See Italian Constitution Art. 10.
32. Protocol, Art. 11, lett. c).
33. Neither Italian law nor the OECD model convention offer adequate guidance on this point; the mechanism described in the text reflects the personal view of the author.
34. The principle of the computation of the net amount is set out in para. 63 of the Commentary to Art. 23B of the OECD model convention only with respect to the determination of income. In the author's opinion, however, such principle can reasonably be applied to capital as well.
35. The computation of such amounts net of specific liabilities aims to prevent significant amounts of generic liabilities from being attributed to items of capital which bear huge amounts of specific liabilities (the lower the net amount of the item of capital, the lower the amount of generic liabilities attributable thereto).

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Example:

(1)	Real property established in the contracting state	100
(2)	Real property established in Italy	200
(3)	Total assets (1 + 2)	300
(4)	Generic liabilities	180
(5)	Specific liabilities attributable to the assets under (1)	30
(6)	Total liabilities (4 + 5)	210
(7)	Net worth (3 – 6)	90
(8)	Net worth tax (0.75% x 7)	0.675
(9)	Amount of the item of capital taxed abroad (1)	100
(10)	Specific liabilities attributable to the item of capital taxed abroad (5)	30
(11)	Other liabilities attributable to the item of capital taxed abroad [(9 – 10) ÷ (3 – 5)] x 4	47
(12)	Net amount of the item of capital which may be taxed abroad (9 – 10 – 11)	23
(13)	Proportion for the application of the foreign tax credit (12:8)	25.5%
(14)	Maximum foreign tax credit allowed (8 x 13)	0.172

D. *Netherlands treaty*

Other potential areas of conflict are raised by the 1957 treaty with the Netherlands. Under Article XVIII:

- capital represented by immovable property may be taxed only in the state where the property is situated;
- capital represented by movable property forming part of the business property of a PE of an enterprise may be taxed only in the state where the PE is situated;
- ships and aircraft operating in international traffic, and boats engaged in inland waterways transport may be taxed only in the state in which the place of effective management is situated;
- shares, bonds and credits may taxed in the state where the owner has his fiscal domicile; such right, however, is not exclusive and the other contracting state may apply capital taxes on the same elements of capital;
- all other elements of capital may be taxed only in the state where the enterprise is resident.

The Netherlands treaty is the only treaty which provides for the exclusive taxation right of immovable property and of property attributable to PEs in one contracting state of a person resident in the other contracting state. Thus Italy is not allowed to tax the share of the net worth attributable either to immovable property situated in the Netherlands or to PEs in the Netherlands of enterprises resident in Italy for tax purposes. In the author's opinion the amount of the items of capital which cannot be taxed will be determined by the same principles set out above, i.e. net of specific liabilities and of the relevant share of generic liabilities.

As to the method for the avoidance of double taxation on capital, Article XIX, paragraph 2 of the treaty sets forth the exemption with progression method. Italy will include all items of capital in the taxable base but will deduct from such tax the amount attributable to items of capital which are taxable in the Netherlands. Since the net worth tax is applicable at a flat rate, the exemption with progression method leads to the same results as the ordinary credit method.

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TAX TREATMENT OF FINANCIAL INSTRUMENTS IN ITALY

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Contents

I. Introduction
II. Derivative Products in General
III. Tax Rules
IV. Swaps
A. Income tax
B. Value added tax
V. Repurchase Agreements
VI. Options
A. Income tax
B. Value added tax
VII. Caps, Floors and Collars
A. Income tax
B. Value added tax
VIII. Futures
A. Income tax
B. Value added tax

I. INTRODUCTION

Following the 1972/1973 reform, which completely restructured the Italian tax system, many statutes and administrative measures affecting the securities market were adopted in Italy. The process has intensified in recent years for several reasons, including the need to keep up with more developed financial markets (this goal was also pursued by implementing EC legislation).[1] Both the burgeoning state deficit and the consequent need of the Fisc for increased revenue led to the enactment of new tax provisions.[2]

A statute of particular relevance for the securities market is Law No. 1 of 2 January 1991, which introduced Securities Investment Companies (the "SIM Law").[3] Under the SIM Law investment services concerning securities, if performed on a professional basis and *vis-à-vis* the public, are exclusively reserved to SIMs and – to a limited extent – to banks and fiduciary companies.

II. DERIVATIVE PRODUCTS IN GENERAL

The utilization of derivative products in Italy has only recently become popular.[4] Existing instruments which have been successfully tested in more sophisticated financial markets have been imported and adapted to meet the specific needs of the Italian market.

The diffusion of financial instruments started in the absence of specific legal rules, leading scholars and practitioners to try to label any new financial "unidentified object" according to traditional civil law categories, which often lack the necessary flexibility or which do not reflect the real features of the transaction. In particular, it is disputed whether contracts such as swaps, options and futures are to be regarded as aleatory contracts, insurance contracts or wagering contracts. The problem is not merely theoretical: under Article 1933 of the Civil Code obligations arising from wagering contracts are not legally enforceable. Moreover, to construe derivative contracts as wagering contracts may imply application of the 25 percent final withholding tax on the income, as provided by Article 30 of Presidential Decree No. 600 of 29 September 1973 ("Decree 600").

According to authoritative civil law experts, in a wagering contract the risk is artificially created by the parties and it concerns an event which, in the absence of the wager, would be of no interest to the parties. On the contrary, in aleatory contracts (such as insurance contracts), the risk exists before execution of the contract, the purpose of which is often to eliminate or reduce negative effects should the risk materialize. Based on this theory it can be concluded that as a rule derivative products are aleatory contracts and cannot be considered wagering contracts.[5]

1. On 17 May 1991, Law No. 157, which tackles insider trading activities, was enacted in compliance with EC Directive 89/592; undertakings for collective investment in transferable securities ("UCITS") are dealt with by Law No. 77 of 23 March 1983, as amended by Legislative Decree No. 83 of 25 January 1992, implementing EC Directives 85/611 and 88/220. Legislative Decree 83/1992 sets forth, for the first time, the rules for marketing units of foreign investment funds in Italy.
By Legislative Decree No. 84 of 25 January 1992, and in compliance with EC Directive 85/611, SICAVs made their appearance in the Italian legal system.
Law No. 149 of 18 February 1992 introduced the first complete set of rules regarding takeover bids and the public offer of securities.
2. Law No. 102 of 25 March 1991 introduced a capital gains tax applicable to individuals (other than professional entrepreneurs) on the transfer of shares, quotas of limited liability companies, convertible bonds and other securities. Prior to Law 102/91 the capital gains were taxable in the hands of such individuals only in case of a qualified participation.
3. See in general Elisabetta Righini, *I valori mobiliari* (Giuffre, 1993).
4. Among the factors hindering the diffusion of financial instruments based on foreign currency were the exchange control restrictions, which were abolished by a Ministerial Decree of 27 April 1990 (effective from 14 May 1990).
5. This issue was discussed in a report published by the Research Department of the Bank of Italy in August 1987, where it was concluded that derivative products should not be considered wagering contracts based on their economic function, which deserves legal protection. Banca d'Italia, Temi di discussione, "La tassazione e i mercati finanziari", No. 94 (August 1987), at 75.

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This article first briefly summarizes the general rules of Italian tax law which are relevant to financial instruments, and then overviews the income tax and VAT aspects of derivative products; other indirect taxes and minor duties are not examined.[6]

III. TAX RULES

The global income received by resident individuals, other than professional entrepreneurs, and by resident non-commercial entities (hereinafter collectively referred to as "non-entrepreneurs") is taxable if its components fall under one of the categories of income in the Italian Income Tax Code ("ITC"). Such categories include income from real property, income from capital, employment income, income from independent services, business income and miscellaneous income. Income received by resident corporate entities and other resident taxpayers engaging in commercial/industrial activities ("entrepreneurs") is deemed to be of a business nature, and is taxed at the ordinary corporate tax rate, or in case of individuals and transparent entities, at the progressive personal income tax rates.

Corporate income is subject to corporate income tax ("IRPEG") at the rate of 36 percent, and to local income tax ("ILOR") at the rate of 16.2 percent; the combined corporate income tax rate is therefore 52.2 percent. Personal income tax ("IRPEF") is levied at progressive rates ranging from 10 to 51 percent. Business income derived by individuals is also subject to the 16.2 percent ILOR. Income received by individuals other than entrepreneurs is taxable at IRPEF progressive rates. ILOR applies only to specific categories of income, i.e. in addition to business income, to income from real property and income from capital. Income derived by non-resident individuals and corporate entities (in the absence of a permanent establishment ("PE") in Italy) is subject to IRPEF and to IRPEG, respectively, if produced in Italy.[7]

Value added tax ("VAT") applies at the ordinary rate of 19 percent to the sale of goods and rendering of services if the transactions take place in Italy and are performed for consideration by entrepreneurs or professionals.

IV. SWAPS

This section deals with the tax treatment of interest rate swaps and currency swaps.[8]

An interest rate swap is a contract where for a certain period of time, the parties exchange a financial position characterized by a fixed interest rate with another financial position characterized by a variable rate.[9] The parties make periodic payments to each other on the basis of notional amounts and predetermined interest rates. As a rule, interest rate swaps are meant to minimize the risk of interest rate fluctuations.[10]

A currency swap is a contract where the parties undertake to initially exchange two principals of equivalent value but in a different currency, and to make a series of payments of a predetermined amount to each other at fixed dates in the currency initially received. At the expiration date the parties must return the capital initially received. In other cases the principal can be merely notional.

Because of the exchange control regulations, until 1990 currency forward agreements, currency agreements in cash and currency options with non-resident counterparties were not allowed. As a result, currency swaps developed in Italy in the form of domestic currency swaps (or indexed lire swaps). Under a domestic currency swap, the Italian-resident parties to the contract undertake to pay or to receive at a predetermined date an amount in Italian lire, calculated on the basis of the difference between the contractual exchange rate and the exchange rate current at the expiration date of the contract.[11] In principle, domestic currency swaps aim at "freezing" the exchange ratio between a foreign currency and Italian currency for a certain period of time. Due to the exchange control deregulation, it is expected that the use of currency swaps other than the domestic ones will develop in Italy in the future.[12]

In a Circular Letter of 12 November 1991, the Italian Banks Association ("ABI") issued two standard swap agreements concerning interest rate swaps and domestic currency swaps. The applicability of the ABI standard agreements is limited to transactions between resident banks and/or financial institutions. In both agreements, emphasis is placed on limiting risks connected with fluctuations in interest rates and/or the exchange rate of the Italian currency in order to exclude a merely speculative purpose which may evoke a wagering contract. The ABI initiative is in line with the international standardization of swaps promoted by a number of organizations, in particular the International Swap Dealers Association.

1. Interest rate swaps

(a) *Entrepreneurs*

As mentioned above, income received by entrepreneurs is automatically included in business income. Any proceeds

6. For instance, registration tax applies at a rate of 3%, calculated on the contractual consideration. The tax does not apply if the contract is concluded through the exchange of business correspondance rather than by an ad hoc deed or when the contract is concluded abroad.
7. ITC Art. 3.
8. See in general Emilio Girini and Cesare Vecchio, *Futures, options, swaps, commercial paper* (Ipsoa Informatica, 1988); see also by the same authors, "Profili civilistici, valutari e fiscali del domestic currency swaps", 20 *Bollettino Tributario* (1989), at 1532; "Profili, civilistici, valutari e fiscali dell'interest rate swaps", 22 *Bollettino Tributario* (1989), at 1700.
9. See *supra* note 5, at 65.
10. Although this definition does not cover all existing forms under which interest rate swaps are structured, it corresponds to one of the most common types, usually called a fixed-floating interest rate swap.
11. Definition of the Bank of Italy in its Instructions for the drafting of the balance sheet of enterprises and for the drafting of the consolidated balance sheet of banks and financial institutions, issued on 15 July 1992.
12. However, the tax monitoring provisions enacted by Law No. 227 of 4 August 1990 (immediately after the deregulation) may represent an obstacle. In fact, such provisions created a burdensome system of control which may turn out to have effects similar to those of the ostensibly abolished exchange control restrictions. Under Art. 2 of Law 227, for instance, banks and other financial institutions and intermediaries must collect evidence, to be kept at the tax authorities' disposal for five years, of any international transfer from or to Italy of cash or securities, whenever the transfer is effected in favour or on behalf of resident non-entrepreneurs, if the relevant amount exceeds 20,000,000 lire (approximately US$ 15,000).
Moreover, non-entrepreneurs must report in their income tax return any such transfer concerning investment abroad effected during the year, if the total amount exceeds 20,000,000 lire. When the transfer of cash and securities to and from abroad is made through non-resident intermediaries, the reporting requirements must be complied with even if the transfer is not connected with any investment abroad, e.g. if it is effected for tourism or health purposes.

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gained in connection with the swap must therefore be included in the profit and loss account and are taxed at ordinary income tax rates upon filing the annual tax return. The income is represented by the amounts received by one party from the other, normally calculated as the difference between the interest rates taken as a reference when the dates of payments coincide.

If the duration of the swap contract covers more than one tax period or if the contract is still pending at the close of such period an issue arises about the timing factor, i.e. when does the income/loss become relevant for tax purposes. Under ITC Article 75, paragraph 1, proceeds and costs are taxable/deductible in the tax period in which they accrue. However, if in such period the existence of the proceeds/costs is not certain, or if their amount cannot be determined objectively, the proceeds/costs are taxable/deductible in the tax period in which such conditions (certainty, precise quantification) are realized.

As a rule, the obligation to pay a certain amount under an interest rate swap arises – and the relevant income becomes certain – on the dates indicated in the contract. Therefore payments between the parties represent an income/loss to be accounted for and included in taxable income (or, respectively, deducted) in the fiscal year in which they are due under the contract. In other words, the deduction of deferred expenses, calculated on the basis of the performance of the market at the end of the tax period, appears to be excluded by the ITC.

However, Regulations issued by the Bank of Italy on 31 July 1992, concerning the drafting (for civil law purposes) of the balance sheet of financial institutions, seem to prescribe opposite accounting criteria with respect to the operations "outside the balance sheet" aimed at limiting risks of fluctuations in interest rates, exchange rates or market prices. Hopefully, this discrepancy will be resolved with the expected reform of business income taxation.

(b) *Non-entrepreneurs*

To identify the correct tax treatment of an interest rate swap entered into by a non-entrepreneur, it is necessary to ascertain whether the relevant income fits into one of the categories of income in the ITC. Specifically, it has been discussed whether income from interest rate swaps can be regarded as having the nature of interest. According to prevailing opinion, the answer is no. As a rule, interest rate swaps do not grant to the parties the availability of the amounts set forth in the contract; these amounts are generally treated as "notional amounts" to serve as a basis for the calculation of the payments to be effected at the due dates. Therefore it can reasonably be argued that such payments do not represent interest deriving from the utilization of capital.

This conclusion is confirmed by the wording of ITC Article 41, which lists and defines items of income from capital.[13] None of the items appears to cover income from interest rate swaps. The catch-all provision contained in Article 41(h), which classifies as income from capital "any other income in a defined amount deriving from the utilization of capital" does not apply either, because no utilization of capital takes place in interest rate swaps. Moreover, the predetermination of the amount received is lacking. Finally, income from interest rate swaps does not appear to be covered by any of the items of "Miscellaneous Income" contained in ITC Article 81 examined below. It can reasonably be concluded that such income is not taxable in the hands of non-entrepreneurs.

(c) *Non-residents*

ITC Article 20 lists the cases where income received by non-residents is regarded as being produced in Italy and is therefore taxable there; the provision specifically deals with each of the categories of income in the ITC.

Income from interest rate swaps received by a non-resident company represents business income, taxable in Italy upon filing the tax return only if it is received through a PE.[14] Therefore in the absence of a PE no tax is levied in Italy. If the recipient is an individual, the income cannot be included (as illustrated above) in any of the ITC categories, so it is not taxable in Italy.

2. Domestic currency swaps

(a) *Entrepreneurs*

Proceeds and losses deriving from domestic currency swaps are, respectively taxable and deductible. With respect to the timing factor, the moment at which such proceeds and losses become relevant for tax purposes is normally identified with the expiration date when the obligation of one party to pay arises and can be determined by its amount.

As mentioned, following the exchange control deregulation, it will be possible to utilize currency swaps other than domestic currency swaps. In such case, whenever there is an actual transfer of currency between the parties, their respective obligations will be certain at the time of execution of the contract and will consequently be accounted for.[15]

Under ITC Article 72, certain deductions from business income are allowed to reduce the exchange risk in international transactions carried out in foreign currency. Article 72 does not allow the deduction of losses deriving from credits and debts in foreign currency when the exchange risk is neutralized by ad hoc contracts such as swaps and options.[16]

(b) *Non-entrepreneurs*

Income from currency swaps if received by non-entrepreneurs is dealt with by a recently introduced provision of the ITC. Article 81, paragraph 1 c ter [17] includes among

13. Such items include interest and other income deriving from loans, deposits and current accounts; interest and other income deriving from bonds and similar securities; income deriving from forward sale contracts concerning bonds and similar securities; interest and other income deriving from securities other than shares and similar securities.
14. ITC Art. 20(1)(e).
15. See Umberto Spano, "Currency swaps: aspetti contabili e fiscali", in *Bancaria* (1993) at 58 where it is pointed out that, due to the novelty of the instrument in Italy, the accounting procedures are still not clear.
16. See Ettore Scandale, "Italy creates exchange rate reserve", *International Tax Review* (June 1992), at 28.
17. Para. c ter was introduced by Art. 67 of Law Decree No. 213 of 30 June 1993, not yet converted into law.

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taxable capital gains those gains realized on forward sales of currency or through other contracts which, even implicitly, refer to the value of a currency at the expiration date of the contract in order to determine the consideration.[18] Notwithstanding the rather cryptic legislative language, it cannot be doubted that the expression "other contracts which, even implicitly, refer to the value of a currency at the expiration date of a contract to determine the consideration" includes domestic currency swaps; the Government report accompanying the pending bill of conversion is very clear on the point.

Article 67 of Law Decree 213 of 30 June 1993 also provides that entrepreneurs who intervene in any way as payors in the "other contracts" mentioned in Article 81, paragraph 1 c ter must levy a final 12.5 percent withholding tax on the capital gains. These withholding agents must pay the amount net of the withholding tax due. In the absence of consideration on which to effect the withholding, the person who realized the capital gains must pay to the withholding tax agent who intervened in the transaction a sum corresponding to the amount of the withholding tax.

According to Law Decree No. 378 of 17 September 1992 ("Law Decree 378"),[19] such capital gains, when realized on a sale to a non-resident, are regarded as foreign-source income for purposes of Law No. 227 of 4 August 1990 ("Law 227"). Thus, at the time of filing the annual tax return, the capital gains will not be included in total income, but will be taxed separately at the 12.5 percent rate. The taxpayer may, however, elect to include such gains in his total income if he wishes to benefit from the foreign tax credit granted under ITC Article 15.

B. *Value added tax*

1. Interest rate swaps

Presidential Decree No. 633 of 26 October 1972 (the "VAT Decree") does not specifically contemplate interest rate swaps or currency swaps. On one occasion,[20] the Ministry of Finance, which had been requested to provide clarifications on the VAT treatment of swaps, admitted that it was not in a position to give the requested information. In substance, the Ministry stated that swaps are atypical contracts with respect to which the legal aspects relevant for VAT purposes are not well known.

Under the broad definition provided by Article 3 of the VAT Decree, services subject to VAT are those rendered for consideration under independent labour contracts, independent contracts, contracts of transport, mandate, forwarding, agency, brokerage, deposit and, in general, services rendered in connection with obligations to perform or not to perform, and to permit, from any source. At first glance the obligations arising from a swap contract may be regarded as the rendering of services. According to the prevailing interpretation, however, interest paid by one party to the other under a swap contract does not represent consideration for the transaction; on the contrary, the interest is the object of the obligation and the relevant payment an assignment of money. Under Article 2, paragraph 3(a) of the VAT Decree, an assignment of money is not a taxable transaction for VAT purposes.

VAT is, however, levied on commission fees, if any, payable pursuant to the contract. It is common practice to include in the swap contract a fee which specifically aims at remunerating the element of service which is embodied in the swap. This fee should reduce the risk that the entire amount of money exchanged under the agreement may be viewed by the tax authorities as consideration for the service and therefore subject to VAT.

Article 12 of the pending bill of Consolidated Text of VAT exempts many financial transactions from VAT in accordance with Article 13 of Directive No. 77/388. The Ministerial Report accompanying the bill expressly states that the exemption covers swaps and, in general, transactions concerning credits, payments and cash.

2. Domestic currency swaps

As in the case of interest rate swaps, payments effected under domestic currency swaps do not represent consideration but are the object of the obligation; they represent assignments of money, not subject to VAT.

V. REPURCHASE AGREEMENTS

Prior to the legislative changes mentioned below, domestic currency swaps were often utilized in association with currency repurchase agreements ("repos"). In a repo, one party sells a certain amount of securities in currency at a certain price. At the same time, the seller undertakes to repurchase from the buyer, at a predetermined higher price and at a predetermined date, the same amount of the same securities. The expiration date of the repo does not normally exceed 90 or 180 days. An intermediary usually intervenes in the transaction. To avoid the exchange risk, the investor can enter into a domestic currency swap expiring on the same date as the repo.

Until recently, income from repos was not subject to tax in the hands of individuals. Repos were often effected on tax-exempt securities, so that the investor received income higher than that otherwise produced by the securities. In other cases, the intermediary sold to the client foreign securities with respect to which the expiration of the coupon did not take place during the client's period of ownership. The intermediary thus paid to the client, tax-free, the interest accrued (and the exchange gain, if any, deriving from the domestic currency swap).

This coupon washing technique allowed resident individuals and other taxpayers (such as resident investment funds) to

18. In the case of forward sales, capital gains are represented by the difference between the consideration for the sale and the consideration for the purchase of the sold currency if the purchase and the execution of the forward agreement are simultaneous; in other cases, capital gains are represented by the difference between the consideration for the sale and the value of the sold currency at the exchange rate current at the date the contract was executed.
19. Converted with amendments into Law No. 437 of 14 November 1992.
20. Ruling No. 460667 of 30 June 1987.

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avoid the 30 percent final withholding tax on interest from foreign bonds. The tax rate has been reduced to 12.5 percent by Law Decree No. 372 of 9 September 1992 ("Law Decree 372").[21]

Repurchase agreements gradually became more and more sophisticated; to meet growing demand, non-resident issuers of exempt securities increased the production of such securities, often tailored to the Italian market. Due to the lack of a sufficient quantity of securities, some intermediaries started to effect more than one repo on the same security. Repos became a serious competitor to domestic state bonds and banks when newly- introduced tax provisions radically modified the situation.

First, Law Decree 372 cancelled the exemption on income (interest as well as gains upon sale) from state bonds and similar securities issued abroad, as well as the exemption on income deriving from bonds issued by institutions such as the World Bank, the European Bank for Investments, etc. Such income is now subject to a 12.5 percent withholding tax, final in the case of non-entrepreneur individuals and UCITS.[22]

Law Decree 372 also amended Article 26, paragraph 3 of Decree 600, with respect to transfers of bonds issued by non-residents. When such a transfer is effected by resident individuals or UCITS, the 12.5 percent withholding tax applies to interest, premiums and any other income reflected in the consideration, both explicitly and implicitly; the seller of the bond must declare the interest, premiums and other income accrued when the bonds were in his possession. This provision obviously aims at preventing the coupon washing operations described above.

A few days after the enactment of Law Decree 372, Law Decree 378 added letter b bis) to ITC Article 41, paragraph 1, thus leading to the taxation of income deriving from repurchase agreements concerning bonds and similar securities as income from capital. Under this provision, income deriving from forward agreements in respect of bonds and similar securities is taxed as income from capital.

As clarified in the government report accompanying Law 437/92, letter b bis was added to ensure that bonds received equal tax treatment to income from bonds (as a rule taxed) and to income from forward sale agreements (such as repurchase agreements) even if income from the bonds which are the object of the forward sale agreement is in itself exempt from income tax (e.g. in case of bonds issued abroad by the state before 9 September 1992).[23] In other words, proceeds from repurchase agreements are subject to taxation with respect to any kind of bonds/similar securities, wherever issued and whoever the issuer, regardless of the tax regime, i.e. exemption or taxation, applicable to the explicit or implicit interest on such bonds/securities.

This may lead to discriminatory treatment of the investment concerning the same kind of securities depending on the form taken by the investment. An investor can obtain various kinds of income from the same securities such as interest, when the investor holds both the security and the coupon at the time the interest is paid; implicit interest, when the investor sells the securities and the coupon prior to expiration of such coupon; or income from negotiation, whenever the investor enters into a repurchase agreement. If the investments concern securities which benefit from a tax exemption on the relevant interest, the exemption applies only in the first two cases above. In the third case, the entire differential is subject to taxation with no relief for the portion attributable to interest.

As such income is classified as income from capital by ITC Article 41, in the absence of a double tax treaty the income should be taxed in the hands of non-residents when paid by the Italian state, by residents or by PEs of non-residents in Italy.[24] For treaty purposes, it is not clear whether such income is in the nature of interest; if so, treaties to which Italy is a party normally also provide for taxation in the source state. If, on the contrary, the income is regarded as not being included in any of the categories of income contemplated by the treaty, as a rule it will be taxed in the state of residence of the recipient.

Generally Italy's treaties apply only to residents of one contracting state. For treaty purposes, a resident of a state means a 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. Therefore in principle if the non-resident taxpayer is not subject to taxation in its state of residence (as may be the case of OICVMs and SICAVs) treaty provisions do not apply.

An exception to this principle is contained in Article 10 ter, paragraphs 9 and 10 of Law No. 77 of 23 March 1983.[25] Under Article 10 ter, a non-resident OICVM located in another EC member state which complies with EC Directives can, with respect to its investment in Italy, benefit from Italy's double tax treaties. The application of the treaty provisions is allowed only with respect to the portion of Italian-source income proportionally corresponding to the participation held by the non-resident, and subject to reciprocity.

VI. OPTIONS

Under an option contract one party (holder) acquires, upon payment of a premium, the right (not the obligation) to purchase from or to sell to the other party (writer) a certain amount of assets (securities, currency, interest rates, merchandise, futures) at a predetermined date and price (strike price). If the holder acquires the right to purchase, the option is a "call option"; if he acquires the right to sell, the option is a "put option". Under a European option, the option right must be exercised at the expiration of the contract; under an American option, the right can be exercised at any time between the execution and expiration of the contract.

21. Converted with amendments into Law No. 429 of 5 November 1992.
22. Art. 26 para. 1 of Decree 600, as amended by Law Decree 372. The new provisions apply to securities issued on or after 10 September 1992.
23. See in particular Andrea Manzitti, "Il regime tributario delle cessioni a termine di obbligazioni e valute", *Le Società*, No. 1 (1993), at 38, and "Italy's New Rules on the Taxation of Financial Transactions Examined", *Tax Notes International* (1993), at 371; see also Andrea Manganelli, "New Measures on the Taxation of Income from Capital", *European Taxation* (February 1993), at 64.
24. ITC Art. 20(1)(b).
25. As amended by Art. 13 of Legislative Decree No. 83 of 25 January 1992.

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In general, options are regarded as being covered by Civil Code Article 1331, which reads as follows:

> "Whenever the parties agree that one is bound by its declaration, whereas the other has the right to accept or reject it, the declaration of the first party is regarded as an irrevocable proposal to the effect of Article 1329.
>
> If no deadline has been fixed for the acceptance, the deadline can be determined by the court".

Under Article 1329, if the proponent undertakes to hold its proposal during a certain period of time, the revocation produces no effect.

Subject to certain conditions the SIM Law qualifies options and futures as securities for the purposes of securities intermediation activity if the options and futures concern securities listed on the stock exchange, interest rates and currency, and provided the contractual clauses and terms are standardized. Under the Regulations of the Bank of Italy of 2 July 1991 (the "Regulations") implementing the SIM Law, options regarded as securities for purposes of such Law are defined as derivative standardized contracts which grant to one of the parties, against payment of consideration named premium, the right to purchase or sell securities or other financial instruments at a certain price by a given date or upon expiration of the contract.

With respect to standardized options and futures, Article 23 of the SIM Law provides that the National Committee for Companies and Stock Exchange is authorized to issue regulations, aimed at creating a specific market, having regard to the structure of foreign futures and options markets, particularly EC markets.

Whereas a futures market has already been established (see below), the options market (which is currently negotiated over the counter) remains in project form under examination by the competent authorities. The realization of the market is expected at the beginning of 1994.

Article 23, paragraph 4 of the SIM Law expressly provides that options and futures which have to be negotiated by SIMs are not wagering contracts and that Article 1933 of the Civil Code (non-enforceability) does not apply.[26]

A. *Income tax*

1. Entrepreneurs

Prior to the issuance of the Regulations, which concern, *inter alia*, the drafting of the balance sheet of SIMs, no official provision governed the accounting and tax regime of options, and the procedure generally adopted was the following:

- the premium received was taxed in the tax period in which the contract was executed;
- the premium paid was deducted in the same tax period.

The Regulations specifically contemplate the entry of options in the balance sheet of SIMs. Some authors argue that the provisions can be extended to any kind of company, and are also valid for purposes of determining taxable income. Other authors are reluctant to accept such an automatic extension of the principles stated in the Regulations.

According to the Regulations, the premium paid becomes a cost upon expiration of the option if the option is not exercised. If the option is exercised, the premium increases or reduces the acquisition costs or proceeds from the sale of the securities or currency concerned. The premium received is included in the proceeds at the time the contract is executed (although, according to some authors, reference should be made to the time when the premium is actually cashed). When the option contract is executed, no transfer of ownership of the assets takes place; it is only upon the expiration date of the contract that the purchase/sale, if any, will affect the income of the parties.

The premium represents a deductible cost for the holder and a taxable proceed for the writer. With regard to the timing aspect, the taxpayer who receives the premium should include it in taxable income in the tax period in which the option was executed because at that date the writer undertakes the irrevocable obligation for which he receives the premium, so that his right to the premium becomes certain at that time. By paying the premium, the holder acquires a mere right to enter into a sale contract which may hypothetically produce income; the execution of such a contract represents a future possible event.

As mentioned above, in determining business income, the costs relating to the proceeds of a particular tax period are deductible in the period they accrue. Therefore the holder should impute the premium to his income at the date of expiration of the contract. As a consequence, if the option is not exercised a loss takes place. In the case of an option in the money, the premium is included in the cost of the asset for tax purposes; if a negotiation profit is realized, the premium will reduce the gross profit of the transaction.

2. Non-entrepreneurs

If a non-entrepreneur receives the premium for an option, different provisions apply depending on the object of the contract. If the option concerns shares and similar securities, income deriving from the sale of the option is regarded as being covered by ITC Article 81, paragraph 1 c bis. This provision includes among taxable capital gains those realized upon the sale of shares, quotas representing the capital or the assets and other similar participations, certificates representing participation in companies, associations and other entities, resident and non-resident, convertible bonds, option rights and any other right, other than interest, connected with the above-mentioned relationships, even if such sales derive from premium transactions, from sales in cash or from forward sales.[27]

26. It is not clear, however, if the above rule can also be extended to the remaining options and futures. Indeed, it may be argued that if the legislator excluded the wagering nature of the contract in this specific case, a contrariis such nature is present in all other cases. See Augusto Fantozzi, "Note minime sul trattamento fiscale di options, caps, floors and collars", *Diritto e Pratica Tributaria*, I (1992), at 540.

27. If more than 15 years elapse between the date of purchase or the date of the underwriting for an amount higher than that deriving from the option right and the date of sale, no account is taken of the capital gains; the last participations acquired are regarded as first sold.

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Although Article 81, paragraph 1 c bis does not specifically deal with premiums for options, it is foreseeable that the Ministry of Finance will regard the provision as applicable to premiums for options on shares and similar securities. This conclusion is reached from the broad meaning given by the Ministry to the expression "premium transactions".[28] With regard to premiums for options concerning goods other than shares, most commentators believe that they should be taxed as miscellaneous income under ITC Article 81; in particular, reference is made to Article 81, paragraph 1 (i), dealing with income deriving from occasional commercial activities, and to Article 81, paragraph 1 (l), concerning income deriving from obligations to perform, not to perform and to permit.

3. Non-residents

As mentioned above with respect to interest rate swaps, if the income is received by a non-resident company, it is taxable in Italy if the company has a PE in Italy. If the recipient is an individual, ITC Article 20, paragraph 1(f) applies, under which the non-resident's income is taxable in Italy if it is derived from activities carried out in Italy or related to goods existing in Italy.

B. *Value added tax*

In the absence of specific legal provisions and official clarifications, the VAT regime for options appears rather dubious. The exemption under Article 10 of the VAT Decree may be challenged if the option is not exercised. In such a case, no transfer of ownership – and therefore no transaction – concerning the securities/foreign currency appears to take place. However, since the Ministry of Finance has in the past broadly interpreted the concept of "transactions concerning securities", it is possible to argue that the exemption also applies in the case of options.[29] Similarly, the sale of an option may be regarded as a transaction concerning securities/foreign currency, therefore VAT exempt. However, options concerning merchandise should be subject to VAT.

VII. CAPS, FLOORS AND COLLARS

Under an interest rate cap one party makes periodic payments at predetermined dates to the other party. The amount of the payments is obtained from the application to a notional amount of the positive difference – if any – between a variable rate taken as a parameter and a contractual rate. The first party receives a premium of fixed amount, agreed upon at the time the contract is executed. The party paying the premium wants to limit the risk of an increase in the interest rate of his debt; the other party intends to receive a fixed amount *vis-à-vis* the possibility of having to make payments in the future.

Under an interest rate floor the amount of the periodic payments is obtained from the application to a notional amount of the positive difference, if any, between the contractual rate and the variable rate taken as a parameter. The payor in this case also receives a premium. The party paying the premium intends to limit a risk of a reduction in the yield of his investment.

An interest rate collar is a combination of a cap and a floor. Under a collar, the purchaser of a cap also sells a floor; at the contractual deadlines, he may receive the difference between the parameter rate and the cap rate, or he may pay the difference between the floor rate and the parameter rate; no payment is due if the reference rate is comprised of the cap rate and the floor rate.

A. *Income tax*

1. Entrepreneurs

The remarks made with respect to the general applicability of the Regulations apply here as well.

According to one theory, the recipient should include the premium in the taxable income of the year in which the contract was executed. Other authors do not agree with this interpretation, based on the fact that such contracts are considered supply contracts, according to which the relevant obligations are performed over a certain period of time. Therefore both the payor and the recipient should include in taxable income and, respectively, deduct the premium according to the duration of the contract, i.e. allocating the income/cost over such period.

B. *Value added tax*

The VAT regime of caps, floors and collars is the subject of discussion among experts. According to one theory, the amounts paid under the contracts represent a supply of goods, i.e. a supply of money, not subject to VAT under Article 2, paragraph 3 a) of the VAT Decree. As a result, the relevant premium is not subject to VAT. Others argue that the obligations arising from caps, floors and collars should be regarded as the rendering of services, so the premium would represent consideration, taxable for VAT purposes. According to a minority opinion, caps, floors and collars are insurance contracts, so the relevant obligations are VAT-exempt under Article 10, paragraph 2 of the VAT Decree. In any event, commission fees, if any, payable under the contract are subject to VAT. The premium is generally considered subject to VAT as consideration for a service; the service is represented by supply of cash.

As mentioned above, the pending bill of the VAT Code lists many exempt financial transactions. The list may be regarded as covering the operations contemplated in the contracts under discussion.

VIII. FUTURES

Under a futures contract, the operator undertakes to buy or sell a certain amount of goods, securities or currency at a predetermined date and price. Futures are therefore forward contracts, the effects of which take place at a date subsequent to the date of execution. This definition does not cover stock index financial futures, where one party undertakes to pay or

28. Ruling No. 22/8 of 22 October 1990 and Ruling No. 14/8/650 of 11 April 1991.
29. Ruling No. 323352 of 7 April 1986.

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to receive at a predetermined date an amount obtained by multiplying the difference between the value of the stock index at the date of execution and the value of the same stock index at a subsequent date, agreed upon by the parties. The object of the stock index future is therefore the result of arithmetical averages (compound or simple) calculated with reference to a certain basket of securities or to the stock exchange index. As a result, at the date of expiration there is no exchange of securities between the parties, but rather a cash settlement.[30]

The above-mentioned Regulations of the Bank of Italy, implementing the SIM Law, define futures as standardized derivative contracts, according to which the parties undertake to exchange at a predetermined date certain securities or other financial instruments, or to pay or to receive an amount determined on the basis of a reference index. This definition, although given for purposes of the SIM Law, may be regarded as covering financial futures in general.

Due to the absence of a local market, futures traditionally have been negotiated by Italian operators in foreign markets. In particular, Italian state bonds are negotiated in the LIFFE market, and were also present for a certain period on the MATIF market.

With regard to financial futures, Article 23 of the SIM Law granted to CONSOB the power to establish markets for the negotiation of standardized forward contracts concerning:
- financial instruments linked with securities listed on the authorized markets as well as relevant indexes;
- interest rates as well as relevant indexes;
- currencies as well as relevant indexes.

On 11 September 1992, the Italian market of futures on state bonds (MIF) commenced activities. According to the operators, the progress of such market is satisfactory.

A. *Income tax*

1. Entrepreneurs

According to prevailing opinion, futures do not produce effects relevant for income tax purposes until their expiration when the differential received/paid becomes a taxable income/deductible loss.

2. Non-entrepreneurs

Income deriving to non-entrepreneurs from a futures contract concerning bonds (in particular state bonds) is generally regarded as capital gains on bonds, not taxable under ITC Article 81. If the object of the futures contract is represented by shares, quotas of limited liability companies and similar securities, capital gains are taxable under ITC Article 81, paragraph 1 c bis. Under this provision, capital gains realized through standardized contracts negotiated in the authorized markets are not taxable. Therefore income from futures on state bonds negotiated in the MIF is not subject to taxation.

B. *Value added tax*

The majority of commentators tend to regard financial futures as exempt operations under Article 10, paragraph 1, No. 3 and 4 of the VAT Decree, which lists among VAT-exempt operations those concerning foreign currency and shares, bonds and other securities.

30. See Renato Patemollo, "Il regime fiscale dei futures su titoli obbligazionari", 8 *Corriere Tributario* (1992), at 544; see also by the same author, "Il regime fiscale dei futures su indici di borsa", 17 *Corriere Tributario* (1992), at 1229.

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TAXATION OF ITALIAN-BASED FLOWS OF INTEREST AND ROYALTIES IN AN INTERNATIONAL CONTEXT

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I. INTRODUCTION

The removal of non-tax barriers (capital and exchange controls) to international capital flows, and the globalization of financial and industrial markets has focused attention on the effect of taxation on foreign direct investment. A general concern has arisen about how taxation may influence inward and outward direct investment flows and the ways in which these investments are financed. Concern has also been expressed about the ways in which revenue from international transactions is shared between countries and the new possibilities for tax avoidance.[1] An examination of these issues requires an analysis of the domestic tax regime and how this regime interacts with existing international tax treaties.

Like most OECD countries, Italy is both an importer and an exporter of capital, and therefore its taxation of international capital income flows reflects its dual role as both a source country and residence country. This role has been emphasized since 1987 when Italy began to take steps to liberalize cross border capital movements.[2]

Contents

I. Introduction
II. Domestic Provisions
A. General
B. Foreign-source income
C. Italian-source income
III. Royalties
A. Definition
B. Deduction
C. Taxation of royalties under domestic law
D. Taxation of royalties under Italian treaties
IV. Interest
A. Definition
B. Deduction
C. Taxation of interest under domestic law
D. Taxation of interest under Italian treaties
V. International Tax Avoidance Measures
VI. Transfer Pricing Rules
VII. Conclusion

II. DOMESTIC TAX LAW

A. *General*

Resident companies[3] are subject to two taxes on income, i.e. corporate income tax ("IRPEG") and local income tax ("ILOR"). Resident individuals[4] are subject to individual income tax ("IRPEF") and ILOR. IRPEG is currently levied at a flat rate of 36 percent on worldwide business income, that is all net income derived during a tax period by a resident company, subject to unilateral and treaty relief provisions. IRPEF is levied at progressive rates on the worldwide income of resident individuals, also subject to unilateral and treaty relief provisions. ILOR is levied at the rate of 16.2 percent on both residents and non-residents but only in respect of income arising in Italy.

Non-residents are only subject to tax on Italian-source income. Non-resident companies are subject to IRPEG and ILOR on certain items of Italian-source income, and business income derived by an Italian PE. Dividends, interest and royalties derived by a non-resident are subject to withholding tax, but not to IRPEG. Interest and royalties derived through a PE in Italy must be included in the taxable income of the PE, and in such a case no withholding tax is levied on royalties. Withholding tax on interest may generally be credited against IRPEG and ILOR.

Withholding tax operates as an advance payment of income tax for resident corporations and Italian PE's of foreign companies, and as a final tax in the case of individuals and non-resident entities which do not have a PE in Italy. In cases where the withholding tax is a final tax, the income to which it relates is excluded from the tax base of the recipient.

B. *Foreign-source income*

All foreign-source income, including royalties and interest, must be included in the taxable income of a resident taxpayer, although a tax credit is granted for foreign income tax – including any withholding tax – paid against Italian income tax. The foreign tax credit is granted on a per country basis up to an amount equal to that part of the Italian tax attributable to the foreign income. The credit may not exceed the foreign taxes paid, and is only available in the year such foreign taxes are paid. For purposes of ILOR, an exemption is granted for foreign-source income.

1. See *Taxation and International Capital Flows* (Paris: OECD, 1990) and, more recently, the papers of the Seminar, "The Taxation of Profits in a Global Economy", organized by the OECD in Rome, on 18 and 19 June 1992.
2. See *OECD Economic Surveys: Italy* (Paris: OECD, 1990).
3. Under Income Tax Code ("ITC") Art. 87(3) resident companies are companies whose legal seat, registered office or principal business are located in Italy.
4. Under ITC Art. 2, resident individuals are individuals who for the greater part of the tax period are registered in the Civil Registry or who are resident or domiciled in Italy.

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Royalties and interest derived through a PE situated abroad must be included in the PE's taxable income, and are subject to Italian income tax. Again the foreign tax credit mechanism is available to avoid double taxation of the income. ILOR is not levied on the income of a PE situated abroad because it is only imposed on Italian-source income.

C. *Italian-source income*

Article 20(1) of Presidential Decree 917 of 22 December 1986 (Income Tax Code ("ITC")) provides that the following items of income are deemed to be derived in Italy:

(a) income from real property;
(b) income from capital paid by the state, by residents of Italy or by Italian PEs of non-residents;
(c) income from employment for services rendered in Italy;
(d) income from self-employment for services rendered in Italy;
(e) income from business activities carried on in Italy through a PE;
(f) miscellaneous income derived from activities carried on or related to assets located in Italy;
(g) income from partnerships.

Additionally, the following types of income are always deemed to be derived in Italy if paid by the state, by residents of Italy or by PEs of non-residents:

(a) pensions and similar types of income, including termination indemnities related to income mentioned under c, d and e above;
(b) income treated the same as employment income;
(c) compensation for the use of intellectual property, patents and trademarks as well as processes, formulae and information relating to experience acquired in industrial, commercial or scientific fields (know-how);
(d) compensation earned by enterprises, companies or non-resident entities for artistic or professional services performed on their behalf in Italy.

III. ROYALTIES

A. *Definition*

Although royalties are mentioned in several provisions of the ITC, Italian tax law does not provide a specific definition of royalties.[5] Generally speaking, however, royalty income includes income derived from the use by third parties of intellectual property, patents, trademarks, inventions and know-how.

If derived by the author or inventor, ITC Article 49(2)(b) deems royalty income to be professional income if it is not produced in the carrying on of a commercial enterprise. It should be noted that income derived from the use of trademarks is not mentioned in this provision; such income is better classified as business income since the user is the author or inventor.[6] Royalty income derived by an individual who is not the author or inventor is deemed other income.

For purposes of business income ITC Article 68(1) provides that depreciation of "rights to use intellectual property, patents, and trademarks as well as processes, formulae, and information relating to experience acquired in industrial, commercial or scientific fields (know-how)" is limited to an annual amount not higher than one-third of the total cost of the intangible.

ITC Article 20(2)(c) contains an absolute presumption of connection between Italy and the income (hence taxation in Italy on the basis of the source principle) when paid by the state, by residents of Italy or by PEs of non-residents. Article 20(2)(c) is the culmination of a long debate which began under the 1958 ITC when Italy had a pure territorial tax system,[7] and continued under the income tax legislation until 1981. The main issue was whether royalties paid by an Italian company to a non-resident company were exempt from IRPEG and ILOR.[8]

On one hand, non-residents were only subject to IRPEG (or IRPEF depending on the status of the recipient) and ILOR on business income if the income was derived through a PE in Italy. On the other hand, income from independent activities derived from Italian sources was subject to both IRPEG (or IRPEF) and ILOR even in the absence of a fixed base in Italy. Royalty income was deemed to be income from independent activities unless derived by a business enterprise in the course of its business activities.[9] This view was supported by Article 19 of Presidential Decree No. 597 which provided that a royalty is deemed to be income produced in Italy when the payor is a resident of Italy, and by Article 25 of Presidential Decree 600/73[10] which provided that income from independent activities was subject to withholding tax in the case of self-employment and in the case of business establishments.[11]

However, the controversy involved royalties paid from 1 January 1974 to 31 December 1981. For royalties paid after 1981, Presidential Decree No. 897 of 30 December 1980

5. Ministerial Circular No. 42 of 12 December 1981, however, provides that royalties include compensation for "any copyright whether literary or artistic or scientific regardless of the media which is used for the diffusion of these work (books, various publications, records, films, tapes etc.)".
6. See M. Leo, F. Monacchi, M. Schiavo, "Le imposte sui redditi nel nuovo testo unico", (Milano, 1990), at 494.
7. Under the ITC of 1958 the Supreme Court held the payment of royalties by residents was the main criterion for application of the taxation at source principle. See Supreme Court of 24 July 1965 No. 1750 in *Dir. prat. trib.* (1965), II, at 462.
8. This controversy was at issue in a well known case which was finally resolved in 1983 in favour of the non-taxability (because of lack of territoriality) of royalties paid to a non-resident company without a PE in Italy. See decision of the Central Tax Commission of 9 March 1979, No. 3508 in 19 *European Taxation* (August 1979), at 271; decision of the Supreme Court of 17 June 1981, No. 3931 in 21 *European Taxation* (1981), at 227.
Decision of the Supreme Court of 7 July 1983, No. 7184 in 23 *European Taxation* (September 1983), at 300. The Tax Administration itself followed this judicial interpretation in Ministerial Circular No. 9/748 of 16 October 1984 in *Dir. prat. trib.* (1985), I, at 127.
9. See the 1979 decision of the Central Tax Commission, *supra* note 8. The rationale underlying this rule was that royalties were included in revenue derived from independent activities in the provisions dealing with individuals, and under Art. 9(5) of Presidential Decree No. 597 of 29 September 1973 income earned in Italy by non-resident companies was taxable there only when the company maintains a PE in Italy.
10. As defined in Art 49(2)(b) of Presidential Decree 597.
11. See, A. Fantozzi, "Tax Treatment of the Importation and Exportation of Technology, Know-how, Patents, Other Intangibles and Technical Assistance", *Cahiers de droit fiscal international*, Vol. LXa (Rotterdam 1975), at 229, 230.

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(effective in 1982) provides that royalties received from an Italian source are subject to a final withholding tax. The amendment was made on the basis that, even in the absence of a PE of the non-resident, the continuous use of intangible assets may create an economic connection to Italy to justify taxation.[12]

B. *Deduction*

The general rule in Italy is that all ordinary business expenses, including royalty payments, are deductible in computing taxable profits. The deduction of royalty payments to associated companies may, however, be deducted subject to certain limitations (see below "Transfer Pricing").

C. *Taxation of royalties under domestic law*

Royalties received by an Italian resident from abroad are subject to IRPEG (or IRPEF). Royalties paid by a resident company to another resident company (or resident individual) or to an Italian PE of a non-resident company are not subject to withholding tax. However, Presidential Decree 600 of 29 September 1973, as amended[13] provides that royalty payments to any non-resident are subject to withholding tax at the rate of 30 percent on 70 percent of gross royalties (resulting in an effective rate of 21 percent), unless reduced by a treaty. The 30 percent abatement of the taxable base relates to assumed lump sum expenses connected with production of the income.

In addition, royalties paid by an entrepreneur resident in Italy to a non-resident company are subject to value added tax at the rate of 19 percent.[14]

D. *Taxation of royalties under Italian treaties*

There is no doubt that the high Italian tax burden applying to royalties paid to non-residents jeopardizes the importation of technology more than it discourages the outflow of taxable income, in terms of royalties, toward entities located in low-tax jurisdictions, as was the intention of the tax legislator in 1980.[15] The protectionist tendency of the Italian tax legislator unfortunately becomes evident at the international level since recent Italian treaty policy is to recognize that the source state may tax royalties, in contrast to the OECD recommendation that royalties arising in a contracting state and paid to a resident of the other contracting state should be taxable only in that other state if such resident is the beneficial owner of the royalties.

The only treaties which provide for a zero rate of withholding tax on the payment of royalties are those concluded with Cyprus, Czechoslovakia,[16] France,[17] Germany,[18] Greece, Hungary, Ireland, Israel, Malta,[19] Netherlands (old treaty still in force) and the former USSR.

Furthermore, among the reservations on Article 12(1) of the OECD model, as revised in September 1992, Italy explicitly reserves the right to tax royalties at source, and is only prepared to grant favourable treatment to certain royalties (i.e. copyright royalties); it also reserves the right to subject the use of, or the right to use, software to a tax regime different from that provided for copyright.[20] However, neither observations nor reservations have been made as regards the definition of "royalties" under Article 12(2) of the OECD model, which is extensively used in treaties concluded by Italy; the term royalties means "payments of any kind received as a consideration for the use of, or the right to use, any copyright or literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience". In conclusion, it appears that the treaty definition is reasonably compatible with the thrust of Article 20(2) so that no interpretative problems may be expected on the matter.

IV. INTEREST

A. *Definition*

ITC Article 20(1)(b) refers to "income from capital paid by the state, by residents of Italy and by PEs of non-residents". "Income from capital" is defined in ITC Article 41, and includes:

- interest and all other income deriving from loans, deposits and current accounts, including the difference between the sum at expiration and the amount loaned or deposited;
- interest and other income deriving from bonds and similar securities, and from other securities which are not shares, including the difference between the sum or the fair market value of assets received at expiration and the issuing price;
- other income of definite measure derived from the use of capital, excluding interest (other than that indicated above).[21]

12. See A. Noteboom and J.H.Th. Schipper, "Tax Treatment of the Royalties and/or Lump Sums Paid by Enterprises, in Developing Countries for Technical Assistance and Licences under Patents" in *Studies on Taxation and Economic Development* Vol. II (Amsterdam: IBFD, 1973), at 45; S. Mayr, "Una nuova disciplina per i soggetti non residenti: royalties ed altri compensi", *Boll. trib.* (1982), at 112.
13. As amended by Presidential Decree 897 of 30 December 1980.
14. Interest, however, is not subject to value added tax.
15. See Mayr *supra* note 12, at 115.
16. 5% only applies on the gross amount of royalties arising from patents, trademarks, designs or models, plans, secret formulas or processes, or for the use of, or the right to use, industrial, commercial or scientific experience.
17. The rate applies on the gross amount of royalties arising from the use of or the right to use any copyright of a literary, artistic or scientific work.
18. The rate applies on the gross amount of royalties arising from the use of or the right to use any copyright of a literary,
artistic or scientific work, as well as on the gross amount of royalties in respect of payments of any kind received as consideration for the use of, or the right to use, motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting.
19. The rate applies on the gross amount of royalties arising from the use of or the right to use any copyright of a literary, artistic or scientific work, including cinematographic films or tapes for television.
20. This reservation was added on 23 July 1992.
21. The tax legislator would exclude from the taxable base not only" compensative" interest but also "moratory" interest, interest for late payment, and other "correlative" interest other than that deriving from loans, deposits and current accounts, bonds, and similar securities which are not shares. See Leo *supra* note 6, at 385.

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According to civil law literature,[22] interest must have the following characteristics:

- the interest obligation to pay must be connected to the main obligation;
- there must be general similarity between the object of the main obligation and the additional obligation, since interest must be "an amount of fungible things";
- it must be periodic, making reference to the "acquisition date" rather than the expiration date of the obligation to pay interest, which could also be determined differently, according to the willingness of parties;
- the amount of interest due must be determined by multiplying the duration by a rate which is proportional to the main obligation (so-called "interest rate").[23]

The first characteristic distinguishes interest from other types of payments such as annuities or annual performances due in perpetuity, which are not associated with an obligation to return capital (or principal). The general equality characteristic distinguishes interest from royalties because royalties represent non-fungible compensation for the use of a specific intangible. The latter two characteristics distinguish interest from dividend distributions. Dividends could be associated with the main obligation of the contribution to the company's capital, but dividends are never determined in advance since they depend on the current economic and financial condition of the company.

B. *Deduction*

As is the case with royalties, interest payable is deductible (regardless of whether it is paid to residents or non-residents) if it is related to business income and, since interest paid by companies is generally deemed connected with their business, interest paid by companies is generally deductible.

Resident companies reporting business income which includes exempt income or income which is subject to final taxation at source cannot deduct the total amount of interest payable because that interest is deemed proportionately connected with all categories of the taxpayer's income. However, under ITC Article 63, interest is deductible in an amount corresponding to the ratio between the amount of gross receipts and other income included in business income and the total amount of all income and receipts, including non-taxable and exempt income.[24] Finally, if a taxpayer derives interest income from tax-exempt state bonds acquired after 28 November 1984, only the interest paid which exceeds the amount of the tax-exempt interest can be deducted.

C. *Taxation of interest under domestic law*

As mentioned above Italy taxes the worldwide income of its residents; non-residents are only subject to tax on Italian-source income.[25] Thus interest income received by Italian residents is subject to IRPEG (or IRPEF depending on the status of the recipient), although as noted above a foreign tax credit is allowed in the year in which the foreign tax was paid.

Article 26 of Presidential Decree 600 of 29 September 1973 sets forth the various withholding tax rates applicable to interest income. The applicable rates are as follows:[26]

- 12.5 percent for interest on state bonds or bonds issued by quoted companies;
- 15 percent for interest on loans; and
- 30 percent for interest on bank deposits and bonds issued by non-quoted companies.

The withholding operates as an advance payment of income tax for resident corporations and Italian PE's of foreign companies, and as a final tax in the case of individuals and non-resident entities which do not have a PE in Italy.

D. *Taxation of interest under Italian treaties*

Generally speaking, tax treaties concluded by Italy have standard clauses similar to Article 11 of the OECD model tax treaty, i.e. interest arising in a contracting state and paid to a resident of the other contracting state may be taxed in that other state. However, such interest may also be taxed in the state of source provided the withholding tax charged does not exceed a flat percentage (the OECD recommends 10 percent).

Treaty regimes for interest are generally more favourable than the domestic regime, i.e. a few treaties provide for a zero withholding tax[27] while most provide for a flat withholding tax ranging between 10 and 15 percent.

It should be noted that Italy made a reservation to Article 11(4) of the OECD model treaty[28] as to the right to subject interest to the taxes imposed by its law whenever the recipient has a PE in Italy, even if the indebtedness in respect of which the interest is paid is not effectively connected with the PE.

V. INTERNATIONAL TAX AVOIDANCE MEASURES

Article 11 of Law 413 of 30 December 1991 amended ITC Article 76 by providing an anti-tax haven measure which dis-

22. See, F. Ferrara Jr., "Il fallimento" (Milano 1986), at 29.
23. See, M. Libertini, "Interessi", in *Enciclopedia del diritto*, Vol. XXII (Milano, 1972), at 96.
24. See A. Fantozzi, "Taxation of Interest and Dividends in Italy", 37 *Bulletin for International Fiscal Documentation* (September/October 1983), at 420 for the regime under the old foreign exchange control Law No. 43 of 7 February 1956. See also M. Alderighi, "Italy" in "The Tax Treatment of Interest in International Economic Transactions", *Cahiers de droit fiscal international*, Vol. LXVIIa (Rotterdam, 1982), at 495.
25. ITL Art. 20(1)(b).
26. If the interest is foreign source, a resident individual taxpayer may either pay a 30% final tax on the income and forfeit the right to a foreign tax credit, or alternatively include the interest in his taxable income so that it is taxed at the normal (progressive) rates, and then utilize the foreign tax credit.
27. Treaties concluded with Cyprus, Hungary and the former USSR.
28. "The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest 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."

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allows the deductibility of certain expenses.[29] In particular, Article 76(7-bis) disallows the deduction of costs and expenses arising from transactions between resident enterprises and companies domiciled in non-EC states or territories which have a preferred tax regime,[30] if the latter companies directly or indirectly control or are controlled by the enterprise, or are controlled by the same company which controls the enterprise. The deduction may be allowed, however, if the taxpayer can prove that the foreign companies principally carry on a true commercial activity, or that the transactions are carried out for actual economic purposes and were in fact performed.

Outgoing royalties and interest must be included in costs and expenses. However, some doubt about the new legislation may arise regarding interest; explicit reference is made to expenses and other negative items of income "arising from transactions" with companies located in low-tax countries: the aim of the provision appears to be to attack transactions which are clearly described, distinctly individuated and "financially" defined.

If this presents no problem in the case of royalties since they refer to the use of intellectual property, patents and trademarks as well as processes, formulae and information relating to experience acquired in industrial, commercial or scientific fields, the case for interest is slightly different. As stated by a famous Italian economic scholar[31] and confirmed by Italian tax legislation, interest is generally deemed to be connected with a business activity, since a loan, for example, is deemed to serve the business enterprise as a whole. Thus it would not be possible to disallow interest deductions unless the general principle is amended to permit a loan (and the interest accruing) to be associated with the specific activity financed (and the positive items of income which it generates.

VI. TRANSFER PRICING RULES

ITC Article 76(5) contains the rules regulating transactions between affiliated parties – such transactions must conform to the arm's length principle. Transactions between a resident enterprise and non-resident companies which directly or indirectly control the enterprise, which are directly or indirectly controlled by such enterprise, or which are controlled by the same company which controls the enterprise, are valued on the "normal value" of the goods transferred or services rendered or received if there is an increase in the taxable income. The same rules apply in the case of a decrease in taxable income but only if a mutual agreement procedure under a tax treaty is used. The "normal value" essentially means arm's length consideration for the goods or services.

The Minister of Finance in a Circular Letter of 1980[32] prescribed the methods of valuation for various transactions involving intangible property. For interest on loans, the Circular states that in determining the arm's length rate of interest reference must be made to the interest rate prevailing in the lender's country of residence.[33] In the case of royalties, it is agreed that the three basic methods (comparable price method, resale price method and the cost-plus method) will rarely apply to transactions involving intangibles, because the uniqueness of most intangibles makes it difficult to find comparable transactions (or comparable profit mark-ups). The Guidelines in the Circular Letter set parameters which determine the normal value for such transactions, i.e. if the royalties do not exceed 2 percent of sales proceeds they will generally be accepted; more evidence will be necessary to justify royalties ranging from 2 to 5 percent; and royalties higher than 5 percent will only be accepted in exceptional cases (e.g. the highly technological nature of the relevant sector).[34]

VII. CONCLUSION

Much work remains to be done to successfully achieve full integration in the international financial and industrial markets. It is better to hope for external pressure to modify domestic tax legislation than to wait for a domestic initiative.

The proposed EC Directive on interest and royalty payments between parent companies and subsidiaries located in different EC member states may offer a solution in this respect; to ensure equality of tax treatment between national and transnational transactions it is proposed to exempt from withholding tax interest and royalty payments made between parent companies and subsidiaries located in different EC member states.

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29. See generally S. Mayr, "The new anti-avoidance provision concerning transactions with low tax jurisdiction", *Intertax* (May 1992), at 289; A. Manganelli, "New Rules on International Tax Avoidance", 32 *European Taxation* (October, 1992), at 347.

30. A preferred tax regime is defined in ITC Art. 76 as one which exempts the income of the aforementioned companies from income taxes or charges it to a tax lower than half of the total tax charged on income of the same nature of a resident company.
In a Ministerial Decree of 24 April 1992, the Italian Ministry of Finance issued a "black list" of tax haven countries to which the anti-tax haven provision applies. The list is divided into three sections: countries or territories deemed to be tax havens without limitations; countries which are generally deemed to be tax havens with the exception of certain activities which are subject to taxation at a medium rate and therefore are not affected by the anti-tax haven provision; and countries which are generally deemed not to be tax havens but which, due to certain specific offshore legislation or other tax incentives, are deemed to be tax havens only with respect to specified low-taxed activities.

31. See, G. Zappa, "Il reddito d'impresa: scritture doppie, conti e bilanci di aziende commerciali" (Milano, 1937).

32. Circular 321/2267 of 22 September 1980.

33. For an in-depth explanation, see G. Maisto, "Italy" in *The Tax Treatment of Transfer Pricing* (Amsterdam: IBFD), at 32.

34. Id. at 27.

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TAX INCENTIVES IN ITALY

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I. INTRODUCTION

There are few areas in Italian tax law which manifest such a lack of legislative coordination as tax incentives. The main reason is that for decades the issue of tax incentives has been largely ignored, and no systematic studies are available. However, this area has become increasingly popular in Italy during the last few years – in fact, all programmes of the recent governments have included a comprehensive reform and coordination of the sector. Although Italian tax legislation in fact contains hundreds of tax incentive measures, until recently the sector attracted very little attention, as is evident by the lack of precise estimations of the cost of incentives to the national budget and of any projection or quantification of the actual effects of tax incentives in orienting decisions of investors.

Thus far, however, the only result of the focus on tax incentives is Article 17 of Law No. 408 of 29 December 1990 which authorized the government to enact Legislative Decrees to reform existing rules on exemptions, tax incentives or substitute tax treatments having a tax incentive character.[1] The reform process, which started at the end of 1990, is not yet complete, and probably will not be completed in the near future.

This article summarizes the history of Italian tax incentives, describes the main incentives and offers some thoughts on possible future developments.

Contents

I. Introduction
II. Concept of Tax Incentives
III. Legislative Evolution of Tax Incentives
IV. Major Tax Incentives
A. Mezzogiorno
B. Other territories
C. Agricultural sector incentives
D. Cooperatives
E. Incentives for small enterprises
F. Relief for the Credit sector
G. Tax incentives for profit reinvestment
V. Conclusion

II. CONCEPT OF TAX INCENTIVES

There is no clear definition of "tax incentive" in Italy, and the terminology used by the legislator in formulating tax laws is ambiguous and indecisive. Scholars have attempted to formulate a definition, primarily by examining the differences between tax exclusions and tax exemptions (the latter comprising the most important form of tax incentive).

Traditional literature[2] made a distinction between tax incentives, tax exclusions and tax exemptions based on their respective structures. In particular, tax exclusions are justified by economic or technical factors based on tax considerations, while tax exemptions are based on non-fiscal political and social factors. However, an alternative theory adhered to the position that fiscal considerations were always the basis of tax exclusions – tax incentives may come in a variety of forms such as exclusions, exemptions, deductions, deferral, tax credits, etc. so the form is not determinative. Under this theory a functional analysis must be made of the rationale underlying the incentives, i.e. tax exclusions[3] are the result of the tax authorities limiting their jurisdiction, while tax exemptions are based on a balancing of the interests of the taxpayers and the tax authorities, which concludes in favour of the taxpayer in certain circumstances. In this sense, tax exemptions are deemed equivalent to tax subsidies, in that as they could be replaced by a cash subsidy from the tax authorities to the taxpayer.[4] In fact, when identifying tax incentives reference is frequently made to "tax expenditures" – special tax preferences constitute implicit payments by the tax authorities effected by way of a reduction in a specific tax liability.

The most recent doctrine[5] expounds a theory according to which tax incentives are tax regimes which derogate from ordinary regimes, serve promotional purposes and are more favourable in certain circumstances. To identify a tax incentive it is necessary to find an "ordinary" regime, characterized by the structural provisions necessary for application of the tax (determination of the entities subject to tax, the rate schedule, tax period, etc.). Once this is established, it is necessary to determine whether a promotional derogation leading to more favourable treatment is provided. Again for classification purposes it is useful to refer to the justification for the

1. The decrees were originally to be enacted by 31 December 1991. The date was extended to 31 December 1992 by Art. 9, para. 1, Law No. 413 of 30 December 1991, yet no reform was enacted. Therefore, a new Delegation Law will have to be approved if the reform is to be effected.
2. A. Fedele, *Profilo dell' imposta sugli incrementi di valore delle aree fabbricabili* (Milan, 1968).
3. For example, certain personal exemptions, the degree of progression in the income tax rate structure, the relationship between corporate income tax and income tax for shareholders, etc.
4. This theory comports with the North American theory that tax incentives are equivalent to subsidies – this is why the concept "tax expenditures" has been developed. See, in this respect S.S. Surrey, *Pathways to Tax Reform* (Cambridge, 1973). German literature reaches the same conclusion, considering tax incentives for hidden subsidies and thus relating more to economics than fiscal law; see K. Tipke, J. Lang, *Steuerrecht, Ein systematischer*, 13th ed. (Vienna: Grundriss, 1991).
5. F. Fichera, *Le agevolazioni fiscali* (Padoa, 1992).

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incentive, i.e. if the incentive is justified on the grounds that it encourages particular activities or provides special relief or assistance (thereby achieving a particular economic or social goal), then that special treatment should be classified as a tax incentive.[6]

III. LEGISLATIVE EVOLUTION OF TAX INCENTIVES IN ITALY

The first attempt to rationalize tax incentives was undertaken in the tax reform initiated in 1971. In particular, Law No. 825 of 9 October 1971 contained a general delegation to the government for a comprehensive tax reform. The tax reform, enacted through several Legislative Decrees approved in 1972 and 1973, replaced most (if not all) taxes previously in effect with a reduced number of direct and indirect taxes.

One of the objectives of the tax reform was to drastically limit exemptions and incentives.[7] The Parliamentary Commission set up to study the tax reform was aware of the problems created by exemptions and incentives, and the Commission sharply criticized the existing regime, which was characterized by numerous and uncoordinated legislative provisions. The Commission urged a drastic cut in both the number and importance of tax incentives, and more importantly, a suggestion was made that tax preferences which could still be justified should be substituted to the extent possible by subsidies, tax bonuses or credits. Moreover, tax incentive policy should be coordinated within a comprehensive state policy of tax and non-tax incentives.[8]

However, the legislative evolution of tax incentives after the tax reform was far from satisfactory. In compliance with the Delegation Law, on 29 September 1973, the Government enacted Decree No. 601, "Rules on tax incentives" (the "Tax Incentive Decree"). The Ministry of Finance's Report on the Tax Incentive Decree recognized that the objectives of the Delegation Law were not completely achieved. The Report stated that the Ministry of the Treasury concluded that the substitution of existing tax incentives with subsidies proved to be extremely difficult, and therefore recourse should be made to the traditional method of tax exemptions. Furthermore, the planned reorganization of the entire state incentives policy remained a paper project. Therefore at the outset, the Tax Incentive Decree was deemed to be only a complex of rules to cover the lack of legislative provisions resulting from the repeal of pre-existing tax incentives.

In the final analysis, the sole achievement of the tax reform in this respect was the approval of the Tax Incentives Decree which does not even include all incentives (i.e. some incentives are contained in the laws governing single taxes).

In very general terms, the Tax Incentive Decree is divided into six chapters:

- Chapter 1 (Articles 1-7) concerning tax incentives for specific persons (incentives relating to the buildings of the Vatican, compensation to employees of the Catholic Church, foreign consulates and embassies, etc.);
- Chapter 2 (Articles 8-9) concerning incentives for the agricultural sector;
- Chapter 3 (Articles 10-14) concerning incentives for cooperatives;
- Chapter 4 (Articles 15-22) concerning incentives for the credit sector;
- Chapter 5 (Articles 23-30) concerning incentives with a territorial scope of application (mainly those applicable to the Mezzogiorno area);
- Chapter 6 (Articles 31-34bis), concerning miscellaneous incentives.

However, immediately after enactment of the Tax Incentive Decree, many tax provisions introducing tax preferential treatment were passed, so that by the end of the 1980s, the picture was extremely chaotic.

In 1988, Law No. 362 of 23 August 1988 provided that the Ministry of Finance must indicate in the Preliminary Note on Expected Revenue the financial effects and consequences of all tax incentives introduced during a particular year, together with an indication of the beneficiaries and the goals of the incentive.

In 1989, a special working group was set up within the newly-created Committee for Fiscal and Budget Policy. The working group established criteria for identifying tax incentives, and prepared a questionnaire to be sent to various parties in which all elements of tax incentives were to be separately indicated in order to faciliate a classification of incentives by dividing them in accordance with their goal, economic sector, category of beneficiary, geographic area of application, form and estimate of tax expenditure.

This led to a second attempt to organize the sector, which commenced with Law No. 408 referred to in the introduction. Article 17 of this law authorized the Government to enact one or more Legislative Decrees concerning the revision and modification of existing rules on exemptions, tax incentives or substitute tax treatment having a tax incentive character. Article 17[9] lists the principles the Government must follow in implementing the Legislative Decrees:

(1) exemptions, tax incentives or substitute tax treatment having a tax incentive character must be replaced with expenditure in order to permit, within the amount budgeted, the granting of tax credits or bonuses, the amount of which will be determined on the economic circumstances of the beneficiaries of the incentive;

(2) existing exemptions, tax incentives or substitute tax treatment having a tax incentive character, even if coherent within the structure of the relevant tax, may be maintained, in whole or in part, if they can still be justified (in compliance with constitutional provisions or specific economic, social or cultural goals which are compatible with EC directives); the need for the incentive, in relation to the dimension of the activity and the geographical area

6. See S.S. Surrey, E.M. Sunley, "Tax Incentives as an Instrument for Achievement of Governmental Goals", *Cahiers de droit fiscal international* (Deventer: Kluwer, 1978), at 18.

7. This is clearly stated in several Parliamentary Reports on Law No. 825/71.

8. By non-tax incentives the Commission meant all state incentives which do not have a direct impact on the tax position of the beneficiaries, e.g. grants, contributions, low-interest financing, etc.

9. Modified by Art. 9, para. 1, of Law No. 413 of 30 December 1991.

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where it will apply (with particular reference to the Mezzogiorno) must be taken into account;

(3) exemptions, tax incentives or substitute tax treatment having tax incentive character referred to under (1) and (2) are to be applied for only a limited period of time, except those which are created to comply with specific constitutional provisions;

(4) the amount budgeted to reorganize the sector cannot exceed 50 percent of existing tax expenditure, as computed on the basis of estimation made on 31 December 1990.

In May 1991, the Ministry of Finance prepared a list of existing tax incentives in respect of individual income tax, corporate income tax, local income tax and value added tax (the "Incentives List") on the basis of tax legislation enacted up to 31 December 1990, together with an estimate of their cost. The Incentives List contains 370 tax incentives, 190 of which indicate their effect in terms of actual cost.[10]

The agricultural sector enjoys 38 different incentives;[11] the industrial sector enjoys 19 incentives;[12] the service sector, 19 incentives; finance and banking sector, 16 incentives[13]; and the construction industry enjoys five different incentives.[14]

In general, the Incentives List contains all tax rules which deviate from a general tax treatment, without any distinction between the various forms that a tax incentive may take (exclusion, exemption, substitute tax, separate tax, deduction, rate reduction, tax credit, etc.). The List merely indicates, for each incentive, the "general" rules and the rule which derogates from the general rules. This led authors[15] to conclude that the legislator made an implicit determination that a "tax incentive" encompassed all tax treatment which derogates from a rule which is considered to be "general".

Several tax incentives included in the List raise doubts. For instance, the dividend tax credit granted to resident shareholders[16] of resident corporations, which is unanimously considered as a means to eliminate economic double taxation, is considered a tax incentive.[17] Similarly, the 60 percent corporation tax exemption for dividends received by Italian resident corporations from certain non-resident related corporations[18] has been included in the tax incentives list.[19] Clearly, this rule was introduced to (partially) eliminate the international double taxation of dividends.

In June 1991 the Council of Ministers approved a draft Legislative Decree for the revision of tax incentives (the "Draft Decree"). The Draft Decree is divided into five articles and contains four Appendices:

- Article 1 provides that tax incentives in Appendix A1 may be maintained in an amount established annually by the budget law; paragraph 2 provides that the tax incentives listed in Appendix 2A may continue to apply without limitation;[20]
- Article 2 provides that tax incentives in Appendix B must be substituted by tax credits.[21] Such credits are not to be included in the determination of taxable income, and the total amount of the credit may not exceed 50 percent of the increase in revenue deriving from the repeal of such incentives;
- Article 3 provides that tax incentives in Appendix C, i.e. those whose objective is no longer valid, are to be abolished;[22]
- Article 4, paragraph 2 provides that tax incentives in Appendix D may be maintained without the limitations set forth in Article 5 (see below);[23]
- Article 5 establishes a ceiling for direct tax purposes for all tax incentives. In particular the reduction of income taxes, due to the cumulative application of tax incentives other than those mentioned in Appendices B and D may not in any case be higher than a given percentage (to be established annually) of the tax that would have been paid if the incentives were not applicable.[24]

Although it approved the Draft Decree, the Parliamentary Commission expressed several reservations, noting that some provisions of the Draft Decree were not in full compliance with Article 17. In particular, the Commission pointed out conflicting text: although the Delegation Law authorized the Government to revise and modify the existing rules on tax incentives, but only insofar as they derogate from the normal regime, the Draft Decree does not make any distinction and it includes "tax preferences" which are inherent in the structure of the relevant tax. In consideration of the Commission's reservations the Government withdrew the Draft Decree and proposed that Parliament postpone the term for enactment of new legislation.[25]

IV. MAJOR TAX INCENTIVES

Below are some of the major tax incentives which are currently available under Italian tax law.

A. *Mezzogiorno*

Probably the most well known tax incentives are those relating to the Mezzogiorno,[26] which are contained in Presidential

10. This amounts to some 80,800 billion lire.
11. 19 of these incentives generate a tax expenditure of some 3,600 billion lire.
12. 14 of which generate a tax expenditure of 705 billion lire.
13. Four of which generate a tax expenditure of 1,450 billion lire.
14. Generating 1,200 billion lire in tax expenditure.
15. See *supra* note 5, at 277.
16. As well as to Italian permanent establishments of non-resident persons.
17. See Art. 14 of Presidential Decree No. 917 of 1986.
18. Dividends from qualifying non-resident, non-EC, tax-haven corporations are excluded from the 60% exemption.
19. Art. 96 of Presidential Decree No. 917 of 1986.
20. Appendix A1 includes most of the tax incentives granted to the cooperative sector and the film industry. Appendix A2 includes indirect tax breaks for the purchase of a residence.
21. The incentives included in Appendix B are for the most part those provided for the Mezzogiorno and other depressed areas.
22. Appendix C includes incentives for taxpayers in areas which have been hit by earthquakes and several incentives for the energy sector.
23. The incentives in Appendix D are generally those introduced for social purposes.
24. It should be noted that the Governmental Explanatory Report accompanying the Draft Decree clearly indicates that the ceiling mechanism was proposed in order to implement a scheme similar to the US minimum tax.
25. In consideration of the remarks of the Parliamentary Commission the Parliament decided to grant the Government an extension of the term for approval of the reform of the tax incentives sector. See *supra* note 1.
26. The State aid system to the Mezzogiorno area has recently been subject to significant changes. In particular, the aid to the Mezzogiorno has been embodied

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Decree No. 218 of 6 March 1978 and Law No. 64 of 1 March 1986. The Mezzogiorno area (Southern Italy) comprises the regions of Abruzzo, Molise, Campania, Puglia, Basilicata, Calabria, Sicilia, Sardegna, the provinces of Latina and Frosinone, as well as certain areas in the provinces of Rieti and Rome. Tax incentives, which take the form of tax concessions, and non-tax incentives, such as grants and low interest loans, are available to both domestic and foreign investors.

1. Tax concessions

A ten-year total exemption from corporate income tax ("IRPEG") is available for companies established in the Mezzogiorno area after 29 March 1986 and engaged in new productive activities.[27] The exemption is applicable from the date of formation of the company.

A ten-year exemption from local income tax ("ILOR")[28] is granted for new or expanding industrial plants located in the Mezzogiorno area. The exemption starts from the first year activities become profitable, and extends to profits generated by the trade of products manufactured in qualifying plants.

A total exemption from ILOR is granted for profits generated by resident companies which are reinvested for the construction, expansion or reconstruction of industrial plants in the Mezzogiorno area.[29] A total exemption is also available for profits generated by resident companies which are directly reinvested in the transformation of agricultural land.
These exemptions are available until 31 December 1993.

2. Low interest loans

In addition to the above concessions, long-term loans are available to qualifying industrial companies at favourable interest rates (from 4.5 to 7.5 percent). These loans are granted by special credit institutions, and the interest and principal generally become payable from the third year of the loan. The amount of the loan may be as high as 70 percent of the total cost incurred in constructing industrial buildings and purchasing machinery.

3. Cash subsidies

Cash subsidies may be granted for the construction, expansion and modernization of industrial plants. The amount of the subsidy is equal to 40 percent of the first 7 billion lire, 30 percent of the next 23 billion lire and 15 percent of amounts exceeding 30 billion lire. The grant is increased by one-fifth for specific priority investments, and for investments in thinly populated areas.

4. Other incentives

In addition, the same Presidential Decree and Law also provide for substantial reductions in social security contributions for the employer and the employee, as well as reductions in consumption charges for electrical power used by industrial facilities.

Finally, all enterprises may deduct from business income donations made to legally recognized entities headquartered in the Mezzogiorno which are engaged solely in scientific research. The total deduction may not exceed 2 percent of reported taxable income.

B. *Other territories*

Law No. 19 of 8 January 1991 contains several measures to attract investment to the Friuli-Venezia Giulia region. Article 3 provides for the creation of a financial centre in the existing free-trade zone of Trieste. Financial companies and institutions (such as branches and subsidiaries of banks, insurance companies, fiduciary companies, financial companies borrowing and lending in foreign markets, etc.) may operate in the financial centre, and will be deemed non-resident for purposes of exchange control regulations and banking laws. Income produced by such enterprises in the financial centre is exempt from IRPEG, and ILOR is levied at a reduced rate of 8.1 percent. Moreover, the enterprises are not subject to tax withholding obligations.

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in a legislative framework of economic aid which relates to the entire national territory. The areas to which the State aid applies will be divided in accordance with EC directives into three categories, i.e. depressed areas, areas facing an industrial decline and disadvantaged rural area.
These changes do not relate to tax incentives (in the sense that the tax reductions referred to are still in existence). Broadly, the new legislative provisions (Decree No. 415 of 22 October 1992, converted into Law No. 488 of 19 December 1992 and Legislative Decree No. 96 of 3 April 1993) provide for the following:

- The Agency for the Promotion of Development in the Mezzogiorno (Agmez) and the Department for the Extraordinary Intervention in the Mezzogiorno have been abolished as from 15 April 1993; the powers and duties of such entities have been transferred from the Ministry of the Mezzogiorno to the Ministry of Budget;
- the Minister of Budget has been given responsibility for monitoring and coordinating State aid for all economically depressed areas (not only the Mezzogiorno);
- an observatory on regional policies has been set up within the Ministry of Budget to verify the implementation and effectiveness of all action undertaken in the economically depressed areas;
- all competence for granting direct subsidies and concessions has been transferred to the Ministry of Industry, Commerce and Craftsmanship.

The Ministry of Budget recently proposed that financial aid will be granted by way of "tax bonuses" which can be used to pay taxes and social security charges on newly employed individuals. Moreover, the tax bonuses can also be sold (in whole or in part) to other group companies or to banks, provided the receiving enterprise obtains a guarantee in favour of the tax administration of a corresponding amount. Tax bonuses can only be transferred in an amount not exceeding 150% of the capital invested in the business in the qualifying area.

27. The effects of the tax exemption for purposes of IRPEG are also passed on to the shareholders of the Mezzogiorno companies when profits earned by such companies are distributed. As a general rule resident taxpayers receiving dividends from resident corporations are entitled to a dividend tax credit equal to 9/16 (or 56.25%) of the dividend. The amount of the tax credit is included when computing the taxable base of the shareholder and then subtracted from the gross tax. To prevent a shareholder from claiming the dividend tax credit in respect of dividends originating from income which was not subject to tax (in part or in full) at the distributing company's level, an equalization tax is levied on the excess of the amount distributed to the shareholders from the earnings of the tax year over 64% of the net income declared for purposes of IRPEG. However, if the distributed dividends are formed by profits subject to the tax incentives available in the Mezzogiorno, the equalization tax does not apply.

28. ILOR is levied on the same income which is subject to IRPEG. The current rate of ILOR is 16.2%.

29. To obtain the exemption an interested company must make a request in its annual tax return, indicating the amount of profits which it intends to reinvest. A project illustrating the proposed investment, the expected dates of commencement and termination of the construction and the financial plan must also be attached to the tax return. The work must be initiated within one year from the date of filing the tax return and completed within the next two years. If these deadlines are not met, the tax saving must be returned and a penalty of 50% is due.

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A ten-year exemption from ILOR applies for artisan and industrial enterprises operating in certain areas of Central and Northern Italy.

Under Law No. 26 of 29 January 1986, the ten year tax exemption from IRPEG applies to corporate enterprises engaged in new productive activities in the provinces of Trieste and Gorizia. Moreover, all enterprises operating in Trieste which are engaged in industrial production, scientific and technological research or port services, as well as all (new or modernized) artisan and industrial enterprises operating in Gorizia may benefit from an exemption from ILOR until 31 December 1995.

C. *Agricultural sector incentives*

The agricultural sector benefits from the more important incentives including the following:

(1) 15 to 40 year exemption from ILOR for land used for reforesting projects;
(2) 5 to 25 year exemption from ILOR for land used for rejuvenation or initial planting of fruit plantations;
(3) 50 percent exemption from ILOR for agricultural income derived from land over 700 meters high, or land included in the list prepared by the Central Census Commission, or land comprising mountain reclamation districts.

D. *Cooperatives*

A full exemption from IRPEG, individual income tax ("IRPEF") and ILOR is granted to agricultural cooperatives and their consortia for income derived from raising animals on feed of which at least one-fourth is obtained from land held by members. The exemption also applies to the processing, transformation and sale of agricultural products and animals contributed by members, and income earned by small-scale fishing cooperatives and related consortia.

A total exemption from IRPEG, IRPEF and ILOR is granted to production and labour cooperatives and consortia, provided the total amount of wages and salaries (including social security contributions) paid to members who are employed on a continuous basis is not less than 60 percent of the total amount of all other costs and expenses (excluding expenses incurred for the purchase of raw materials and semi-finished goods). If the amount of wages and salaries is less than 60 percent but more than 40 percent of the above amount, the exemption is reduced to 50 percent.

A 25 percent exemption from IRPEG and ILOR is granted to all other cooperatives and their consortia. Moreover, that part of the profits earned by cooperatives and their consortia which is used to increase the social capital is excluded from income taxes. This amount becomes taxable for the members (and not for the cooperative or consortium) if and when the capital is reimbursed to them.[30]

1. Consortia

Law No. 240 of 21 May 1981 introduced a full exemption from IRPEG and ILOR for consortia and consortial companies set up, also in cooperative form, by and between small and medium sized enterprises engaged in the industrial, trade and artisan sectors, with the purpose of promoting the development and marketing of products manufactured by the associated enterprises.[31] The exemption is granted with respect to profits which are reinvested, within a period of two years from their realization, in fixed assets.

E. *Incentives for small enterprises*[32]

Small enterprises are eligible for a number of incentives, including tax credits, grants and contributions and low interest loans in order to promote research, innovation and development.[33]

1. Tax credits

Tax credits are available to small enterprises engaged in the manufacturing, trade and service sectors for fiscal years 1991-1993 for investment in research and development, including services relating to increasing production capacity, acquisition of technology, entering new markets, etc. Equity investments in innovative companies made by finance companies whose corporate purpose is to temporarily participate in small corporations facing financial difficulties ("at risk corporations") also give rise to tax credits. These tax credits may be used to offset IRPEG or ILOR; any excess can be carried forward four years, or be offset against value added tax.

The tax credits may also be enjoyed by cooperatives and partnerships, whose members are at least 60 percent women, by corporations whose capital is owned for at least two-thirds by women and two-thirds of the directors of which are woman, as well as by individual enterprises operated by women, and which are engaged in the industrial, artisan, agriculture, trade or service sector.[34] Tax credits may be substituted by contributions equal to 30-50 percent of the costs incurred for the acquisition of machinery, assets, services, research expenses, new production, trade or quality control systems, etc.[35]

2. Grants and contributions

The Ministry of Industry, Commerce and Craftsmanship may allow grants and contributions in lieu of tax credits.

Financial contributions may also be made to joint ventures between small enterprises, which are entered into for the research or acquisition of advanced technologies, purchase of raw materials, creation of a common distribution network, promotion of sales activity, implementation of technological and scientific research, creation of joint trademarks, etc.

30. Art. 7 of Law 31 January 1992, No. 59.
31. Only consortia set up by at least five associated enterprises, none of which may own more than 20% of the capital, qualify for the incentive.
32. According to Art. 1 of Law No. 317 of 5 October 1991, a small enterprise is defined as an enterprise having no more than 200 employees and no more than 20 billion lire in invested capital. A small commercial or service enterprise is an enterprise with no more than 75 employees and no more than 7.5 billion lire in invested capital.
33. Law No. 317 of 5 October 1991.
34. Law No. 215 of 25 February 1992.
35. Id.

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3. Low interest loans

Loans granted at favourable rates by specialized credit institutions are also available for such joint ventures.

F. *Relief for the credit sector*

An amount equal to 50 percent of the profits that banks and other credit institutions set aside for legal and statutory reserves in excess of ⅓₀ of year end profits is exempt from ILOR. Moreover, 50 percent of the interest derived from loans granted by banks and other financial institutions to regions, provinces, municipalities, hospitals or public social welfare and educational institutions is exempt from IRPEG.[36]

G. *Tax incentives for profit reinvestment*

Article 12 of Law No. 333 of 11 July 1992[37] contains special provisions aimed at granting tax incentives for all enterprises (individual and corporate) which reinvest part of their profits in "innovative investments". The incentives may be enjoyed by enterprises which, in 1993, 1994 or 1995 earn taxable income at least 15 percent higher than that of the preceding year. If this condition is met, the excess of taxable income over the income of the preceding period is subject to tax (IRPEF, IRPEG and ILOR) of 50 percent of the excess, provided the amount of innovative investments effected in the period is higher than the sum of the excess profit and the amount of tax deductible depreciation taken in such year.[38]

These provisions have been criticized because due to the current economic recession, few enterprises will realize a 15 percent increase of taxable profit in the current and subsequent two tax periods.

V. CONCLUSION

The immense difficulties encountered in Italy in listing tax incentives, quantifying their costs and effects, and drawing up tax expenditure budgets are a strong indication that tax incentives are little understood or studied. In addition, it is highly contradictory that, notwithstanding the "negative image" the public has of tax incentives, their number continues to expand steadily. This phenomenon is accompanied by the "persistence" of tax incentives, i.e. tax incentives are often introduced on a temporary basis but are extended from year to year.

However, the emphasis which has been put on tax incentives during recent years reflects the increasing awareness of their importance and (in particular) their effects on revenue. Another important trend is that of the recognition in the fiscal process that direct expenditures are alternative courses to tax incentives in order to accomplish governmental goals. However, little consideration is given to the criteria that should govern the choice between these courses once a decision is made to provide government financial assistance to achieve a particular goal.

Therefore, it is not unfair to say that the inability of the Italian government to identify and quantify the tax expenditures imbedded in the Italian tax system is an important sign that Italy has probably lost control of an important aspect of its fiscal policy.

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36. Art. 21 of Presidential Decree No. 610 of 1973.
37. Converted into Law No. 359 of 8 August 1992.
38. An example may be useful to clarify the mechanism:

1992 taxable income	6,000,000 (a)
1993 taxable income	7,000,000 (b)
excess profits [(b)-(a)]	1,000,000 (c)
1993 depreciation (in total)	500,000 (d)

Since the 1993 income exceeds the 1992 income by 16.7 percent, if the innovative investment effected in 1993 is higher than 1,500,000 [(c)+(d)], then the taxable income for 1993 will be 6,500,000 [(b)-50% of (c)].

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TAX AVOIDANCE: THE ITALIAN EXPERIENCE

Avv. Bruno Gangemi

I. INTRODUCTION

> "It is practically impossible to counteract tax avoidance by means of a general statutory provision, the interpretation of which would be difficult and not always fair."

So reads the 1963 conclusion of the Commission on the Study of Tax Reform which in 1961 was charged with the task of outlining the basic principles of a comprehensive tax reform (enacted in 1972-73). The Commission thoroughly examined the problem of tax avoidance and the pros and cons of a general provision which would allow the tax authorities and courts to determine whether the sole or main purpose of a transaction was tax avoidance. A majority of the Commission concluded that, notwithstanding the advantages of a general provision, the negative aspects would outweigh its advantages. Factors which played a significant role in the Commission's conclusion included an increase in tax litigation, evidentiary problems associated with showing the taxpayer's intent to avoid tax, and difficulties in interpretation.

The Commission recommended tackling the avoidance problem by ad hoc provisions, identifying the particular transactions which were perceived to constitute tax avoidance. For that purpose, the Commission defined tax avoidance as "a method which the taxpayer may adopt to reduce or avoid the tax burden by artificially structuring his activity or behaviour, but fully complying with the statutes, at least formally, so as not to commit a tax violation". This 30 year old definition is valid today, and my remarks hereunder are based on the definition formulated by the Tax Commission.

In spite of the Commission's recommendation, the Italian Parliament enacted an anti-avoidance provision (limited to corporate reorganizations), which is found in Article 10 of Law 408 of 29 December 1990. Article 10 is the first piece of Italian tax legislation that refers to "business purpose" and provides as follows:

> The tax authorities may disallow the tax benefits realized in mergers, divisions, transfers, reorganizations, demergers and capital reductions when such transactions are carried out without a valid business purpose and for the exclusive purpose of fraudulently obtaining a tax saving.
>
> The tax due on the income assessed by the tax office under Article 10 and the interest thereon are provisionally billed to the taxpayer after the decision of the tax court of first instance or after one year from the taxpayer's appeal, if the tax court has not issued a decision by that date.

The discussion below examines the reasons why the Italian Parliament abandoned its traditional attitude toward tax avoidance and repudiated the approach recommended by the Tax Commission.

II. BACKGROUND

A glance at the process which led to this Copernican revolution in Italian tax philosophy may help to understand how the new provision will be interpreted by the courts. The process may also shed light on future trends in the anti-avoidance campaign.

Certain features of the Italian tax system undeniably foster tax avoidance. For example, the existence of several rates of VAT may induce taxpayers to structure their transactions artificially in order to minimize the tax burden. Tax avoidance schemes may also be encouraged by the numerous tax benefits still available in Italy.[1] Such benefits include local incentives (southern Italy, Trieste, etc.), tax exemptions for specific items of income (e.g. income from state bonds) and bene-

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This article is based in part on earlier articles on the same subject. See Gangemi, B., Chapter Italy, in Tax Avoidance, Tax Evasion (London: International Bar Association, 2d ed., 1987) and S. Bellettini of Macchi, Cellere & Gangemi, "Italy intensifies anti-avoidance effort," International Tax Review (February 1992).

Contents

I. Introduction
II. Background
III. Methods to counter tax avoidance
IV. Civil law not effective to counter tax avoidance
V. Form over substance
A. General application
B. Exceptions: Substance over form
VI. Mergers under surveillance
VII. Recent developments
VIII. Conclusion

1. Some of the tax benefits have been abolished (e.g. state bonds).

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fits applicable to certain economic sectors. Finally, the different rates and the technicalities relating to the registration tax provide opportunities for avoiding the higher rates.

In addition, the generally accepted principle of "form over substance" often provides taxpayers with a valid defence to a challenge by the tax authorities, particularly with respect to sophisticated transactions, often inspired by Anglo-Saxon experience. For example, tax avoidance opportunities have increased dramatically by the internationalization of the Italian economy, the proliferation of transactions not specifically covered by the Civil Code and the exchange of experiences and techniques between tax consultants of different jurisdictions.

The tax authorities' dilatory and often clumsy reaction to the ingenious schemes devised by taxpayers and the commonly shared opinion that certain "sophisticated" taxpayers can successfully escape the ever-increasing tax burden constitute the technical and political background which made it possible for the Government to enact Article 10 of Law 408.

III. METHODS TO COUNTER TAX AVOIDANCE

A discussion of the Italian tax avoidance industry must start with the registration tax, which dates back to 1862 and represented a major source of revenue until the end of World War II.[2] For decades, the tax has created the legal arena in which taxpayers and tax authorities demonstrated their skill in inventing and combating tax avoidance schemes.

The early schemes aimed at reducing or escaping the heavy burden of the death and gift taxes, making recourse to "ante mortem" agreements and arrangements which were subject to the lighter burden of the registration tax. A common countermeasure consisted of "juris et de jure" presumptions (i.e. legal presumptions which a taxpayer cannot rebut). For instance, the transfer of real estate to relatives in direct line is taxed as a gift if the registration tax applicable to the transfer is lower than the gift tax. Similarly, goods and rights disposed of in the last six months of a person's life are, subject to certain exceptions, included in the taxable basis for death tax purposes.

The same approach has been adopted in the income tax area. According to income tax rules, now superseded, capital gains resulting from the disposition of shares or real estate were subject to personal income tax only if the seller's intent was speculative. However, in certain instances, a speculative intent was presumed by law, i.e. the taxpayer could not rebut the tax authorities' claim, even though he might be able to demonstrate the absence of a speculative intent.

This was the case with regard to capital gains resulting from the disposition of shares in Italian companies if the shares disposed of in a 12-month period exceeded 2 percent of the capital of a company listed on a stock exchange or 10 percent if the company is not listed; with respect to limited liability companies, the tax on the gain was levied if the quotas (participations) exceeded 25 percent of the company's capital. As to real estate, a speculative intent was presumed if the purchase or sale of real estate not used by the taxpayer or his family occurred within five years of the last disposition or if, in the case of land zoned for construction, the sale was preceded by construction work.

It is the common belief, however, that the most effective way to defeat tax avoidance is through ad hoc rules "tailored" to specific schemes. Parliament has passed a variety of countermeasures to fill in gaps and loopholes found by taxpayers.

Starting with earlier examples, an irrevocable mandate, without the necessity of rendering account, granted to a person to sell one's property is subject to registration tax at the rate applicable to the transfer of the property in question. In the absence of such provision, the mandate might have been tax exempt. Article 1201 of the Civil Code provides that a creditor receiving payment from a third party may subrogate the latter to his rights; under the Registration Tax Law, the deed of subrogation is subject to the rate of registration tax which applies to the transfer of the rights belonging to the new creditor.

Another example relates to VAT. In order to circumvent the non-deductibility of the 38 percent VAT on sales of luxury cars, taxpayers made extensive use of leasing contracts (taxed at 19 percent). A 1978 decree put a stop to such an easy and lucrative scheme by providing that VAT applies to the amounts payable under a leasing contract at the same rates that apply to sales of the leased goods.

Other examples pertain to the income tax. Since 1 January 1979, taxpayers have not been entitled to elect to pay personal income tax on dividends at a flat rate of 30 percent. The opportunity to be taxed at this flat rate had been regarded as an easy way to avoid the progressivity of the personal income tax.

Finally, Presidential Decree 643 of 26 October 1972 concerning the tax on increases in value of real estate has also been regarded as a measure to discourage tax avoidance (particularly with respect to the personal income tax and death tax) effected by transferring the title of personally owned real estate to real estate companies wholly owned by the transferor. Decree 643 provides that tax applies at progressive rates to the difference between the value of real estate at the time of purchase and the value at the time of sale. In the case of real estate owned by companies, the tax also applies at ten-

2. The Registration Tax Law was substantially amended in 1923, 1972 and 1986. The Law provides that all written agreements and other instruments executed in Italy are, as a rule, subject to the tax. All written agreements executed abroad providing for the transfer or lease of real property located in Italy are also subject to registration tax. The tax is also due on the formation or dissolution of a company, increases in capital, and judgments of Italian courts, including judgments to enforce foreign judgments or awards. Agreements which are not subject to the tax upon execution may become subject to it later if related documents or instruments are used (i.e. deposited with certain Italian authorities) or if they are quoted fully or in part in instruments or judgments subject to registration tax. The tax is usually levied on the value of the agreement, i.e. the value of the rights which are disposed of or the obligation in the agreement, irrespective of the consideration indicated by the parties. The rate of the tax, which may vary from 0.25% to 15%, depends on the nature of the agreement. Certain agreements are subject to tax at nominal rates. Since 1973 most of the agreements reached by, or transactions entered into by, companies which had been subject to registration tax are subject only to VAT; thus, the importance of the registration tax has been reduced somewhat.

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year intervals to the difference in value realized during the ten years of uninterrupted ownership.

IV. CIVIL LAW NOT EFFECTIVE TO COUNTER TAX AVOIDANCE

Although specific provisions have traditionally been regarded as the most effective method of discouraging tax avoidance, the inadequacy of this method is unquestionable and was pointed out 30 years ago by the Commission on the Study of Tax Reform.

In some civil law countries, the principles of the Civil Code, suitably developed and interpreted in the courts, have been used to counter tax avoidance, in the absence of a broad statutory anti-avoidance provision. Thus, the principles of abuse of rights, simulation, *fraus legis*, etc. often function as the general anti-avoidance rules and "business purpose" doctrine developed in common law countries. In this regard, the Italian Civil Code has a variety of "tools" in its arsenal comparable to those available in, for example, France or Belgium where they have also been used in the area of taxation.

The tools in Italy, however, have not been effective in the tax area. The few attempts to use the Civil Code principles have been frustrated because the relevant legal principles have not been properly or sufficiently developed. Under Article 1344 of the Civil Code, a contract in fraud (i.e. for circumventing the application of a mandatory provision) is null and void. Based on a broad interpretation of Article 1344, the tax authorities tried to disregard the tax consequences of avoidance schemes without prejudice to their civil law effects. The courts have never accepted this approach on grounds that the concept of fraus legis means the circumvention of a specific mandatory provision; in contrast, tax avoidance (as defined in Section I, above) is technically in compliance with the statutes and is effected without formally violating the law. Based on this kind of reasoning, the Court of Cassation has repeatedly stated that civil law sanctions (such as the nullity of contracts) cannot be used to strike down tax schemes and related benefits; the tax system contemplates ad hoc provisions to prevent and penalize tax fraud.

The *fraus legis* doctrine would not, unless properly developed, be very effective or beneficial to the tax authorities. Indeed, a court decision nullifying a contract will not allow the tax authorities to collect any tax, much less the tax which is deemed to have been avoided.[3]

Tax avoidance can hardly be attacked under Article 1414 of the Civil Code concerning simulated contracts (e.g. sales contracts which conceal a gift or contracts where the actual circumstances do not correspond to the legal form). Scholars distinguish between absolute simulation and relative simulation. In the former, the parties pretend to have entered into an agreement which they do not actually want and which is never executed (e.g. in order to defraud his creditors, a debtor simulates a sales agreement with a third party). In relative simulation, the parties pretend to enter into a certain agreement, but actually perform a different one (e.g. a sham sales agreement which conceals a gift), or a person pretends to enter into an agreement with one party while actually entering into the agreement with another. In this connection, Article 1415(2) of the Civil Code provides that "third persons may plead simulation against the contracting parties when it is prejudicial to their rights".

On this basis, the tax authorities, when they prove that an agreement is simulated and that the government has suffered a loss as a result, can argue that (a) the simulated agreement will not have any effect as between the parties, or (b) tax should be levied on the transaction actually intended and performed by the parties. For example, in Decision 3,927 of 20 December 1958, the Court of Cassation ruled that the tax authorities may impose the death tax with respect to assets which were the object of a simulated sales agreement. Obviously, the tax authorities must demonstrate that the sales agreement was simulated, i.e. that no sales agreement had actually been executed.

A careful analysis of the matter leads to the conclusion that, under Italian law, a simulated agreement entered into for the purpose of reducing or avoiding tax constitutes tax evasion rather than tax avoidance. As a practical matter, in both absolute simulation and relative simulation, the parties hide some or all of the elements of the agreement from the tax authorities, or the parties create a legal appearance which does not correspond to the actual circumstances. In neither case are the transactions real or within the law.

Turning to the abuse of rights doctrine, it is important to stress that the only Civil Code provision dealing with this doctrine is Article 833 concerning the right of owners of real estate. Article 833 provides that "the owner may not carry out acts which have no purpose other than to harass or cause annoyance to others".

It is surprising how little scholars and judges have contributed to the doctrine of abuse of rights in Italy. For example, a well respected scholar argued that the concept is *per se* self-contradictory and pertains to the study of sociology rather than the law. The few court decisions dealing with this doctrine do not add to the development of the doctrine. Without further comment, it can be concluded that the abuse of rights doctrine in Italy is a "dry well".[4]

V. FORM OVER SUBSTANCE

A. *General application*

The failure to develop the doctrines of fraus legis and abuse of rights and to extend them to the tax area deserves comment. Article 12 of the "Provisions on Law in General", preliminary to the Italian Civil Code, provides that:

3. For sake of completeness, it should be added that a few scholars have attempted to develop the fraus legis doctrine claiming, inter alia, that the provisions circumvented by a tax avoidance scheme are embodied in Art. 53 of the Constitution ("Each one must contribute to the public expenditure in proportion to his financial ability"). This highly technical issue has been interestingly developed by F. Santonastaso, "I negozi in frode alla legge fiscale", *Diritto e Pratica Tributaria* 1970 I, and by U. Morello, "Frode alla legge", Collana degli Annali della Facoltà di Giurisprudenza dell'Università (Milan: Giuffre, 1969).

4. An exception is the elaborate analysis of Prof. P. Rescigno ("L'abuso del Diritto", *Rivista di Diritto Civile*, 1965) which does not deal with the tax aspects of the doctrine.

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> "In applying statutes, no meaning may be attributed to them other than that made clear by the actual meaning of the words, according to their context, *and by the legislative intent*." [Emphasis added]

It may be argued that this fundamental principle of interpretation allows the courts to consider the "spirit of the law". Indeed, there is no question of the legitimacy of restrictive and *extensive* interpretation of the law. The maxim "minus dixit quam voluit" is a generally accepted approach to statutory interpretation.

The second paragraph of Article 12 provides that:

> "If a controversy cannot be decided under a specific provision, consideration shall be given to the provisions governing similar cases or analogous matters; if the uncertainty remains, the case shall be decided according to the general principles of the legal system of the State."

It is generally understood and agreed that this paragraph defines the limits of the judge's authority: he has broad discretion, but may not decide a case by "supplementing" legal principles when they do not precisely fit that case.

As to taxation, Article 23 of the Italian Constitution provides that "no personal or patrimonial obligation shall be imposed other than by law".

In summary, it may be argued that the basic principles of the Italian legal system do not constitute an insurmountable barrier to the interpretation and evolution of legal principles so as to extend them to tax avoidance.

The theory that a tax should be levied according to the economic results of taxpayers' behaviour was developed 50 years ago by Professor Grizotti. His theory was based, inter alia, on the language of Article 8 of the Registration Tax Law of 1923 stating that "taxes are levied according to the actual nature and effects of the deeds or conveyances, even though the name or form does not correspond to them". This principle, in view of its general character, is valid for all taxes. It may be argued that Professor's Griziotti's theory represents the Italian version of the step-transaction doctrine. Indeed, the theory is based on the notion that, in a complex transaction or a preordained series of transactions, the tax should be levied on the end result.

The negative reaction of scholars precluded further development of this theory. Their criticisms were based on sound orthodox legal arguments and generally reflected the concern that Professor Griziotti's theory would broaden the fisc's discretion to such an extent as to put at risk the certainty of the tax rules. The Court of Cassation, sharing this concern, has repeatedly ruled that the tax authorities may not investigate the economic results intended and obtained by a taxpayer; the tax authorities' analysis is limited to the legal consequences of the taxpayer's behaviour. This was the end of a short-lived but intelligent theory which, as stated, seldom received the court's support.

B. *Exceptions: substance over form*

In a few cases, the courts deviated from the generally accepted principle of "form over substance" and seem to have adhered to the step-transaction doctrine. In one case, a father gave to his sons, by a duly registered deed, state bonds which were exempt from all taxes, including the gift tax. By a separate deed, also duly registered, the father and sons exchanged the state bonds for real property and paid the registration tax. The tax authorities claimed that the two transactions constituted a de facto gift of real property, which was subject to a higher tax than the registration tax paid.

The Court of Cassation, in Decision 2,658 of 9 May 1979, reversed the decision of the Milan Court of Appeals and ruled that the two transactions (the gift of the state bonds and their exchange for real property) were designed to achieve a result different from that typical of such transactions, i.e. gift of real property, and that consequently the gift tax was due. Although the transactions used by the parties were legitimate, they attained a fraudulent purpose which allowed the tax authorities to tax the final result of the transactions. The Court of Cassation, however, did not identify the provisions which empowered the tax authorities to tax the "final result"; such provisions, in fact, do not exist.

In Decision 5,563 of 6 October 1980, the Court of Cassation used a similar interpretation. In that case, A, B and C, owners of a building, obtained a licence from the competent authorities to demolish the existing building and construct a new one on the same site. A and B reserved the "right of superficie"[5] with regard to their portion of the building (i.e. two out of ten apartments in the building). By a separate agreement with A and B, D undertook to construct the two apartments with respect to which A and B had reserved their right. Both agreements were duly registered, and the registration tax was levied at a nominal amount pursuant to special legislation concerning low-cost housing programmes.

The tax office claimed that the registration tax should have been levied at the normal rates since, by entering into the two agreements, the parties had in effect undertaken to exchange ownership of the land on which the original building stood for the new apartments; such a transaction did not qualify for the registration tax benefit. The Court of Cassation accepted the tax office's claim and found it possible to assume a link between the two transactions. On this basis, the Court interpreted the text of the agreements, not literally, but taking into account the effect of the two agreements, so as to determine the final result intended by the parties. In this case as well, the Court of Cassation did not indicate the legal provision which justified its decision. Indeed, it would appear that these decisions were written, and the Court's arguments presented, as if the Italian tax system had a general anti-avoidance provision.

A meaningful, though isolated, extension of this attitude to the income tax is represented by the case involving an Italian company whose Board of Directors, in submitting the balance sheet to the shareholders for approval, proposed to distribute as dividends the year's profits amounting to 525,000,000 lire. The shareholders' meeting did not adopt the Board's recommendation and transferred the profits to a special reserve; the shareholders' meeting also resolved to

5. According to Art. 952 of the Italian Civil Code, the owner of land on which a building has been erected may dispose of the right to the land separately from the right to the building (or part thereof and vice versa). This means that the owner of land on which a building has been erected can sell the land and reserve the property rights ("right of superficie") to the building.

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distribute to the shareholders 500,000,000 lire out of the existing reserve consisting of premiums paid by the shareholders during prior capital increases. Premiums are not subject to income tax or withholding tax pursuant to a certain law, since they are deemed to be in the nature of capital.

The Milan Revenue Office claimed that the resolution concealed an "indirect" distribution of profits by using the scheme in which premiums were distributed. By Decision 2,115 of 5 May 1978, the Court of Cassation, reversing the Central Tax Commission's decision, agreed with the Milan Revenue Office. The Court of Cassation took the same view in Decision 5,264 of 7 October 1981 in which it reaffirmed that the distribution to shareholders of the reserves consisting of premiums is tantamount to a distribution of dividends if the profits of the year are transferred to a reserve rather than distributed.

In all of these cases, the Court of Cassation appears to have disregarded the "form" of the transactions in favour of their "substance". Needless to say, this approach does not fit in the framework of Italian legislation and, in the absence of specific provisions governing the issue, the approach may create embarrassing consequences. For instance, with regard to Decision 2,115, one could ask about the subsequent tax treatment of the distribution of the profits transferred to the reserve and, in particular, whether the withholding tax should apply at the time of distribution. If this question is answered in the affirmative, the Court's interpretation would in effect nullify the exemption granted by law. If the question is answered in the negative, the same interpretation would exempt the distribution of dividends from the withholding tax, which the law requires to be levied.

As indicated earlier, these cases are exceptions to the established principle which the Court of Cassation has reaffirmed on several occasions. On 24 April 1979, the Court, in ruling on a case involving tax avoidance, held that a tax may be levied only in the cases provided for by law, even though instances may occur which escape tax due to loopholes in the legislation; only Parliament, and not the judge, is empowered to eliminate such loopholes.

VI. MERGERS UNDER SURVEILLANCE

It is well known that mergers, reorganizations, split-ups and similar transactions offer opportunities for tax saving, and tax specialists throughout the world devote special attention to these transactions. The few attacks by the Italian fisc, based on arguments such as simulation and fraud on the law, were rejected by the courts. Under the pressure of the State's ever-growing financial deficit and the awareness that "ad hoc" provisions would have reduced, but not eliminated, tax avoidance connected with mergers and similar transactions, the tax authorities claimed a more powerful tool.

Since 1986 the Government or Members of Parliament have drafted numerous bills containing different versions of a general anti-avoidance provision. The latest proposal, subsequently dropped, provided:

> "Contracts and unilateral deeds, whether or not related, which are executed with the primary aim of avoiding wholly or partly the payment of tax and which represent an adequate means for achieving that aim, shall be regarded as tax avoidance transactions.
>
> Such contracts and deeds shall be disregarded by the tax authorities, who shall for tax purposes apply the rules of law which are being circumvented.
>
> Subject to the opinion of the State attorney, the tax authorities shall assess the avoided tax. Any assessment of the avoided tax which is not adequately supported shall be null and void."

Parliament did not approve any of these bills. One of their main concerns, which played a decisive role, was that the vague and ambiguous wording of the proposed rules would increase the uncertainty regarding tax enforcement.

The hectic and very troublesome process by which the tax authorities tried to limit the abuses connected with mergers and reorganizations produced some results. Parliament set the first restriction in 1986. This reduced the tax losses deductible in a merger transaction: the total loss eligible to be carried by the surviving company may not exceed the net worth of the companies involved in the merger.

This provision stopped the retail business involving "coffin corporations", i.e. corporations whose only assets were accumulated losses. In order to further restrict the abuses which were still possible, other prerequisites for the deductibility of losses of merged companies were introduced effective 1 January 1988. For example, the amount of salaries and sales of the merged companies in the year of merger must exceed 40 percent of the average salaries and sales of the two preceding fiscal years.

These provisions made recourse to mergers much less attractive than in the past, but did not totally frustrate the ingenuity of taxpayers. Indeed, the provisions may easily be circumvented by other types of corporate reorganization, e.g. contribution of profitable going concerns to companies with accumulated losses.

The tax authorities' awareness of the limited scope of the amendments approved by Parliament induced them to make another attempt for a broad anti-avoidance provision. This time, however, alerted by Parliament's reaction to the previous versions, the fisc submitted a more precise proposal, now embodied in Article 10 of Law 408 (quoted in Section I, above). Article 10 has particular relevance to mergers and similar transactions and permits the tax authorities to disallow, for tax purposes, part of the cost of shares and in general the tax benefits of such transactions, if they are carried out without a valid business purpose and for the exclusive purpose of fraudulently obtaining a tax saving. Article 10 also provides, however, that it does not apply to mergers, reorganizations, demergers and capital reduction resolved by 30 October 1990.

The process of enacting Article 10 attracted the resistance and criticism which traditionally accompany attempts to introduce such legislation. The Government eventually succeeded by claiming that the proposed legislation had a limited purport (i.e. the defeat of tax schemes realized through corporate reorganization) and that a similar provision could be found in the recently enacted EC merger directive (90/434 of 23 July 1990). In this regard, it should be noted that the statute implementing the directive (Decree 544 of 30 Decem-

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ber 1992) does not contain an anti-avoidance provision. The Government apparently assumed that the anti-avoidance aspect was already dealt with by Article 10 of Law 408. This conclusion may be correct, except that Article 10 does not cover transactions involving an exchange of shares.

Due to the novelty of Article 10, neither the Ministry of Finance nor the tax courts have yet had an opportunity to comment on its meaning; nor have legal scholars devoted the necessary attention to the rule. The reference to a "valid business purpose" introduces a concept which is new to Italian tax law. Its interpretation will certainly give rise to endless disputes, which will be encouraged by the somewhat vague wording of Article 10.

For instance, "tax benefits" disallowed by the tax authorities certainly refers to income tax advantages, but may very well also include indirect taxes. If the avoidance scheme extends its effects to numerous taxpayers, it is not clear to what extent and at which level the "disallowance" will operate. Moreover, it is disputable whether the taxes (direct and indirect) paid in implementing an avoidance scheme are refundable or creditable against the higher tax liability claimed by the fisc.

Uncertainties also exist as to the identification of the benefits attainable through "transformation" or "reduction of capital". As to the "business purpose", the merger directive allows a member state to withdraw a tax benefit whenever it appears that the transaction "has, as its *principal* objective, tax avoidance". The directive further provides that the lack of valid commercial reasons may constitute a presumption that tax avoidance is the principle objective.

Article 10 allows the fisc to withdraw a benefit if the transaction is carried out "without valid economic reasons" *and* "for the *exclusive* purpose of fraudulently obtaining a tax saving". It may be questioned whether the different language is just a matter of semantics or whether it will result in different interpretations regarding the application of the provision.

In the debate which accompanied the approval of Article 10, the opponents reiterated the traditional arguments against a broad anti-avoidance provision and emphasized again the risks of granting uncontrolled discretion to the tax authorities. The criticism induced Parliament to pass the "Interpellation Procedure" (Article 21 of Law 413 of 30 December 1991) whereby a taxpayer who intends to carry out an operation contemplated under Article 10 may request an advance ruling from the competent Directorate of the Ministry of Finance. If the taxpayer does not receive an answer or if the answer is unsatisfactory, he may submit his request to an ad hoc "Committee on Anti-Avoidance Provisions", composed of high-ranking ministerial officers and three experts appointed by the Ministry of Finance. If the taxpayer does not comply with the Committee's opinion, he must rebut in court the presumption that the transaction is illegal.

VII. RECENT DEVELOPMENTS

The business purpose test is directly or indirectly used in other recently enacted rules. Article 11 of Law 413 of 13 December 1992 has severely restricted the use of tax haven companies to carry out avoidance (and evasion) schemes. Article 11 disallows all payments (including those for the purchase of goods and equipment) made by Italian resident entrepreneurs to related companies resident in tax haven jurisdictions. This provision does not apply if the Italian resident taxpayer demonstrates that the transaction has a valid economic purpose. As a practical matter, the avoidance (evasion) purpose and the absence of a business purpose are assumed to exist if the recipient is a related company in a tax haven jurisdiction.

The Government adopted a similar approach to reduce possible abuses resulting from the implementation of the parent-subsidiary directive. The benefits under the directive (e.g. withholding tax and affiliation exemption for dividends which Italian companies distribute to, or receive from, EC parents and subsidiaries) are granted to EC companies directly or indirectly controlled by non-EC parents, provided the taxpayer demonstrates that the companies were not interposed for the sole or principal purpose of taking advantage of the directive. As in mergers and reorganizations, a taxpayer may request an advance ruling from the administration regarding tax haven transactions and dividends distributions under the parent-subsidiary directive.

The step-transaction doctrine seems to have been taken into account by the Ministry of Finance in Ruling 26 of 20 February 1992.

Leasing transactions are, as a rule, subject to 19 percent VAT which is not recoverable by private individuals, but interest on loans and financial transactions is exempt from VAT. A recent case illustrating the application of these rules involved a financial company, a leasing company and an individual. Financial Company A granted a loan to Mr Smith. The relevant amount was credited directly to the bank account of Leasing Company B, which entered into a car leasing contract with Mr Smith. The amount credited to Company B was labelled as "caution money"; in addition, Company A gave a guarantee to Company B for Mr Smith's obligation to Company B. Mr Smith paid interest (exempt from VAT) to B and rental fees (subject to VAT) to A. The rental fees charged to Mr Smith were below the normal market fee, since they did not include cost of financing. Company A agreed to pay Company B a fee for its role as an intermediary, and Company B agreed that, if Mr Smith defaulted, it would sell the car on the market and reimburse Company A.

The tax authorities claimed that the various transactions and covenants among the parties should be construed as a single contract, i.e. a car leasing transaction, which was artificially split up in order to reduce VAT liability ("each of the three parties achieved its/his contractual purpose by coordinating the different and distinct agreements"). This case has not been taken to court, and it is not known how a court would construe the transactions involved.

VIII. CONCLUSION

This article has demonstrated that the basic principles of the Italian legal system do not constitute an insurmountable barrier to extending the doctrines of fraus legis and abuse of rights to tax avoidance. The article has also shown that the

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courts and scholars have frustrated the attempts to develop these doctrines. The arguments put forward, based on fine distinctions and inferences, have a common denominator: the concern that the fisc's power to "pierce" the legal form of a transaction would result in a broad discretion to interpret that transaction. This consideration is the key to understanding the reasons why the former attempts to enact tax avoidance legislation were defeated. If this is still the case, the question is how to reconcile the concern with the business purpose approach taken in the recent statutes.

The answer probably lies in a domain other than legal doctrines. The undeniable fact that tax evasion opportunities have decreased dramatically in the past 20 years has also contributed to changing the traditionally sympathetic attitude of the average taxpayer toward tax evasion and avoidance. Without embarking on a sociological analysis, the Italian approach to the business purpose doctrine may be the political answer to a new, commonly shared desire for greater fiscal fairness.

It may be interesting to look into the reasons why this change in attitude resulted in introducing the business purpose doctrine into the legal system rather than in developing well-known legal principles. The over-emphasized Anglo-Saxon successes in defeating tax avoidance and the language of the EC directive have surely played a role. However, a careful analysis of this matter would probably lead to minimizing the legal implications of adopting one approach over the other.

It will be interesting to see how the legal community reacts to the new doctrine. It should be stressed again that the wording of Article 10 of Law 408 is far from satisfactory. Such an important innovation deserves a more careful explanation. It may also be wondered whether the interpellation process, in its present form, will contribute to reducing the disputes which will inevitably arise.

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TAX TREATY DEVELOPMENTS

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I. INTRODUCTION

Italy has concluded 51 double tax treaties for the elimination of double taxation on income, 22 of which extend the scope to taxes on capital. Neither Italian tax treaty policy nor domestic legislation are particularly aimed at the attraction of movable capital of multinational enterprises, but rather they aim to make the realization of transnational activities less burdensome.[1]

After the comprehensive tax reform of 1973, new treaties were negotiated with all 11 partners of the EC. These treaties are all in force, with the exception of the Netherlands treaty, which should enter into force by the end of 1993. The four most recently signed treaties with EC partners (France, Germany, the Netherlands and the United Kingdom) present some innovative aspects which are worth comment. After looking at the efficacy of tax treaties in national legislation, this article will focus on key provisions of these four treaties, explaining how the deviations from the OECD model constitute, in some respects, an important evolution of the relationship between the Italian tax system and other tax systems.

The following treaty clauses will be analysed:
- Personal scope
- Taxes covered
- Residence
- Permanent establishment
- Business profits
- Associated enterprises
- Dividends
- Elimination of double taxation.

Contents

I. Introduction
II. Efficacy of Tax Treaties under Italian Law
III. Recent Tax Treaty Developments
A. General
B. Scope of application
C. Taxes covered
D. Residence
E. Permanent establishment
F. Business profits and associated enterprises
G. Dividends
H. Elimination of double taxation
IV. Conclusion

II. EFFICACY OF TAX TREATIES UNDER ITALIAN LAW

The relevance of tax treaties to a country's international relations, and the ability of investors to rely on treaty provisions for determination of the fiscal consequences of a transnational investment are affected by the relationship of treaty provisions to domestic rules. In particular, it is interesting to analyse whether treaty provisions may be overridden by conflicting domestic provisions.

Thus far treaty override has only been used by the United States, although recently Germany and France have utilized it. Italian legislation on the topic is generally not clear, and many questions arise about whether tax treaty provisions supersede domestic legislation.[2] For example, Article 10 of the Constitution provides that the Italian legal system must conform to the recognized rules of international law. According to the majority of commentators, the effectiveness of this provision is limited to the applicability (under Italian law) of the international principles deriving from customary law.[3] Although some commentators have extended the scope of this provision to bilateral treaty rules, an analysis of the discussions held at the time the Constitution was drafted leads to the conclusion that the provision may not be interpreted to allow treaty rules to supersede domestic rules.

Article 75 of Presidential Decree No. 600 of 29 September 1973 (the Income Taxes Assessment Code ("ITAC")) provides that in applying national tax rules in the area of income taxes, international bilateral agreements, if ratified by the Italian Parliament, remain unprejudiced. Finally, Article 128 of Presidential Decree No. 917 of 31 December 1986 (the Income Tax Code ("ITC")) provides that ITC provisions which derogate from rules in international treaties remain applicable, but only if the ITC rules are more advantageous for the taxpayer. The reverse implications of ITC Article 128 would lead to the conclusion that if the treaty provision grants a tax-

1. However, tax treaties are important because Italy is a substantial market, and foreign investments in Italy are mandatory for foreign enterprises which intend to penetrate the market; and because Italy is one of the seven most industrialized countries in the world, Italian investments abroad are significant.
2. In particular, a few recently enacted provisions may raise issues about their relationship with treaties.
3. See A. Cassese, "Il contributo degli internazionalisti ai lavori del Ministero per la costituente", *Rivista di Diritto Internazionale* (1977), at 47-58. For an opposing view which includes in the term "provisions of international law" the provisions contained in bilateral treaties, see Quadri, "Diritto Internazionale Publico" (Palermo, 1968) at 68.

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payer treatment which is more favourable than treatment under the ITC, the treaty provision should prevail.

It should also be noted that treaty provisions may be deemed to prevail over domestic rules because treaties should be considered special laws, since they are put into effect through a specific ratification procedure.[4]

The effectiveness of treaty rules which conflict with domestic provisions adopted after ratification of the treaty is also an issue.[5] No provision addresses this issue. If we follow the approach whereby a subsequent provision supersedes an existing one, and the treaty provision is considered to be equal to ordinary parliamentary provisions, then the new domestic provision legitimately violates the treaty provision, so that the domestic provision should prevail. If, however, the special law approach is taken (as should be the case in the author's opinion), then the law which ratifies the treaty might be overridden only by another special law.

An unfortunate shortcoming derives from the fact that the applicability of treaty provisions over domestic provisions is not specifically addressed, nor is a solution offered in any court decision, so the uncertainty will remain until a clear interpretation is provided.[6]

III. RECENT TAX TREATY DEVELOPMENTS

A. *General*

Under the ongoing process of harmonization of direct taxes in the EC, many treaty clauses may be affected by the contemporaneous applicability of domestic rules which have been adopted in the member states as a result of implementation of EC directives. This is particularly the case with respect to the parent-subsidiary directive, but the problem also arises in treaty rules which address transfer pricing problems.

These are two areas in which the Italian efforts to eliminate international taxation problems by conclusion of new tax treaties have been more significant. Similar problems have also been addressed by the EC Council, and the relation of these rules raises some interesting issues. In addition to examining the latter, this article will also look at provisions which are more relevant for the Italian or foreign economic community (i.e. mainly multinational enterprises), i.e. provisions concerning the residence of persons entitled to treaty benefits, the permanent establishment ("PE") provision, the dividend article and the elimination of double taxation provision.

The following treaties will be analysed:

- the Italy–UK treaty of 21 October 1988, which entered into force on 31 December 1990;
- the Italy–France treaty of 5 October 1989, which entered into force on 1 May 1992;
- the Italy–Germany treaty of 18 October 1989, which entered into force on 24 December 1992;
- the Italy–Netherlands treaty of 8 May 1990, not yet in force.

B. *Objective scope of application*

The treaties with France, Germany and the Netherlands apply to taxes on income and on capital, while the UK treaty is limited to taxes on income. The extension of the scope of application to taxes on capital appears to have more significance nowadays, because in 1992, in order to realize an increase in revenue, the Italian Government introduced several extraordinary measures which provide for the taxation of items of movable or immovable capital.[7] Moreover, only the treaty with France aims at the prevention of fraud – the other treaties are limited to the prevention of fiscal evasion.[8]

C. *Taxes covered*

The four treaties consistently take into account the individual income tax ("IRPEF"), the corporate income tax ("IRPEG")

4. This approach derives from the principle "*lex posterior generalis non derogat priori speciali*". Accordingly, a subsequent domestic provision may not supersede a treaty provision because of the special nature of the latter. The special nature may derive from three aspects of the provision: first, the provision is addressed to specific persons; second, it regulates specific matters; and third, the special provision is put into effect by a distinct provision, e.g. a ratification law.

5. The issue is not merely theoretical. A recent example of a domestic rule which might violate a treaty rule is the anti-tax haven legislation introduced by the Finance Act for 1992. The most significant provision of the anti-avoidance rules now embodied in ITC Art. 76(7)bis denies the deductibility of costs and expenses incurred by an Italian enterprise and paid to companies resident in a tax haven which belong to the same group.
The Italian treaties with Malta, Malaysia, Philippines, Singapore and Switzerland (countries deemed to be "tax havens") contain a non-discrimination article which follows the wording of Art. 24(5) of the 1977 OECD model treaty, which provides that, except for the cases referred to in Arts. 9, 11(6) and 12(6), interest, royalties and other disbursements paid by an enterprise of one of the contracting states (i.e. the Italian enterprise) to a resident of the other state (i.e. a Swiss company) will, 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 (i.e. a hypothetical Italian company). Therefore, in the event of a disallowance by the Italian tax authorities, the taxpayer can argue that such disallowance violates the treaty provision.
Since any decision as to whether a treaty provision should prevail over domestic law has to be made at the time the Italian enterprise files its tax return, it would have been reasonable to issue an interpretative document to clarify the matter. The Ministerial commentary drafted along with the Ministerial Decree which listed the countries deemed to be tax havens for purposes of the anti-tax haven legislation specifically referred to the non-applicability of the restrictive rules with respect to companies which could invoke the application of the tax treaty non-discrimination rule. This document, however, was not made public, and therefore it cannot help the present research.

6. The Constitutional Court has on many occasions affirmed the right of the Parliament to override provisions of international treaties (see e.g. decision of 20 May 1982, No. 96, stating that domestic provisions concerning turnover tax conflicting with Art. 111 of the GATT treaty are not in conflict with Art. 10 of the Constitution. However, the conclusion is different if the treaty override is not done intentionally, i.e. the discrepancy between the treaty and the domestic provision is not specifically intended. In such cases, scholars and court cases as a rule give the treaty provision priority.

7. In particular, Art. 7(6) of Decree Law No. 333 of 11 July 1992 introduced an extraordinary tax on bank deposits, which is also applicable to non-residents who are the beneficial owners of an Italian bank or postal account. For a detailed explanation of the exemption provided by some treaties with respect to this tax, see Andrea Manganelli, 33 *European Taxation* (February 1993), at 64.
The application of treaties which include taxes on capital within their scope is particularly relevant for the new tax on net worth of enterprises which was introduced by the Finance Bill for 1993 (Law No. 394/92). For a comprehensive description of the net worth tax, see in this issue Paolo Ludovici, "The Tax on the Net Worth of Enterprises".

8. For an explanation of the importance of the extension of tax treaties to the prevention of tax fraud, see Bruno Gangemi, "General Report on International mutual assistance through exchange of information", in *Cahiers de droit fiscal international*, Volume LXXVb, at 27.

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and the local income tax ("ILOR"). In the treaties which include taxes on capital, no reference is made to the new tax on the net worth of enterprises, which was incorporated in the tax system through Law Decree No. 394/1992.[9]

D. *Residence*

The definition of the persons entitled to treaty protection follows the "subject to tax approach" of the OECD model. Therefore only persons who are fully subject to the taxes listed in the treaty may invoke application of the treaty provisions. As the taxes covered do not take into account the lump-sum taxes which are paid by mutual investment funds and pension funds,[10] these major investors are not entitled to treaty benefits. That is, dividends and interest which may be derived by these entities from abroad will still suffer the burden of higher withholding taxes because the reduced withholding tax rates under the treaties do not apply. The ultimate consequence of this exclusion is a reduced profitability of the investments in the funds, a negative effect which should be removed. One solution may be the extension of treaty protection to investment and pension funds by negotiating a protocol to the treaties.[11]

For treaty purposes, the residence of corporate entities is determined according to the ordinary criteria contained in Article 4 of the OECD model. The tiebreaker rule in the four treaties provides that dual resident companies will be deemed to be resident in the state of their effective management. ITC Article 87(3) determines company residence according to three criteria, i.e. the place of incorporation, the place of effective management and the place in which the principal activities of the company are located. The treaties only refer to cases of dual residence, while possible triple residence cases are not dealt with in Italian treaties, nor are they examined in the OECD model.[12]

E. *Permanent establishment*

Italian tax provisions do not define a PE despite the fact that under domestic law the concept is used in the same way that it is used in tax treaties.[13] The definition of PE for application of domestic rules with respect to foreign persons who are resident in a non-treaty country is contained in Ministerial Circular No. 7/1496 of 30 April 1977. This definition is similar to the definition of PE in the 1963 OECD model. This is probably the reason why the Italian treaty definition of PE also follows the 1963 OECD definition. Among the treaties under analysis, only the new treaty with France uses the 1977 OECD model definition – the treaties with Germany, the Netherlands and the United Kingdom follow the 1963 model.

F. *Business profits and associated enterprises*

Article 7 of the treaties follows the wording of the OECD model in the case of Germany, France and the Netherlands, laying down an "existence of a PE" condition (Article 7, paragraph 1 of the OECD model), a "distinct enterprise" provision (Article 7, paragraph 2 of the OECD model), an "expenses deduction" requirement (Article 7, paragraph 2 of the OECD model), a "purchase of goods and merchandise" condition (Article 7, paragraph 5 of the OECD model), a "separate article" provision (Article 7, paragraph 7 of the OECD model), an "apportionment of total profits" clause (Article 7, paragraph 4 of the OECD model) and a "maintenance of method" condition (Article 7, paragraph 6 of the OECD model). The last two paragraphs are not included in Article 7 of the Italy–UK treaty. Under the Italian system, profits of Italian PEs of foreign enterprises are always determined through separate accounts, and no modification of the profits determination criteria is permitted.

The treaty rules governing the determination of profits of the PE find a better explanation in the clarifying provisions of the protocols in the treaties with France, Germany and the Netherlands. In the French and Netherlands treaties such rules limit the force of attraction of the PE with respect to positive and negative items of income when the PE sells goods on behalf of the head office and executes contracts for the supply of commercial, industrial or scientific equipment. The protocol to the treaty with Germany only excludes the force of attraction with respect to the supply of equipment contracts and to the PE which consists of a building site or an installation project.

In these cases the exclusion of the force of attraction also takes into consideration the deduction of expenses of the PE. For this purpose, "expenses incurred for the purposes of that PE, in paragraph 3 of Article 7 are to be interpreted to include only expenses relating directly to the activity of the PE".

The protocol to the Italy–France treaty also provides that if the laws of one of the states authorize companies resident in that state to determine taxable profits on the basis of consolidated accounts which include especially the profits of the subsidiaries resident in the other state, such group relief benefit is not to be affected by the provisions of the entire treaty and particularly the provisions of Article 7. This provision is probably related to the desire to maintain the consolidated accounts regime granted to French companies under French domestic legislation even in the presence of a mandatory distinction (according to the treaty) of accounts between the parent company and its subsidiary.

As regards the associated enterprises article, the treaties deviate significantly from the OECD model, mainly due to the

9. The treaties with France, Germany and the Netherlands should also apply to this new tax under Art. 23 of those treaties.
10. Both mutual investment funds and pension funds are subject to a flat rate tax which is levied on the net worth of the fund, and do not pay any tax on the income actually produced.
11. Extension of treaty benefits to investment funds has been provided for in the France–Switzerland treaty and the France–UK treaty.
12. One situation is where a company is incorporated in France, managed in the United Kingdom and carries out its activities in Italy. In this case, the tiebreaker rule would resolve the situation only with respect to the application of the Italy–UK and France–UK treaties. It would not provide any solution with respect to the Italy-France relationship, nor would it deal with income derived from a fourth state. For instance, if the company receives interest from a fourth state, it would in principle be entitled to application of the treaties between one of the three states and the fourth state.
13. ITC Art. 20(1)(e), which deals with the application of IRPEF to non-resident individuals, provides that business income of such non-residents is subject to IRPEF only if, and to the extent that, such income is produced through a PE located in Italy. The principle embodied in Art. 20 is also referred to in ITC Art. 112(2) for purposes of IRPEG, and by Art. 117(3) for ILOR purposes.

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absence of a complete "correlative adjustments" clause. Article 9, following the wording of Article 9, paragraph 1 of the OECD model, only includes the provision which requires that associated enterprises respect the arm's length principle in their contractual relationships.[14] The absence of the correlative adjustment clause is partially solved by the inclusion of a similar clause in the protocol to some of the treaties. The effectiveness of these modified correlative adjustments clause is extremely limited if compared to Article 9, paragraph 2 of the OECD model.

In the Italy–Germany treaty, the protocol provides that correlative adjustments should only take place if the contracting state that is to make the adjustments agrees that the redetermination of the profits of the enterprise resident in the other state reflects conditions that would be agreed to between independent enterprises. The adjustments should in any event be carried out in accordance with the mutual agreement procedure in Article 26 of the treaty. The Italy–Netherlands treaty follows the same lines, referring to the need for a mutual agreement procedure, while the Italy–France treaty provides that the state which should make the correlative adjustment is bound to do so only if it deems such adjustment to be appropriate, and the adjustment should be agreed upon through a consultation between the competent authorities of the two states.

It is evident from the above that the modified correlative adjustments clause does not settle an obligation to make the adjustment on the other state, as is the case in the OECD model, but leaves open the possibility that such state disagrees with the adjustment carried out in the first state. Moreover, the consultation procedure is deemed to be mandatory in the protocol clauses, while, according to the OECD model, it should take place only if necessary. As a result, the correlative adjustment clause in the treaties under examination does not adequately solve the problems of double taxation connected to uncoordinated transfer pricing adjustments. The necessity of initiating a mutual agreement procedure in order to resolve the double taxation problem does not produce any significant improvement with respect to the situation where the modified correlative adjustment clause is missing. Double taxation must in any event be resolved by the mutual agreement procedure.

There is no modified correlative adjustment clause in the Italy–UK treaty, which adopts a more practical approach. The problems related to double taxation in the event of uncoordinated transfer pricing adjustments should soon be resolved by the arbitration procedure set forth in the 1990 EC arbitration convention. Since Italy, France, Germany and the United Kingdom all belong to the EC, enterprises resident in those states should be able to make recourse to this alternative solution.[15] However, the Convention will be applicable only after ratification by all member states. Thus far, it has only been ratified by Denmark, France, Italy and the United Kingdom.

G. *Dividends*

Article 10 of the treaties probably contains the most relevant deviations from the OECD model. The rules which govern the taxation of transnational dividends under the OECD model are, by express recognition of the Commentary to the model, aimed at eliminating juridical double taxation, and do not pursue the elimination of economic double taxation. The provisions of Article 10 of the treaties follow the general criteria adopted in the OECD model, i.e. taxation of the dividends in the country of residence of the recipient, taxation also in the state of residence of the distributing company, but limited to the levy of a withholding tax.

The Commentary on Article 23 A) and B) of the 1977 OECD model is clear in stating that "these articles deal with the so-called juridical double taxation where the same income is taxable in the hands of the same person by more than one state. This case is to be distinguished especially from the so-called economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two states wish to solve problems of economic double taxation, they must do so in bilateral agreements".[16]

This suggestion has been followed by the negotiating parties in the treaties between Italy, France and the United Kingdom. In France, Italy, Germany and the United Kingdom domestic legislation, through an imputation system, eliminates or mit-

14. The criteria for determination of the arm's length price in transactions between associated enterprises have been better outlined in the 1979 and 1984 OECD Reports on transfer pricing. As far as the detailed principles on transfer pricing adopted in Italy are concerned, reference is to be made to the Ministerial Circular No. 2267 of 22 September 1980 which is substantially based on the 1979 OECD Report. The contents of the Ministerial Circular are explained in G. Maisto, Chapter "Italy" *The Tax Treatment of Transfer Pricing* (Amsterdam: IBFD).

15. Art. 6(1) of the Convention provides that where an adjustment of profits is believed to result in double taxation, an enterprise may submit a claim to the competent authority of its state of residence. Other states involved are then notified by this authority.
If the authorities concerned cannot agree on how to eliminate double taxation within two years, an advisory commission is directed to decide the issue within six months (Art. 7). Following that decision the countries involved may enter into additional consultation for up to an additional six months. The national tax authorities may agree to deviate from the commission's ruling, provided that any double taxation is eliminated. However, if the national tax authorities cannot agree on an alternative settlement within the six-month consultation period, the opinion of the advisory commission becomes binding (Art. 12).

16. With respect to intra-group profit distributions, juridical double taxation occurs when dividends are subject to withholding taxes in the country of source and corporate taxation in the country of residence of the beneficial owner of the dividends. Economic double taxation occurs when the business income from which dividends have originated has been subject to corporate income tax in the hands of the distributing company, and the dividends are also subject to tax in the hands of the beneficial owner, in the form of withholding taxes at source or of corporate income tax in the residence country.
Under tax treaties, the exemption method eliminates juridical double taxation by exempting the dividends when they are received by the beneficial owner. It does not help to avoid economic double taxation, as the profits of the distributing company are subject to corporate income tax in the hands of the distributing company and to withholding taxes in the hands of the receiving company.
The tax credit method eliminates juridical double taxation by allowing the beneficial owner of the dividends to credit the withholding taxes levied in the source country. The business profits, after having been taxed in the hands of the distributing company, are taxed also as dividends in the hands of the beneficial owner.
Under these two alternatives, the exemption method usually grants a lower transnational global burden, due to the fact that the treaty already provides for a reduced withholding tax rate. Accordingly, the net double burden amounts to the withholding tax levied in the source country. In the case of the credit method, the withholding tax is fully recovered, but the profits may be taxed at the rate of the corporate income tax in force in the country of residence, which is usually higher than the rate of the withholding tax provided for in the treaty.

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igates economic double taxation of dividends distributed by resident companies to resident shareholders. The imputation credit is not extended by domestic legislation to non–resident shareholders. In the Italy-France and the Italy–UK treaties, the benefit of the underlying tax credit is granted to shareholders resident in the other contracting state when the distributing company is resident in the first state.

In particular, Article 10(4) of the Italy–UK treaty provides that a resident of the United Kingdom who receives dividends from a company resident in Italy is entitled, if he is the beneficial owner of the dividends, to the tax credit to which an individual resident in Italy would have been entitled had he received those dividends. However, if the recipient is a UK company which alone or together with one or more associated companies[17] controls directly or indirectly 10 percent or more of the voting rights in the company paying the dividends, the UK company is only entitled to a tax credit equal to one-half of the ordinary credit (subject to the treaty withholding taxes of 5 or 15 percent). In both cases the person receiving the dividends and tax credit must be subject to UK tax on such dividends. The tax credit is considered a dividend, and withholding taxes are levied on the grossed-up amount. Under similar conditions, an Italian shareholder who receives dividends from a UK company is granted the tax credit to which a UK resident shareholder would be entitled had he received those dividends.

The Italy–France treaty provides, in Article 10(4)(a), that a resident of France who receives dividends from a company resident in Italy which would entitle a resident of Italy receiving such dividends to a tax credit, is entitled to a payment from the Italian Treasury equal to such credit, reduced by the 15 percent withholding tax, provided the gross amount of such dividends is added to the taxable base of the recipient determined for purposes of the French income tax. If the shareholder receiving the dividends is a company which is subject to corporate tax in France and which holds, directly or indirectly, for a period of at least 12 months preceding the date the dividends were declared, at least 10 percent of the capital of the Italian company paying the dividends, or which is subject to the French tax regime applicable to parent companies, the amount of the tax credit paid by the Italian treasury will be reduced by one-half. Such payment is deemed to be a remittance of dividends, and therefore it will be subject to a 5 percent withholding tax.[18] When the shareholder resident in France is not entitled to payment of the full tax credit, he is entitled to a refund of an amount equal to the equalization tax pertaining to such dividends, provided the equalization tax has in fact been paid by the distributing company on account of those dividends. This refund is also subject to the levy of the 5 or 15 percent withholding tax. Under similar circumstances, an Italian shareholder of a French company is entitled to repayment of the tax credit on the part of the French Treasury, or, alternatively, to a refund of the French equalization tax.

In the domestic legislation of countries which adopt an imputation system, an equalization tax is normally levied when the company distributes dividends which derive from exempted or non-fully taxed profits. This equalization tax is also normally due if the distribution is effected in favour of non-resident shareholders, which somehow represents an unreasonable levy, as the non-resident shareholder does not benefit from the tax credit granted to the resident shareholder.

In Italy the question of application of the equalization tax on dividends distributed to non-resident shareholders of Italian resident companies has been examined by the Constitutional Court. The judgement of the Court was influenced by the Central Tax Commission of Rome, which brought into question the constitutionality of the equalization tax on such dividends. The Court held that the equalization tax levy on distributions to non-resident shareholders does not infringe the principles laid down in the Constitution. However, the Court stated that the levy of the equalization tax on distributions to subjects who are not entitled to the imputation credit is unreasonable, and should be resolved by way of bilateral agreements.

As mentioned above, refund of the equalization tax is provided for in the Italy–France treaty as an alternative to repayment of the full tax credit, provided the tax has been effectively paid by the Italian company. The possibility of a refund of the equalization tax is also provided for in the Italy–Netherlands treaty and the Italy–Germany treaty.

Dutch domestic legislation uses the classical system rather than the imputation system, so the equalization tax problem only arises with respect to distributions from Italian companies to Dutch resident shareholders. Article 10(3) of the Italy–Netherlands treaty provides that a resident of the Netherlands who receives dividends distributed by a company resident in Italy is entitled to a refund of the amount corresponding to the equalization tax owed, if applicable, by that company in respect of those dividends. The refund is permitted on condition that the Dutch shareholder is the beneficial owner of the dividends on the date the dividends are declared by the Italian distributing company. The refund is subject to the deduction of a 5, 10 or 15 percent withholding tax. The rate of withholding tax depends on the nature of the Dutch recipient and the extent of its participation. Where the recipient is a Dutch company with a participation of more than 50 percent the rate is 5 percent, where it is a Dutch company with a participation of no more than 50 percent but at least 10 percent the rate is 10 percent. In all other cases the rate is 15 percent. To qualify for one of the two reduced withholding rates on the refund (5 or 10 percent) a further condition must be satisfied, i.e. that the participation has been held for a minimum period of 12 months. As mentioned above, no provision for repayment of the equalization tax is required in the

17. Art. 10(4)(b) of the Italy–UK treaty provides that for purposes of this provision "two companies shall be deemed to be associated if one controls, directly or indirectly, more than 50% of the voting power in the other company, or a third company controls more than 50% of the voting power in both of them".

18. However, Art. 10(8) of the treaty provides that where the beneficial owner of the dividends is a company resident in a state, and more than half of its capital is owned by one or more persons who are not resident in that state, the provisions regarding the tax credit payment will apply only if such company furnishes the competent authorities of the other state (if so requested by that competent authority) information permitting the authority to determine whether the company acquired the holding in good faith for business reasons or in the normal framework of investment operations, and not primarily to benefit from the tax credit.

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reverse situation, as no equalization tax is levied in the Netherlands.

The German system also provides for an imputation system of taxation of dividends in the domestic context, but the extension of the tax credit to a shareholder resident in the other state has not been included in the treaty by the express decision of the German authorities and, due to the absence of reciprocity, it is not granted by the Italian authorities to the German shareholders. A refund of the equalization tax is, however, contained in the treaty.

Article 10(5) provides that a German company which directly owns at least 25 percent of the capital of a company resident in Italy and which receives dividends distributed by such company is entitled to a refund of the equalization tax attributable to those dividends, provided the equalization tax has been actually paid by the Italian company and subject to the deduction of a 10 percent withholding tax. The refund is also subject to the condition that the German company is the beneficial owner of the dividends, and has held the shares in the Italian company for at least 12 months preceding the date the dividends were declared.

H. *Elimination of double taxation*

Article 24 of the four treaties provides the criteria to be used for the elimination of double taxation on items of income whose right to taxation is granted to the source state. The treaty criteria are similar to the foreign tax credit system under the Italian ITC.[19]. The general rule is subject to an exception with respect to dividends which an Italian resident company derives from its German subsidiary. ITC Article 24(2)(b) provides that income from dividends is excluded from the base upon which Italian tax is levied if the dividends are paid to an Italian company by a German company where at least 25 percent of the capital is owned directly by the Italian company.

The adoption of this exemption rule is strange in all the Italian treaty relationships, the tax credit system being the one consistently adopted.[20]

IV. CONCLUSION

Italian tax treaty policy displays few new developments for the elimination of double taxation. This is particularly true if the methods of elimination of double taxation of transnational flows of profits are taken into consideration. In other areas, for example the elimination on double taxation of transfer pricing adjustments, the methods adopted are weaker than methods in the OECD model, and they reflect the inadequate desire, also on the part of the other contracting states, to solve double taxation problems normally faced by multinational enterprises.

As a part of the Government's international economic policy, the role of double tax treaties is not the facilitation of Italian investments abroad or attraction of foreign investments to Italy. Treaties only serve to realize transnational activities in a less burdensome atmosphere, and this goal is quite satisfactorily accomplished.

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19. Under ITC Art. 15, a credit for foreign taxes is allowed up to an amount equal to that part of the Italian tax which is proportional to the ratio between foreign-source income and gross income. The credit may be claimed only in the tax return for the year in which the foreign taxes are paid; otherwise the right to the credit is lost.
If income is produced in more than one state, the credit is calculated separately with respect to each state. If the Italian tax has been finalized for the year in which the foreign-source income was included in the taxable base and the taxpayer later receives a refund for foreign tax, a new calculation is made, taking into consideration any subsequent increase in taxable income. In any event, the tax credit is accorded in the year in which it is claimed.
For an explanation of the Italian foreign tax credit system, see B. Gangemi, "Credito d'imposta e redditi esteri", 4 *Bollettino Tributario d'Informazioni* (28 February 1990).

20. The only other exception in an Italian treaty is the exemption from Italian taxes for dividends received by an Italian company from a Brazilian company. See Italy–Brazil treaty Art. 24.

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CUMULATIVE INDEX – 1993 Nos. 1-6

I. ARTICLES

Canada:
Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Reseach Incentives 255

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Denmark:
Bente Moll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

Finland:
Kari S. Tikka:
Fundamental Tax Reform: 25 Percent Rate on Capital Income and Corporate Income 348

France:
Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Hong Kong:
Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283

Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

G.K. Kawatra:
1993/94 Budget 294

International:
Sijbren Cnossen:
What Kind of Corporation Tax? 3

Ken Messere:
Recent Tax Revenue Developments in OECD Countries and Some Policy Implications 323

© 1993 International Bureau of Fiscal Documentation

John Prebble:
100 Years of Income Tax 59

Stanley C. Ruchelman:
US Tax Considerations in International Derivative Products 235

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Japan:
Alum Bati:
Taxation of Dividends and Interest 202

Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Singapore:
Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

United States:
Stephen A. Mihaly:
How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the Best Method Rule of the New Section 482 Regulations 307

Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

Bruce Zagaris:
The US–Netherlands Income Tax Treaty: Tax Collection Assistance and Evidence-Gathering 342

Wim Wijnen:
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96, 219, 254

IV. CONFERENCE DIARY 39, 149, 285, 347

V. BIBLIOGRAPHY

– Books 49, 100, 150, 226, 297, 354
– Loose-leaf services 51, 103, 154, 231, 302
– List of addresses of the major publishing houses appearing in the Bibliography 53

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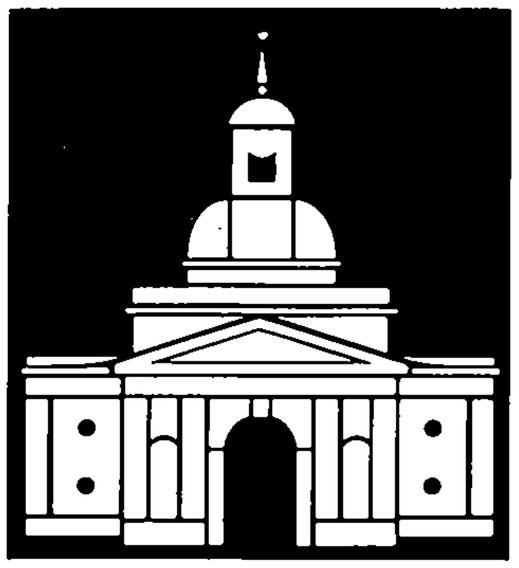
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CONTENTS

VOL. 47 NO. 10 **OCTOBER 1993**

INTERNATIONAL POLICY CONSIDERATIONS IN THE TAXATION OF FOREIGN SOURCE INCOME — 547 — *John Azzi*
The way in which a capital exporting nation chooses to tax earnings derived from foreign investments affects the interests of the nation as a whole, as well as the interests of the resident taxpayers who are affected by such measures, as well as the capital importing country. This article outlines the policy issues involved in the taxation of foreign source income and examines the economic effect of the foreign source income rules recently introduced in Australia.

NEW ZEALAND: COMPREHENSIVE DIVIDEND IMPUTATION, NEUTRALITY AND DOUBLE TAXATION OF CORPORATE PROFITS — 568 — *Andrew M.C. Smith*
To mitigate the double taxation of corporate income arising under the classical system of taxation, New Zealand introduced a comprehensive dividend imputation system in 1988. This article examines the imputation regime adopted in New Zealand and looks at whether the regime is capable of achieving the stated objectives when first introduced.

UNITED STATES: REVENUE RECONCILIATION ACT OF 1993 — 581 — *John G. Rienstra*
The United States has enacted the Revenue Reconciliation Act of 1993. The Act is the first major tax legislation to be enacted since 1990, and represents the most significant change in the US tax laws since the Tax Reform Act of 1986. The author discusses the increased tax rates under the Act and other provisions of interest to international businesses and investors.

NETHERLANDS: PROPOSED TAX HAVEN LEGISLATION — 589 — *Ebel Magnin*
On 16 July 1993 the Dutch Ministry of Finance published a draft bill concerning the amendment of the Corporate Income Tax Act. The draft bill proposes to amend the exemption of intercorporate dividends (participation exemption) where such dividends are received from tax haven companies. The draft bill also introduces a form of earnings stripping provision where interest is paid to affiliated tax haven companies.

GERMANY: NEW THIN CAPITALIZATION RULES — 594 — *Dr Klaus Sieker and Adrian Yeeles*
After years of discussion and a number of unsuccessful attempts a thin capitalization rule has finally been enacted in Germany. This article examines the new rule, analyses the tax consequences of reclassified interest expense and presents some practical considerations.

UNITED KINGDOM: HOLDING COMPANY REGIMES	599	*Eric Tomsett* As a location for an international holding company the United Kingdom is notable for some very significant advantages sharply contrasted by major disadvantages. This article takes a look at both.
BANGLADESH: SALIENT FEATURES OF THE 1993/94 BUDGET	601	*K.A. Gofran* This article highlights a number of tax measures included in the new budget.
BIBLIOGRAPHY		
– Books	602	
– Loose-leaf services	611	
CONFERENCE DIARY	614	
CUMULATIVE INDEX	615	

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INTERNATIONAL:

POLICY CONSIDERATIONS IN THE TAXATION OF FOREIGN-SOURCE INCOME

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This paper was presented during the 5th Annual Conference of the Australasian Tax Teachers' Association, held in Christchurch, New Zealand 17-19 January 1993.

Contents

I. Introduction
II. Objectives of a Good Tax System
A. Appropriate tax policy objectives
B. Conclusion
III. Economic Consequences Arising from the Removal of Tax Biases in Favour of Foreign Source Income
A. Introduction
B. An account of the development and principles of accruals basis taxation
C. Arguments for and against eliminating tax biases in favour of foreign investment income
D. Conclusion

I. INTRODUCTION

The recent spate of legislative reform in the area of taxation, in particular the taxation of international flows of income, provided the necessary impetus for this paper. The focus of the paper particularly in Part III will be the appraisal of the economic effect of the foreign-source income rules (i.e. the accruals rules) which were recently introduced by the Australian Government. It is noted that the way in which Australia, or for that matter any capital exporting nation, chooses to tax earnings derived from foreign investments affects the interests of the nation as a whole, as well as the interests of the resident taxpayers who are affected by such measures, as well as the capital importing country. However, before we turn to such a discussion, it is necessary to outline the policy issues involved in the taxation of foreign-source income. This task will be undertaken in Part II. In this area of taxation, there is the complex problem of shaping tax policy to be consistent with the principle of taxpayer equity when income is generated abroad and subject to tax in a foreign jurisdiction.

II. OBJECTIVES OF A GOOD TAX SYSTEM

Generally, we need to discuss tax policy considerations as a means of evaluating our present tax system. Change, no matter how theoretically desirable, will not come without costs. We have to be concerned with the projected benefits and transition costs in deciding whether there is a clear net benefit with any suggested reform.

Specifically, in formulating tax policy toward investment abroad, the Australian Government must look at the interests and opinions of the private investor but it must also look beyond them. Policy makers must concern themselves with the economic welfare of the nation as a whole, and thus with the extent to which Australian foreign investment conflicts with or contributes to the achievement of various national goals, and to ensure that its tax policy reflects that.

There have been numerous theories propounded as to what constitutes a "good" tax system (see for example, theories propounded by such eminent economists as Adam Smith,[1] John Stuart Mill,[2] and Henry Simons,[3] who propounded theories on how the system of taxation should be utilized, and the justification for such a system in "modern" economic society). The authors of one of the more respected modern textbooks on the theory of taxation have summarized six criteria which they suggest may be used to appraise the quality of a tax structure. They are:

(1) The distribution of the tax burden should be equitable ("Equity").
(2) Taxes should be chosen so as to minimize interference with economic decisions in otherwise efficient markets ("Neutrality").

1. Smith A., *The Wealth of Nations*, Vol. 2 (London: J.M. Dent & Sons Ltd, 1958), specifically at 307, where Smith postulates four principles of tax design.
2. Mill, J.S., *Principles of Political Economy* (London: Longmans, Green and Co, 1848, 1909 reprint), at 357 in particular where Mill comments on the inherent inequity associated with tax policies aimed at introducing a progressive tax system.
3. Simons, H.C., *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938), at 18 where Simons propounds a theory that taxation always affects the distribution of income.

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(3) Where tax policy is used to achieve other objectives, such as to grant investment incentives, this should be done so as to minimize interference with the equity of the system ("Efficiency").
(4) The tax structure should facilitate the use of fiscal policy for stabilization and growth objectives ("Revenue").
(5) The tax system should permit fair and non-arbitrary administration and it should be understandable to the taxpayer ("Simplicity").
(6) Administration and compliance costs should be as low as is compatible with the other objectives ("Administration and Compliance").[4]

In many cases there will have to be "trade-offs" between the various objectives. For example, the promotion of equity may require administrative complexity and may interfere with neutrality and so forth.

Concerns expressed over a number of years regarding the activities of multinationals and the exercise of domestic control over these activities carry with them a suggestion that these activities could have a significant impact on the effectiveness of national tax regimes. Therefore, consideration of the six criteria mentioned arise, which can only be appreciated by looking at the domestic tax system in its international setting.

If we were to confine the consideration of a "good" tax system to a "good" international tax system then it could be easily argued that the goal of any country's tax system with respect to international income flows must be to maximize the net economic benefit derived from foreign investment in the country and from investment abroad by its residents. However, since Australia is a net capital importer with a relatively small economy, it must ensure that its policies do not greatly offend against the current rules of the international tax game, otherwise it may well lose in the end. The interplay of the laws of different countries creates an international pattern or system of taxation from which important economic, moral and political considerations arise. Professor Bird notes that:

> 'Small' countries like Australia are in general advised by tax experts not to attempt to tax international capital flows above the norm prevailing in the dominant capital exporting countries, since by doing so they tend more to penalize the less mobile factors in their own country than to reap any national (or sectoral) gain.[5]

However, Bird distinguishes between portfolio investment and mature direct investment. With respect to the latter the appropriate policy, he suggests, would be for a country like Australia (or for that matter, New Zealand), which is both a capital exporter as well as a capital importer, to implement relatively low domestic corporate tax rates and relatively high withholding taxes.[6] Such a policy would distort capital flows by providing incentives for capital to be attracted to the low tax jurisdiction whilst providing a disincentive for exporting capital in the form of high withholding taxes.

The discussion in the preceding paragraphs concisely illustrates the dilemma between national and international interests which policy makers must confront each time they introduce policy measures to tax international capital flows. That is, no country (especially ones as small as Australia and New Zealand) can have its own way in any aspect of international taxation. This is particularly so in the case of foreign-source income where the source country has the primary taxing rights over such income. In formulating tax policies for combating manipulation of source and residence rules, and particularly, *deferral*[7] of domestic tax in respect of foreign-source income, the capital exporting nation must also consider whether the expansion of foreign investment is an appropriate and effective means of enlarging the market shares of domestic investors abroad. This aspect of the discussion will be pursued in Part III.

The purpose of this section is to examine the appropriate tax policy objectives (i.e. the six criteria of a "good" tax system outlined above) that should underlie taxation of foreign source income. As indicated above, those objectives also underlie the objectives for taxing income generally. Therefore, we will begin with a discussion of tax policies which promote equity in the tax system. Consideration is then given to policies which promote neutrality in the system, and so forth.

A. *Appropriate tax policy objectives*

1. Equity

There are three aspects of equity – horizontal equity (which requires that taxpayers in like positions be treated alike); vertical equity (which requires that those in different positions be treated differently) and inter-nation equity (which requires that distribution of revenues between different states be relatively fair).

Unlike horizontal and vertical equity, the question of inter-nation equity raises the question of what justifies a state in imposing its taxation laws on an individual or a company. This question relates back to the fundamental issue relating to a state's jurisdictional competence to levy taxes in the first place (i.e. source and residence principles). The role of double taxation agreements ("DTAs") could be very significant in this respect. This aspect of equity was the subject of a joint paper by Professors Musgrave and Musgrave "Inter-nation equity",[8] and will not be discussed in any detail here.

Everyone agrees that each taxpayer should contribute his "fair share" to the cost of Government. But there is no such agreement about how the term "fair share" should be defined. There are two main theories propounded for evaluating the basis of equity between the individual taxpayer and the state:

4. Musgrave, R.A. and Musgrave, P.B., *Public Finance in Theory and Practice* (4th ed.) (New York: McGraw-Hill Book Company, 1985), at 225.
5. See Bird, R., "International Aspects of Tax Reform in Australia", in Head J.G. (ed.) *Australian Tax Reform in Retrospect and Prospect* (Australian Tax Research Foundation, 1989), at 173.
6. Id.
7. Prior to the introduction of the accruals legislation, *deferral* of domestic taxes occurred through the simple interposing of a foreign subsidiary in order to earn or receive foreign-source income. Such manipulation was effective by reason of the fact that under general law, a subsidiary is treated as a separate legal entity from its parent; see *Salomon v. Salomon & Co. Ltd* [1897] AC 22.
8. In Bird, R. and Head, J. (eds.), *Modern Fiscal Issues* (Toronto: University of Toronto Press, 1972), at chapter 4.

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(i) the "benefit" principle (as propounded by Adam Smith), or (ii) the "sacrifice" or "ability-to-pay" principle (as propounded by J.S. Mill). The rationale underlying the "ability-to-pay" approach is that people with equal capacity should pay the same tax (i.e. "horizontal" equity), while people with greater ability should pay more tax (i.e. "vertical" equity). Income has been the most widely accepted measure of ability to pay.[9]

Both theories suffer from drawbacks. For example, what benefits are to be considered in relation to the first theory – "status based benefits" or "economic benefits"? With respect to the sacrifice theory, it is argued that such criterion as the moral obligation to the state to contribute to its revenues is not appropriate to determine the taxation of highly individualistic internationally mobile taxpayers whose activities and transactions are difficult to tie to a particular state or community. Additional criteria may be necessary to identify the link between state and individual or company which justifies the extension of the state's tax regime to that individual.

> "For benefit taxation to be equitable, it must be assumed that a 'proper' state of distribution exists to begin with. This is a serious shortcoming since, in practice, there is no separation between the taxes used to finance public services and the taxes used to redistribute income. The ability-to-pay approach better meets the redistribution problem but it leaves the provision for public services undetermined."[10]

In an attempt to overcome the drawbacks of the two approaches to equity mentioned above, Vogel[11] has resurrected the notion of "economic allegiance" as first propounded by Harding in 1933, where he rationalized the right of a state to impose tax on goods and services that are identified with the economic structure of the state.

> "It appears that the State may tax all property, goods, labour, services, and the like, which have become identified with the economic structure of the State, by incorporation into or integration with the business mechanism so defined ... The right to tax then depends upon the fact that the economic wealth is being used in the coordinated economic task of the social group; that it is producing utility or wealth or service in connection with, as part of, and because of the economic transaction of the social group."[12]

The "economic allegiance" theory appears to be an appeal to an element of benefit theory since it relies on the notion that an individual is bound to the state through participation in and enjoyment of the economic benefits provided by that state, whether by virtue of residence, investment, consumption or whatever. Therefore, the same drawbacks present with the benefit theory are implicitly present with the economic allegiance theory. Moreover, it is not certain how the economic allegiance theory could justify one particular state asserting its fiscal jurisdiction over the activities of a taxpayer with various processing and manufacturing plants in a number of countries. The role of DTAs, if there are any, should come into play here in order to restrict the right of the source state to levy taxes up to a particular level, leaving the residue for taxation by the residence state. But this is an imperfect solution.

Whichever theory is applied, it is suggested that the results under both theories should not differ significantly in the international arena. Either of the two fundamental approaches would suggest that an individual or corporation should be liable to tax in each country in which they operate, to the extent of their economic involvement there.

In identifying the shortcomings of both approaches, Musgrave and Musgrave nevertheless concede that the "ability-to-pay" principle is to be preferred to the "benefit" principle. The Asprey Committee, on the other hand, suggested that the "benefit" principle has its place in the discussion of Australian-origin income of non-residents.[13]

If governments were to implement equitable taxation in line with ability-to-pay then, as mentioned earlier, there would need to be certain adjustments and assumptions made before such an approach may be usefully applied.[14] The problem is further exacerbated by the existence of tax preferences and incentives for special interest groups. In fact, tax preferences and incentives, coupled with the complexity of modern tax legislation and the often inadequate administrative arsenal to monitor such complex rules, afford many opportunities for legitimate (as well as illegitimate) tax planning. This fact should not, however, detract from adhering to or at least striving for greater equity whenever tax reform measures are contemplated or implemented. Within the sphere of the specific topic of this paper, the application of the concept of equity (i.e. both horizontal and vertical) as developed from the "ability-to-pay" principle involves several special problems which were alluded to earlier. These problems may be summarized as follows:[15]

(i) Which persons should be treated equally? Usually this question is resolved in favour of treating residents (or citizens in the case of the United States) who are taxable on their worldwide income equally. It is noted that there are two concepts of individual equity – national and international equity. Under the latter concept of equity residents or citizens should include any foreign source income on a current basis in their income for domestic tax purposes, so that they are treated the same as residents who have only domestic source income. Whereas, under the national equity concept, only net income (net of all foreign taxes) repatriated to the individual investor should be subject to domestic taxation.[16]

(ii) A problem which is linked to the first problem lies in the definition of a "resident" (or "citizen" in the case of the United States). In terms of the general principles of equity, a nec-

9. This fact is not beyond controversy. Some commentators would hold that "consumption" would be a superior base. In fact, John Hobbes, in his philosophical treatise, *Leviathan* , argued that a person should pay tax on what he or she uses and not on the fruits of labour which are saved.
10. Musgrave and Musgrave *supra* note 4, at 228.
11. Vogel, K., "World-wide vs. Source Taxation of Income – A Review and Reevaluation of Arguments", in McLure, Sinn, Musgrave, et al. *Influence of Tax Differentials on International Competitiveness* (Deventer: Kluwer, 1990), at 121-125.
12. Harding, A.L., *Double Taxation of Property and Income* (UPS, 1933), at 42.
13. The "ability-to-pay" principle was preferred by the Asprey Committee as the appropriate principle for identifying the fairness of a tax system (see *Taxation Review Committee: Full Report* (Canberra: AGPS, 1975), at para. 3.7).
14. See generally, Musgrave & Musgrave, *supra* note 4, at 244-246.
15. See Arnold, B.J., *The Taxation of Controlled Foreign Corporations: An International Comparison* (Toronto: Canadian Tax Foundation, 1986), at 52-54.
16. See Musgrave P., *United States Taxation of Foreign Investment: Issues and Arguments* (Cambridge, Mass: Harvard Law School, 1969), at 122.

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essary assumption is that if you are a resident of one country you cannot also be a resident of another. If this were the case, then scope for international double taxation would exist, and the ability-to-pay approach would be imperceptibly distorted. Another difficulty which is related to this problem is the issue of whether equal treatment should be judged from the perspective of only domestic taxation or with respect to the total burden, foreign and domestic.

(iii) Should equitable principles differ when corporations rather than individuals are involved? This question, it is suggested, depends on whether a country has a "classical" system or an imputation system. Without embarking on a detailed discussion of either the classical or imputation systems, broadly, under a classical system, a corporation is a separate taxable entity in substance; therefore foreign corporations should arguably be treated the same as other corporations and individuals. Since tax is ultimately paid only by individuals (who receive dividends), however, this view of equity and corporations is not very satisfactory. On the other hand, under an imputation system, a corporation is treated as a conduit, and the corporate tax is a means for currently taxing the undistributed income of a corporation.[17] Consequently, it is suggested that equity is relevant only with respect to individual shareholders.

(iv) Under the principles of equity, the tax consequences of doing business overseas through either a branch or a subsidiary should be exactly the same. However, by extending the principles of equity to the corporate investor, it is necessary to distinguish between the various forms of offshore investments – that is, branch, subsidiary or portfolio investments. The principles of international equity with respect to the corporate investor dictate that the following should be observed:[18]

(a) Foreign branch profits gross of foreign tax should be taxed as earned to the domestic parent, with a direct credit given for the foreign taxes paid.
(b) What constitutes equitable tax treatment of corporations that invest abroad through foreign incorporated subsidiaries depends largely on whether the parent and foreign subsidiary are regarded as separate entities or as a single entity:
    (i) if the single entity approach is taken, then profits of the foreign subsidiary accruing to the domestic parent should be taxed in the same manner as foreign branch profits;
    (ii) if the separate entity approach is taken, then it is suggested that the parent company should only be taxed on investment income received. Therefore, foreign taxes should be treated as a credit against domestic tax under the international equity approach or as a deduction under the national equity approach.
(c) Equitable tax treatment of portfolio investments corresponds to the tax treatment of investments in foreign subsidiaries under the separate entity approach.

(v) Another difficulty which arises only with respect to the taxation of foreign-source income is the equitable allocation of tax revenues between the country of source and the country of residence to be calculated (i.e. "inter-nation equity"). This issue involves the assertion of jurisdiction to tax, the selection of a tax base and the method of providing relief from international double taxation. In this respect, the role of DTAs has most significance, and as such the principles of equity usually take a secondary role to the political processes that go into negotiating DTAs.

(vi) Perhaps the most hotly contested issue so far is the adoption of a system of "*unitary*" taxation by a number of American states to overcome the ability of multinational corporations to manipulate the "arm's length" provisions designed to deal with transfer pricing by diverting income from high tax to low tax jurisdictions.[19] The controversy has been developing for some years now, with Australian authorities refusing to recognize or credit US taxes imposed under a system of unitary taxation, the result being that serious double taxation of particular corporations can arise, especially in respect of those corporations established, for example, in California (i.e. which adopts a unitary taxation system) as well as having a subsidiary in Australia.[20]

The problems outlined in the preceding paragraphs demonstrate some of the conceptual difficulties that drafters of any new tax legislation must grapple with. These problems are further compounded when we come to consider the other criteria for evaluating the design of a "good" tax system.

2. Neutrality

In general, if a tax does not distort private decisions it is said to be "neutral". Given the close link between efficiency and neutrality it becomes easier to assess distortions caused by taxes. Capital is allocated efficiently if pre-tax marginal returns on alternative investments are equal. Accordingly, taxation will not distort allocative decisions involving investments as long as alternative investments are taxed at the same rate. Despite the apparent simplicity of this criterion for neutrality, the question takes on considerable complexity in the international realm. For one thing, neutrality cannot be defined unless, from the national perspective, one defines the alternative investments at issue, being domestic versus foreign investment undertaken by domestic investors, and those undertaken by investors abroad. In the international tax sphere two concepts of neutrality exist – "capital import neutrality" and "capital export neutrality".

Capital import neutrality exists when firms of all nations pay the same rate of tax on capital earnings in the particular country for which capital import neutrality is said to apply. Domestic tax law must not discriminate among investors according to nationality.[21] In applying the concept of capital

17. For a discussion of the policy objectives in introducing an imputation system, see Bird *supra* note 5, at 168-172.
18. See Musgrave *supra* note 16, at 122-124.
19. Corporations that are established in the state and are part of a multinational group are taxable on a portion of the entire group's worldwide income determined in accordance with a formula usually based on payroll, assets and sales. The District Court of California has held that the worldwide unitary tax method, as applied by the State of California, was unconstitutional; see *Colgate Palmolive v. Franchise Tax Board* (unreported, 12 December 1988).
20. In Australia, unitary tax is not recognized as a foreign tax; see Sec. 6AB(2).
21. The most straightforward way to accomplish capital import neutrality is to exempt foreign-source income from domestic taxation.

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import neutrality in an Australian context, it is noted that this concept dictates that in order to create a competitive environment for Australian firms investing abroad, foreign-source income should only be taxed at the rate facing other investors in that source, arguably the rate of the capital importing country.[22] However, the difficulty with the capital import neutrality argument is in identifying the nature of the competitive disadvantage which arguably would arise from the Australian Government imposing tax on those Australian firms investing abroad.

Some commentators cast doubts on whether, in fact, a competitive disadvantage in the form of higher prices for goods produced offshore by those Australian firms investing offshore would arise where the Australian Government did not adhere to the principles of capital import neutrality. It is argued that the burden of tax in the form of higher prices will not be borne by consumers since such a result will be contrary to the generally accepted assumption that company tax is borne by the shareholders and as such should not affect the firms' pricing policies.[23]

On the other hand, it is suggested that if the nature of the competition lies in the competition for share capital, then it does not help to resort to the capital import neutrality argument to support the proposition that Australian firms investing abroad should be taxed at the rate facing other investors in the capital importing country. Firms investing overseas are in most cases competing in domestic capital markets, and as such, will only be competitive where they can offer the same rate of return as other firms competing in those markets.[24] Another commentator has discredited consideration of this concept of neutrality in the case of genuine income earned abroad on the basis that there is no organized evidence tending to show that the costs in foregone revenue of allowing deferral in respect of genuine business income are commensurate with the benefits.[25]

Capital export neutrality, on the other hand, prevails if equal pre-tax returns on domestic and foreign investments provide equal after-tax returns. This view of taxation is favoured most by those advocating the credit method of taxing foreign-source income for reasons both of equity and efficient resource allocation.[26] However, economic evidence supporting either view of taxation of foreign-source income (i.e. capital import or capital export neutrality) cannot provide definitive answers to resolve the debate as to which principle of neutrality should be followed, as the results depend on assumptions which need to be made about the values of critical parameters for which there is little or no empirical evidence. It has been observed that capital exporting countries are forced to establish capital export neutrality because of tax planning opportunities arising from manipulation of foreign tax credit system ("FTCS") rules by multinationals.[27]

Logically, policies to achieve capital export neutrality or to achieve capital import neutrality need not be and, indeed, generally are not consistent with each other. However, for both capital export and capital import neutrality, the focus of policy is the overall tax rate on foreign investments inclusive of levies of both source and residence countries. The policies differ in regard to which tax rate, domestic or foreign, predominates: for capital export neutrality it is the domestic rate, while for capital import neutrality it is the foreign rates.[28]

Without reproducing the formulae which were used by Thomas Horst to test which view of neutrality gave rise to the optimal rate of tax, it is sufficient to merely note the results. It was found by Horst that the optimal rate of tax levied by the capital exporting country on foreign-source income depends on the elasticity of demand and supply for capital in the capital exporting country and the capital importing country as well as on the tax rates in both countries. He was able to show that where it is assumed that the supply of capital in both countries was fixed, then the tax on the foreign-source income should equal the tax on income in the capital exporting country. This would tend to reflect the capital export neutrality result. On the other hand, where the demand for capital is fixed in both countries, then when the combined tax on international income equals the tax on domestic income in the capital importing country, "*capital import neutrality* obtains".[29]

Another view of tax neutrality, "*national neutrality*" (which is also referred to as the national welfare criterion), is propounded. This criterion has been defined as characterizing a regime in which total returns on capital in the domestic country, which are shared between the domestic investor and the Treasury, are the same whether the capital is invested at home or abroad.[30] It is argued that under this standard, the domestic country's capital will be invested abroad up to the point at which before-tax profits at home equal after-tax profits abroad, thereby promoting the viewpoint of the capital exporting country. This, it is submitted, results in maximum national product. This is because the foreign tax levied on foreign investment is not being received by either the domestic Government or the investor, and therefore represents a deadweight loss to the domestic economy. Moreover, it is suggested that national neutrality may be regarded as equitable because it requires taxpayers with equal worldwide incomes to pay the same domestic taxes.[31]

However, in defining this criterion in terms of the Australian economy, it is noted that as both a capital importer and exporter, Australia should tax foreign-source income as earned with a *deduction* for foreign taxes. Where this is the

22. See also Anderson, P., "Economic Policy Considerations in the Taxation of Foreign-Source Income", 5 *Australian Tax Forum* (1988), at 395, 403.
23. Vann, R.J., "The Background and Policy of the Australian International Accruals Regime", The Taxation Institute of Australia – Intensive Seminar Papers, New South Wales Division (9-11 November 1989), at 3.
24. Id.; see also the Treasurer's remarks in *Taxation of Foreign-Source Income: A Consultative Document* (Canberra: AGPS, 1988).
25. McIntyre, M., *The International Income Tax Rules of the United States* (Butterworth's Legal Publishers, 1989), at 6-86.
26. Anderson *supra* note 22, at 403.
27. See Brean, D.J.S., *International Taxation Issues: The Canadian Perspective* (Toronto: Canadian Tax Foundation, 1984), especially at 131.
28. See Anderson *supra* note 22, at 403, and Brean *supra* note 27, at 43.
29. Horst, T., "A Note on the Optimal Taxation of International Investment", 44 *Quarterly Journal of Economics* (1980), at 793, 796.
30. Gumpel P., "The Taxation of American Business Abroad: Is Further Reform needed?" 15 *Journal of International Law & Economics* (1981), at 389, 398. The author qualifies the above definition by stating that to attain national neutrality, there must be no additional preference for domestic or foreign investment.
31. Id. at 399.

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case then it is suggested that as far as the treatment of Australian residents who invest abroad is concerned "the 'nationally efficient' as well as the revenue-maximizing solution ... [is] to allow only the deduction of foreign taxes, but then to give full imputation credits on all foreign source income".[32] However, since the Federal Government has decided to adopt a foreign tax credit system similar to that adopted by most other OECD countries, it is suggested that no imputation credits should be granted for foreign tax paid on foreign-source income.

The Australian Government defended its intention not to allow imputation credits for foreign taxes paid as follows:[33]

- no other OECD country explicitly provides imputation credits for foreign taxes paid;[34]
- such a method would collect less Australian tax than the previous exemption method that was abolished from 1 July 1987;
- it would in some cases require Australia to refund to shareholders taxes paid to foreign governments; and
- there is no evidence that it would be in Australia's economic interest to provide such credits.

The Government's justifications for the "non-neutrality"[35] in the tax system which is created by not allowing imputation credits for foreign tax paid seems to also draw some qualified support from Professor Bird where, after analysing the economic effects resulting from extending the imputation system to foreign-source income, he observed that it may be better on efficiency as well as revenue grounds, where a FTCS is adopted, not to give imputation credits on foreign-source income.[36] Although, from the foregoing discussion, it would appear that this is only a second best alternative to allowing a deduction for foreign tax paid with a full imputation credit.

However, tax policies directed at promoting the welfare of the host country cannot be viewed in isolation. In the case of Australia and New Zealand, the reactions of their major trading partners who are all dominant capital exporters in the world economy (i.e. the United States, United Kingdom, Japan, France and Germany) to any policies introduced to tax international capital flows must be taken into account. Consequently, the design of policies to tax international capital flows should not generally deviate too much from the norm prevailing in those dominant countries; not to do so would make little sense in terms of international political economy.

Clearly, the question of which view of neutrality is more persuasive has been the subject of much controversy.[37] There are two aspects to the controversy. The first relates to which concept of neutrality should be preferred, national or international.[38] The second is in deciding whether capital export or capital import neutrality is more important in formulating policies to tax foreign-source income.

As indicated above, the achievement of national neutrality is facilitated by taxing all foreign-source income on a current basis with a deduction for foreign taxes paid. On the other hand, the achievement of international neutrality is facilitated by the taxation of all foreign-source income on a current basis with the provision of a foreign tax credit for foreign taxes paid by the foreign subsidiary.

In addition, the norm of international practice is to incorporate elements of both capital export and capital import neutrality into the tax policy of capital exporting countries. That is, residents are taxed on their worldwide income with a credit for foreign taxes. Perhaps the major departure from international tax neutrality occurs where there is *deferral* of domestic taxation on the foreign-source income of foreign corporations.

Therefore, for corporate investments in a foreign subsidiary, both neutrality and international equity may be achieved under the single entity approach, which calls for taxation of foreign profits as earned and a full credit for foreign taxes. To this extent, the New Zealand international tax model which currently taxes foreign-source income of controlled foreign corporations ("CFCs") without allowing deferral in respect of genuine foreign business income comes closest of all to achieving this goal.[39] It is noted that of all the other nations which have introduced CFC-type legislation, all but the New Zealand CFC regime contain an exemption for genuine business income.

3. Efficiency[40]

The Asprey Committee took the view that economic efficiency is generally best served by a neutral tax system (where the "tax system" must be understood to refer to all the taxes, Australian and overseas, that bear on the operations). They noted that "a more equitable way of taxing foreign-source income is likely to be more efficient. But the emphasis in considering equity is on income taxation viewed in isolation from other taxes, whereas an appraisal in terms of efficiency must be made of the tax system as a whole".[41]

National interests are adversely affected to the extent that there are certain externalities associated with foreign investment. Efficiency will be compromised if the profitability of operating abroad, rather than at home, is affected by other tax differences (such as those in the area of customs duties) although the same amount of income tax is paid on income from Australian sources as on income from foreign sources.

32. Bird *supra* note 5, at 172.
33. See *Taxation of Foreign-Source Income: A Consultative Document* (Canberra: AGPS, 1988), at 31-32 [hereinafter referred to as the Consultative Document].
34. Canada comes close to providing full imputation credits on distributions out of foreign-source income.
35. The non-neutrality in this case occurs because by not allowing imputation credits in respect of foreign taxes paid will mean that total tax (Australian plus foreign) paid on the foreign income will be greater than that paid on domestic income.
36. See Bird *supra* note 5, at 172.
37. See generally, Anderson *supra* note 22, at 403; Arnold *supra* note 15, at 55; Brean *supra* note 27, at 43; and Gumpel *supra* note 30, at 395-401.
38. The importance of achieving national neutrality or international neutrality also impact, as will be seen below, on the efficient allocation of resources.
39. Recently, the New Zealand Government enacted measures to change the definition of a CFC to mean a foreign company of which five or fewer New Zealand residents own *more than 50%*. As well, a *de facto* control test (similar to that contained in the Australian CFC regime) was added to the definition of a CFC. Sec 245C(1) Income Tax Act.
40. "Efficiency", or more precisely "pareto optimality", refers to an allocation of economic resources that maximizes production or economic growth.
41. Asprey Committee Report *supra* note 13, at paras. 17.29-17.30.

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Other externalities include the loss of development and growth increasing elements customarily generated in the country of investment.[42]

The Asprey Committee were, however, quick to point out that the objective of complete efficiency (in regard to the effect of Australian and foreign taxes on the activities of Australian residents) is clearly outside the competence of the Australian tax system in relation to the effect of Australian and foreign taxes on the activities of Australian residents. For example, there will be instances, depending on the political and economic climate at the time, where non-neutrality and therefore interference, is deliberately instigated where a country wishes to encourage its residents to operate abroad.[43]

A capital exporting nation may depart from the principles of efficiency by taxing foreign investment more heavily than domestic investment for fear that capital outflow will result in national income losses, or in undue income distribution effects, or a desire to increase the rate of domestic growth, by implementing special tax measures which, for example, could assist in stemming the outflow of capital. It is suggested that in the interests of national efficiency, a capital exporting country's tax system should discourage foreign investment beyond the point of national profitability (i.e. where the net return on foreign investment after foreign taxes exceeds the gross return on domestic investment before residence country tax). This can be achieved by allowing a deduction for the foreign tax, thus effectively treating foreign taxes as an expense of business.

4. Revenue

Although it is difficult to obtain reliable data on the incidence of the revenue loss from international tax avoidance, it has been suggested that it is very high.[44] A similar conclusion may be drawn from the data cited by Mr Woodward Jr., US Internal Revenue Service (IRS) Assistant Commissioner, who stated that in March 1987 foreign-owned US firms doing business in the United States paid 16-19 percent less tax than their US counterparts.[45] Mr Woodward's findings were recently confirmed as a result of US Congress study of the tax gap created by transfer pricing practices of foreign controlled US businesses. Hearings relating to transfer pricing issues began on 10 July 1990.[46] The cornerstone of the hearings was a nine-month investigation that focused on 36 foreign-owned US distributors of automobiles, motorcycles and electronics equipment. The investigation resulted from allegations that significant numbers of multinational corporations were avoiding US tax through artificial transfer pricing schemes.

The Subcommittee examined 212 returns filed over a ten-year period by the 36 target foreign companies, finding that more than one-half of the companies paid little or no federal income tax. To stress the point, the Subcommittee cited one example in which a foreign company paid US$ 500 in income tax on sales of US$ 3.5 billion.[47]

Commissioner Goldberg[48] of the IRS testified that foreign-controlled businesses report significantly lower taxable income as a proportion of gross receipts than domestic corporations. The Subcommittee's staff alleged that the primary mechanism by which foreign-owned companies are able to keep taxable profits at a minimal level is through the use of artificial transfer pricing. Such artificial transfer pricing schemes may also achieve the desired tax effect where the US corporation exports its product to a controlled foreign importer. In the latter case, the US corporation would sell its products at an artificially low price thereby incurring a loss in the United States and shifting the profit to the foreign importer which is usually resident in a tax haven country.

An important consideration for states in devising a taxation policy is whether the tax can be implemented effectively, that is, whether it will be sufficiently efficient as a means of raising revenue and provide relatively limited scope for avoidance or evasion which would detract substantially from its effectiveness. Evaluation of this criterion in an international tax sphere is complicated by the fact that there is much more scope for taxpayers to reduce or minimize their liability to taxation by moving assets, relocating or reorganizing economic activity or manipulating their accounts. The opportunities for avoidance of domestic tax are assisted by the territorial limitations on state jurisdiction (in particular enforcement jurisdiction) which limit the ability of the state to control such activities and to ensure that any new policies which are aimed at such activities are implemented in full. This explains the Government's inability to predict accurately the amount of revenue it is expected to raise directly from the new accruals measures.

Taxing authorities tend to raise revenue with respect to international income flows by taxing residents on income derived from foreign sources and non-residents on income from domestic sources. However, the revenue raised by this process is arguably small when compared with revenue raised from taxing transactions which do not cross national borders. One commentator has argued that capital exporting countries are virtually forced to take fiscal responsibility for establishing capital export neutrality, and therefore, although such

42. Musgrave *supra* note 16, at 99. It is suggested that the national interest would be best served in light of these externalities by tax policy that is somewhat selective among the various kinds of foreign investment.
43. The Asprey Committee Report *supra* note 13, at paras. 17.31 – 17.32.
44. Woellner, R. and Burns, L., "International Information Flows – The Tax Implications", 6 *Australian Tax Forum* (1989), at 143, 148, citing Crinion, G.P., "Information Gathering on Tax Evasion in Tax Haven Countries", 20 *International Lawyer* (1986), at 1209, 1211-13.
45. Id., citing Woodward Jr., P., 24 *Tax Notes* (1987), at 17-19.
46. Tax Underpayments by US Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the Committee on House Ways and Means (House of Representatives, 101st Congress, Second Session, 10 and 12 July 1990, Serial 101-123). In pursuance to such Hearings the Subcommittee heard submissions regarding the "Present Law and Certain Issues Relating to Transfer Pricing (Code Section 482): Hearings before the Subcommittee on Oversight of the House Committee on Ways and Means on July 10 and 12, 1990" (Prepared by the Staff of the Joint Committee on Taxation, US Government Printing Office, Washington: 1990).
47. It should be noted that although the study by the House Ways and Means Subcommittee was more concerned with transfer pricing between foreign corporations and foreign controlled US corporations, the findings of the study are also relevant to cases of transfer pricing occurring between US corporations and US controlled foreign corporations.
48. The submissions of Mr Fred Goldberg (IRS Commissioner) before the House Ways and Means Oversight Subcommittee were reprinted in *Daily Tax Report* (BNA) No 133 (11 July 1990).

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countries (notably the United States) tout jurisdictional claims to the worldwide income of their national corporations, in practice the foreign tax credit coupled with sophisticated tax planning by corporations usually results in little tax revenue collected at home.[49] That is, most foreign taxed income will be exempt from domestic taxes in light of the generous operation of the FTCS in recognition of the source jurisdiction's primary taxing right. Moreover, the separate entity approach coupled with some sophisticated tax planning, until recently, enabled multinational corporations to minimize their exposure to the residence country's tax by diverting such income to foreign subsidiaries in low tax jurisdictions. Hence, the need for anti-tax haven legislation in order to protect the domestic tax base (i.e. domestic-source income).

Even where a capital exporting country has in place anti-tax-haven legislation (i.e. accruals legislation), judging from the comments and submissions made to the Treasurer at the time the Australian accruals legislation was being proposed, such legislation is not viewed as a major revenue raiser. In fact, some commentators have tried to downplay the importance of such legislation by suggesting that it would involve more costs (both administrative and compliance) than such legislation would raise in revenue. That is, the purpose for bringing such anti-tax-haven measures is defeated from the outset since it theoretically is not economically viable.[50] However, it is broadly estimated that the likely direct revenue gain from accruals legislation in 1991/92 will be $ 85 million,[51] but the Government's latest estimate for the 1993/94 financial year is a much more conservative $ 60 million to $ 70 million.[52]

Alternatively, a case may be put forward in reconciling the existence of accruals legislation with the objectives of a "good" international tax system (i.e. the revenue criterion) by highlighting the deterrent aspect of such legislation.[53] Although, from the foregoing comments, it is suggested that the direct revenue raised by introducing accruals legislation will not outweigh the costs (both administrative and compliance costs) associated with such legislation, the accruals legislation is nevertheless justifiable on the basis that it will substantially contribute to the reduction of tax haven use by those corporations resident in capital exporting countries. The validity of this justification is inextricably tied in with the economic and other consequences arising to the capital exporting country from such tax haven use, and as will be seen from the discussion in Part III, this is still very much a hotly debated area.

5. Simplicity

As desirable as this policy objective may be, regretfully, with respect to taxation, this objective may (or will) never be realized. This is especially so with respect to taxation of international income flows. The manner in which tax legislation has developed is that it is formulated in most instances as a response (anticipatory in some instances) to tax planning "schemes". The more complex the arrangement or scheme the more complex the tax legislation devised to countervail the arrangement. Evidence has shown that arrangements which cross national boundaries are anything but straightforward. In fact, the accruals legislation which was recently introduced into Australia has been unanimously referred to as one of the most difficult and complex pieces of legislation ever to be passed by an Australian parliament.[54] These comments have been echoed by those persons in Treasury and the Australian Taxation Office who were responsible for drafting the accruals legislation.[55]

6. Administration and compliance

A further important objective which necessarily must underlie any tax policy is that persons who are subject to any tax measures should be able to understand them and to comply with them without undue cost. Similarly, revenue authorities responsible for the administration, collection and enforcement of the tax must be able to understand it so that they may carry out their functions efficiently and to adopt consistent policies when carrying out such functions.

Musgrave and Musgrave concluded that "[c]ompliance cost is substantially larger than administration cost".[56] They estimated that in all, total compliance cost (for both US individuals and corporations) in 1980, of US$ 10 billion would not be surprising.[57] From a postal survey in August/October 1988 of 314 public companies throughout Australia it was estimated that the total compliance costs of public companies' income taxation in Australia for the tax year 1986/87 was between $ 646 million and $ 1,341 million, or 11.4 to 23.7 percent of public companies' tax revenue of $ 5,650 million, as compared with the estimated (gross) compliance costs of UK corporation tax in 1986/87 of 2.2 percent of tax rev-

49. Brean *supra* note 27, at 131. More recently, the Minister of Finance, the Honourable Ruth Richardson, noted that although the changes to the CFC regime are expected to increase revenues, nevertheless, "the primary reason for the proposed changes is to pursue greater fairness and maintain the tax base by applying to income earned through foreign entities the principle of taxing residents on their world-wide income". *The New Zealand Budget 1992* (B.6A, at 84).

50. See comments made by Richard Krever, "Australia's New Foreign Income Attribution System", *Australian Business Law Review* (1988), at 253; Mark Liebler in his submissions to the Standing Committee set up to look into the burgeoning use of tax havens by Australian companies; Arnold *supra* note 15, at 56-5; Robert Richards, "The New Rules for Foreign Source Income", 28 *Australian Accountant* (1989), at 26, 34; and *The Australian Financial Review* (21 March 1990).

51. *Tax Payers or Tax Players*, a Report by the House of Representatives Standing Committee on Finance and Public Administration (AGPS: Canberra, 1989) ("The Martin Committee").

52. Korporaal, G., "New anti-tax haven law: Tough or just tough talk?" *The Sydney Morning Herald* (9 January 1991), at 31.

53. It has been noted that accruals legislation is the only limitation on deferral (see Arnold, B.J., "Future Directions in International Tax Reform", 5 *Australian Tax Forum* (1988), at 451, 457).

54. Such comments were recently made by notable tax advisers presenting papers at seminars organized by the University of Sydney and the University of New South Wales in February 1990, on the draft accruals legislation.

55. See the paper presented by Phil Anderson (who at the time was a senior officer with the Treasury Department), "A Treasury View of the Draft Legislation", delivered at the University of Sydney, CLE Seminar – Committee for Postgraduate Studies on 9 February 1990. See also the paper presented by Peter Smith, "Legislative Purposes and Structure of the New Rules", to the University of New South Wales Taxation Business & Investment Law Research Centre on 19 February 1990; and Arnold *supra* note 15, at 57.

56. Musgrave and Musgrave *supra* note 5, at 291.

57. Id.

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enue.[58] The compliance costs for individuals is a little better, being 7.9 to 10.8 percent of tax revenue.[59]

Despite the relatively high compliance costs for public companies when compared with tax revenues, it was estimated that compliance costs per dollar of turnover fell as company size increased. This figure varied from just under $ 2 for every $ 100 of turnover for companies with a turnover of over $ 5 million per annum to about four cents for every $ 100 of turnover for companies with a turnover of $ 100 million per annum or over.[60]

On the other hand, the cost of federal tax administrations as reflected in the budget of the IRS for the fiscal year 1983 was US$ 2.7 billion, or 0.5 cent per dollar of federal tax revenue.[61] In contrast, the cost of collecting tax in Australia has been estimated to be one cent in the dollar.[62]

Comments made in the section on simplicity above with respect to the complexity of legislative provisions dealing with the taxation of foreign-source income (e.g. FTCS and accruals legislation) are equally applicable when evaluating the administration and compliance costs associated with the same legislative provisions. It is noted that taxpayers must deal with differences between domestic and foreign tax and accounting rules that are often extensive. Moreover, compliance problems are frequently exacerbated by different languages and the necessity to translate amounts from a foreign currency into the domestic currency. Added to these problems are the problems of inadequate staffing coupled with the complexity of the legislative provisions which make it extremely difficult for revenue authorities to collect tax on foreign-source income in a fair, effective and efficient manner.

The difficulty with the collection of tax raised through the accruals legislation (and the recently introduced FIF measures) principally arises from the lack of adequately trained staff who have a workable knowledge of such complex legislation, as well as the inability of revenue authorities to unilaterally gain access to information abroad due mainly to secrecy laws in existence in the foreign country.

From a social perspective, an argument may be mounted along the lines that the significant compliance costs which are associated with such complex legislation as the accruals rules and the FIF measures could easily be absorbed by the large multinational corporations,[63] since it is the large companies to which such rules are principally directed. However, the argument quickly loses force if we analyse the deterrent effect such costs may have on the international operations of smaller multinational corporations, or even those national corporations wishing to operate (i.e. set up subsidiaries or branches) overseas. It appears that Australian practitioners are unanimous in their belief that the accruals rules and the introduction of the FIF measures will cause many Australian firms to "collapse" their offshore subsidiaries.[64]

B. *Conclusion*

Ultimately, in evaluating any reform of the tax system of a country it should be borne in mind that the proposals for reform should be structured to achieve the "over-riding requirement" that the tax system's intended and actual effects should be the same, which in turn requires that opportunities for avoidance, evasion and other manipulations be minimized.[65]

In concluding this part of the discussion, it is noted that the six tax policy objectives discussed above sometimes conflict.[66] An instance where the above objectives could conflict occurs between revenue and equity when a tax system provides inadequate relief for international double taxation. Such a system may produce additional tax revenue but at the cost of significant loss in equity. However, despite such conflicts and inconsistencies, it is the role of government authorities to clearly set priorities between, say, maintaining international neutrality in favour of say, compliance and administration, and to implement measures which reflect such priorities. Invariably, there will be critics whatever the ultimate design of the system turns out to be, especially in light of the fact that the achievement of international neutrality may have to occur at the expense of other important policy objectives. Therefore, in the end, it is more a political decision as to which policy objectives will be followed and which will be disregarded or at least neglected.

The policy objectives of the Australian Government have been set to achieve world efficiency whilst at the same time deviating from such a policy in order to promote national interests, namely the protection of the domestic tax base. Hence, the policy behind the FTCS which does not fully credit foreign taxes. In line with that objective, the Australian Government has adopted an accruals regime of taxation in order to further the objects of the credit system, by eliminating deferral of domestic taxes in certain circumstances. The implicit costs arising from such a commitment to the credit system occurs at the expense of such policy objectives as simplicity which in turn should mean that administration and compliance costs become unnecessarily high.

58. Pope, J., Fayle, R., and Chen, D.L., *The Compliance Costs of Public Companies' Income Taxation in Australia 1986/87* (Australian Tax Research Foundation, Research Study No. 13, 1991), at iv-v. In that study it was also observed that public companies incur estimated average compliance costs of $ 62,604 comprising $ 34,120 (55%) for computational costs and $ 28,484 (45%) for planning costs.
59. Pope, J., Fayle, R. and Duncanson, M., *The Compliance Costs of Personal Income Taxation In Australia* (Australian Tax Research Foundation, 1990).
60. Pope, Fayle and Chen *supra* note 58, at iv.
61. Id.
62. Id. at vii, where the authors cite the Commissioner of Taxation's Opening Remarks to The Economic Planning Advisory Council, 17 February 1989.
63. See Pope, Fayle and Chen *supra* note 58, at iv, where it was estimated that compliance costs per dollar of turnover fell as company size increased.
64. In an article appearing in the *Australian Financial Review* on 21 March 1990, it was stated that "the extra administrative burden [of the CFC legislation] will weigh heavily on subsidiaries with legitimate operations in declared tax havens". See also an article by Barrie Dunstan in *The Australian Financial Review* on 24 April 1992, entitled "Foreign moves on foreign investors".
65. See Mathews, R., "The Structure of Taxation", in *The Politics of Taxation* John Wilkes (ed.) (Hodder and Stoughton, 1980), at 108-112.
66. See Musgrave *supra* note 16, at 128-130, for a discussion of the instances where such policies may conflict.

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III. ECONOMIC CONSEQUENCES ARISING FROM THE REMOVAL OF TAX BIASES IN FAVOUR OF FOREIGN-SOURCE INCOME

A. *Introduction*

As mentioned in Part II, it is difficult to coordinate the intended and actual effects of taxation policy, particularly policy which has an international dimension. This part of the paper is an extension of Part II, in that the main purpose is to ascertain whether governments are justified from an economic perspective in pursuing policies that seek to remove the tax benefit arising from the deferral advantage which can be exploited by resident taxpayers in relation to foreign-source income (i.e. through transfer pricing or by giving income an artificial foreign-source). The theme of this discussion will be an evaluation of the effect of the removal of such tax benefits arising from the deferral advantage through accruals taxation on the capital exporting country, the sectoral groups and interests within that country as well as the capital importing country.

The term "deferral" as it is referred to throughout this paper is necessarily a value-laden term, because it suggests that a special concession has been granted, an implication not made when the rule is applied to domestic corporations.[67] Nevertheless, despite the inconclusive evidence as to the economic effects of this value-laden term (see discussion below), those governments which have introduced legislation aimed at combating deferral cling to the view that such legislation is necessary in curtailing inappropriate tax benefits accruing to movable income earned through a foreign corporation, and consequently, to level out the playing field. This objective was recently summed up by the Staff of the Joint Committee on Taxation as follows:

> It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of US persons' operations and investment. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, Congress believed that a major motivation of US persons in earning such income through foreign corporate vehicles often was the tax benefit expected to be gained thereby. Congress believed that it was generally appropriate to impose current US tax on such income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the US persons' use of a foreign corporation. Congress believed that by eliminating the US tax benefits of such transactions, US and foreign investment choices would be placed on a more even footing thus encouraging more efficient (rather than more tax-favoured) uses of capital.[68]

The objective of "levelling out the playing field" may also be gleaned from the Treasurer's economic statement delivered on 25 May 1988, where he foreshadowed the introduction of the accruals legislation in the following terms:

> The present system for taxing foreign-source income can lead to serious inequities and economic distortions. Taxpayers deriving similar income may be subject to widely differing rates of tax depending on whether they derive income in Australia, in a comparable tax jurisdiction or in a low-tax country. Investment decisions may be made not on the basis of sound commercial criteria, but on the availability of tax minimization opportunities.
>
> The deferral advantage of foreign-source income can be exploited by Australian residents ... through transfer pricing practices or by giving income an artificial tax-haven source. In such cases, little or no activity at all is conducted in the tax haven country but large amounts of profit are recorded there. Very little tax is paid and the income is reinvested, creating more income and wealth for the beneficial owners of the foreign entity without their paying much or any Australian or other tax on the income.[69]

The desire to create conditions conducive to a "level playing field" by removing tax concessions available to Australian resident taxpayers that earn income through a foreign corporation, especially one which is resident in a tax haven should go a long way to upholding the integrity of Australia's fiscal jurisdiction. The Australian Government's attempts at tightening its FTCS rules and transfer pricing rules prior to the introduction of the accruals legislation (and the FIF measures) had been rendered to some extent useless in view of the deferral advantage that was available to resident taxpayers who were able to avoid the operation of such rules by the diversion of investment income to, or the accumulation of investment income in a foreign corporation.

B. *An account of the development and principles of accruals basis taxation*

It was revealed in Part II that the primary reason why it is possible for Australian companies to defer payment of domestic tax on foreign-source income earned by foreign subsidiaries is because of the separate treatment of the subsidiary from its parent company. Accordingly, governments of some of the most industrialized countries in the world have introduced tax measures which disregard the corporate personality of the foreign subsidiary and tax the domestic parent corporation on its proportionate share of the undistributed profits of the foreign company.

The United States was the first nation to introduce measures to tax profits of a foreign subsidiary that was controlled by a US shareholder.[70] Canada did so in 1971, West Germany (as it then was) in 1972, Japan in 1978, France in 1980, the United Kingdom in 1984, New Zealand in 1988 and Australia in 1990. Sweden recently introduced similar accruals legislation. The attractiveness of the accrual basis regime of taxation is that it does not violate any jurisdictional principles of international law, since the tax liability is imposed on the

67. Park, W., "Fiscal Jurisdiction and Accrual Basis Taxation Lifting the Corporate Veil to Tax Foreign Company Profits", *Columbia Law Review* (1978), at 1609, 1610.

68. Staff of the Joint Committee on Taxation General Explanation of the Tax Reform Act of 1986 (1987), at 964-965.

69. Consultative Document *supra* note 33, at para. 2.2. See also Anderson, P.J., "Economic Policy Considerations in the Taxation of Foreign Source Income", 5 *Australian Tax Forum* (1988), at 395, 409 where he states:

> Consistent with the general approach to taxation, aimed at generating a 'level playing field', facilitation does not extend as far as providing encouragement via taxation concessions. The aim of policy is to encourage investment of capital in areas where it will be most productive ... the present system of taxing foreign source income does not ensure this outcome.

70. See Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (codified at Internal Revenue Code Secs. 951-964).

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"controlling resident shareholders" of the foreign subsidiary who are subject directly to the taxing country's jurisdiction. Although the shareholder may not have actually received income, there has in theory been an accretion to its wealth which is arguably under its command, and thus subject to the taxing jurisdiction of the country in which it resides (or is a citizen, in the case of the United States).[71] Such measures, it is submitted, protect the resident country's source jurisdiction.[72]

However, it should be noted that the operation of the accruals rules may be subordinated to the exclusive taxing rights given to certain treaty partners in respect of some items of income.[73] The argument propounded here is that there are a number of DTAs which contain provisions specifying the source of income derived by a person who is a resident of both treaty countries under the respective domestic laws (i.e. a dual resident company). The usual manner in which the relevant DTA deals with such a company is to allocate residence of the particular company exclusively to one of the treaty countries by virtue of a tiebreaker provision. The effect of this is to ensure that the company is only taxable in the deemed residence jurisdiction if the income is from a source in that jurisdiction or from sources outside both treaty countries. There is a strong argument which suggests that items of income received by such a company are not caught by Australia's accruals rules (i.e. they do not enter the calculation of attributable income for "foreign income" tax purposes), because attributable income is taxed by Australia making such items not exempt from Australian tax. In the event that a court of law asked to consider this issue upholds the argument put forward in this paragraph, then Australia's domestic-source jurisdiction may be subject to manipulation despite the existence of accruals measures. The possibility of such a situation having a significant impact on the integrity of Australia's domestic-source rules is somewhat overstated since Australia has only negotiated DTAs with 34 other nations, and in respect of the Australia/Japan DTA there is no tiebreaker provision. Moreover, in respect of the Australia/US DTA, a tiebreaker provision exists only in respect of natural persons who are dual residents.

It was also revealed in Part II that the system of full taxation of foreign profits by the country of residence on a current basis with credits for foreign taxes is consistent with the principle of tax neutrality and international equity, since it effectively places such income for tax purposes on an equal footing with income earned through a domestic corporation. However, it is this latter policy which has given rise to the most controversy, since, prima facie, it advocates the complete elimination of deferral.

The controversy surrounding the policy option for complete elimination of deferral stems primarily from the inconclusive empirical evidence available regarding the economic effects of deferral. It is those arguments which we will be concerned to analyse with the aim of reaching some conclusion with regards to the perceived "harm" said to be caused by deferral. The economic impact of deferral of domestic tax on foreign-source income is intricately tied to the controversy surrounding the economic impact of foreign investment. The crux of the controversy appears to depend on the assumptions that are made about foreign investment. That is, it could be argued that (i) foreign investment is a substitute for domestic investment, or (ii) foreign investment supplements domestic investment.[74] Foreign investment is a substitute for domestic investment if it displaces domestic investment that otherwise would have been made. Foreign investment is supplemental to domestic investment if there is no alternative domestic use of the funds that are invested abroad.

Originally, the proposals in the Consultative Document which foreshadowed the introduction of the accruals legislation in Australia did not distinguish between income derived from conducting genuine businesses offshore – "active income" (e.g. manufacturing, mining, etc.) and those merely deriving investment income – "passive income" (e.g. interest, dividends, etc.), thus providing for the complete elimination of deferral.

After intensive lobbying from the business community, the Federal Government agreed to include an exemption for active income in the Information Paper, which was released in April 1989. The Federal Government, it seemed, was persuaded by the "competition argument", that is, that Australian interests overseas will be seriously hampered if income derived in the foreign jurisdiction was taxed at Australian rates. As a result, the goal of the accruals legislation had changed within the space of one year. The fact that partial deferral of active income was now allowed meant that the goal of the Australian accruals regime had shifted from one of complete elimination of deferral in favour of a goal of eliminating deferral in cases of "blatant tax avoidance and tax-motivated investments".[75]

The US Congress rejected proposals by President John Kennedy to end tax deferral for foreign subsidiaries, and instead enacted Subpart F provisions for the taxation of CFCs and gave strong support for more active enforcement of controls over transfer pricing. By enacting Subpart F and the related PFIC provisions Congress had asserted that its goal is to prevent tax avoidance. In his 1961 tax message, President Kennedy had advocated a regime of taxation which would completely eliminate deferral of US tax by US resident multi-

71. See Park *supra* note 67, at 1611. Ignoring the corporate identity of the foreign corporation does, however, increase the number of rival claims to jurisdiction over the same pot of income.

72. See also McIntyre *supra* note 25, at 6-84 to 85; and McIntyre, J., "Australian Measures to Curb Tax Haven Abuses: A United States Perspective", 4 *Australian Tax Forum* (1988), at 419, 422.

73. Switzerland has placed on record its formal objections to CFC-type taxes as being in breach of DTAs "as they result in effect in extra-territorial application of domestic tax legislation", OECD, *International Tax Avoidance and Evasion* (Paris: OECD, 1987), at 84.

74. For a full analysis of the choices of assumptions that can be made in assessing the relation between foreign investment and the domestic economy of the United States, see Musgrave *supra* note 16, at 10-14. However, after assessing the relation between foreign investment and domestic investment, Professor Musgrave (at 32) concludes:

> Foreign investment that replaces, or substitutes for, domestic investment must be considered the predominant form of foreign investment. Yet, there may be some amount of that substitutes for domestic consumption, and a further, limited amount that supplements domestic investment during periods of widespread slack in domestic business activity.

75. *Taxation of Foreign-Source Income: An Information Paper* (AGPS: Canberra, 1989), at 5.

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national corporations. However, due to strong opposition by multinational corporations, the provisions of Subpart F were only extended, inter alia, to passive income and "base company income".[76] President Carter in 1978 tried to revive President Kennedy's original proposal for complete elimination of deferral but without any success.

In light of the fact that both the US and Australian Governments have experienced and succumbed to intense pressure from industry groups regarding the extent to which deferral should be eliminated, it is now intended to examine more fully the arguments for and against eliminating deferral completely. The arguments to be canvassed below proceed on the premise that accruals basis taxation implies a system of full taxation of foreign profits by the country of residence on a current basis with credits for foreign taxes.

C. *Arguments for and against eliminating tax biases in favour of foreign investment income*

1. Arguments for eliminating deferral completely

After examining the general principles that US tax policy should follow in the field of foreign investment, Professor Peggy Musgrave concluded that there is little reason for giving tax incentives to foreign investment, on the basis that to do so would be contrary to the basic principle which should underlie US taxation of foreign investment income, that is, neutrality.[77] Moreover, she noted that the measures designed to eradicate tax incentives for foreign investment (i.e. deferral of domestic tax) may lead to conflicts and incompatibilities between the various criteria of a good tax system.[78] The differences in size and nature between the Australian and New Zealand economies on the one hand, and the US economy, on the other, may be so significant as to require some qualifications when applying Professor Musgrave's conclusions to the Australian or New Zealand economy. As noted earlier, Australia and New Zealand are "price-takers" in the international arena whereas, the United States is still regarded as a "price-maker", and hence can afford to adopt aggressive tax policies.

As early as 1961, President Kennedy in his tax message for that year said:

> Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which in conjunction with the tax system of other countries, consistently favour United States private investment abroad compared with investment in our own economy ...
>
> [T]he ability to defer the payment of United States tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States ...
>
> To the extent that ... tax deferral privileges result in United States firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States...
>
> [W]e can no longer afford existing tax treatment of foreign income.

The termination of deferral was also proposed by President Carter in 1978 and was hotly debated before being withdrawn. The President's 1978 Tax Program provided five arguments in favour of ending deferral:

- it would remove the situation whereby substantial tax benefits hinged on whether a foreign company was interposed between the foreign income and the domestic taxpayer;
- it would terminate an incentive to invest abroad rather than in the domestic economy;
- it would permit simplification of the rules relating to the taxation of foreign-source income;
- termination would help stimulate competition between large multinational corporations and their smaller competitors by removing tax benefits which accrue principally to the large multinationals; and
- it would strengthen the law aimed at preventing the shifting of profits by transfer pricing.[79]

Reproducing part of President Kennedy's 1961 Tax Message serves a useful purpose in that it provides an insight into the type of arguments to be discussed more fully below, which have been propounded in favour of eliminating tax deferral. For example, the President was concerned as to the taxation inequity between those companies with solely domestic operations and those with foreign operations and the strains on the balance of payments created by the taxation benefits that could be derived by earning foreign investment income.

In terms of the policy objectives discussed in Part II, it appears that both President Kennedy and President Carter were, inter alia, propounding a tax system which promoted capital export neutrality at the expense of international equity, since it was argued by both Presidents that introducing tax measures to eliminate deferral would remove the incentive to invest offshore and would introduce the "single entity" approach into the tax system. As well, President Carter argued that such tax measures would promote the principles of simplicity. In addition, he said that these measures would strengthen the anti-avoidance measures aimed at profit shifting by transfer pricing.

In light of the foregoing, it is surprising to note that the Asprey Committee in 1975 rejected a recommendation to eliminate tax deferral and felt that other means than the accruals legislation drawn along the lines of the US model be used to ensure that Australian resident taxpayers are not unfairly advantaged by deferral of Australian tax. They were very conscious of the complexities and administrative and compliance costs of attempting to tax foreign-source income

76. Broadly, base company income is US-source income which is diverted to a US CFC.
77. Musgrave *supra* note 16, at 107.
78. Id. at 107 and 137-138.
79. Department of Treasury, *The President's 1978 Tax Program: Detailed Description and Supporting Analysis of the Proposals* (Washington, DC: US Government Printing Office, 1978), at 282-296.

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of tax haven companies and trusts. The Committee based this conclusion on the difficulties experienced in the United States with the accruals legislation contained in Subpart F. They noted: "United States experience has not been encouraging. Its provisions are extremely complex and impose great difficulties in enforcing compliance."[80]

Instead the Committee preferred an approach which ensured that the existing source rules are strengthened. They were of the view that the source rules should be effective in reconstructing Australian origin income of non-residents, and preventing the diversion of Australian income to non-residents.[81]

(a) *Capital export neutrality*

Australia and New Zealand both adopt a foreign tax credit regime. This means that Australian and New Zealand corporation tax is generally applied to repatriated profits of foreign subsidiaries of domestic corporations, and a credit given for foreign taxes paid up to the amount of Australian and New Zealand tax due. Accordingly, an incentive to foreign investment (especially in those countries with lower corporate tax rates than Australia and New Zealand) arose by the mere fact that the deferral of domestic tax on the foreign-source income (i.e. by accumulating the profits offshore) meant that domestic companies could ensure a higher after-tax return on those accumulated profits than could otherwise be attained if the profits were repatriated back to Australia or New Zealand, or simply earned in Australia or New Zealand.

Put another way, deferral of domestic taxes on foreign subsidiary profits creates a situation where domestic taxes on accumulated profits are lower than domestic taxes on repatriated profits, thus the incentive to foreign investment. However, it is argued that a tax on retained earnings which is lower than the tax on repatriated earnings will have both an "income" and a "substitution" effect on reinvestment. It will leave a larger volume of after-tax earnings available for reinvestment (the income effect), and it will induce reinvestment rather than distribution (the substitution effect).

> "In all, it seems that deferral combined with a low foreign tax on profits lead to a larger volume of new investment outflow and the reinvestment of a somewhat higher *proportion* of a larger *volume* of after-tax profits. The stimulus to capital outflow is probably not as great as that to reinvestment because affiliates already established abroad may substitute retained earnings for funds of [domestic] origin."[82]

Therefore, by introducing policies to eliminate the deferral advantage for certain foreign investment, Australia and New Zealand share a common goal in that they are attempting to ensure that foreign investment is motivated by genuine economic factors and not by taxation considerations which, even if only in a small way, undermine endeavours to raise revenue, say, to fund public spending programmes. Accordingly, the removal of deferral has been justified on the basis that (i) it reduces the inequities, distortions and revenue losses arising from the present law, and (ii) by ensuring all income earned by domestic multinationals is taxed at rates comparable to that in country of residence, the incentives for the manipulation of transfer pricing will also be greatly reduced.[83]

Another argument in favour of eliminating tax deferral alluded to by President Kennedy and President Carter, is the need to ensure that corporations with domestic operations do not suffer loss of competition as a result of the high tax bills they face compared with the low tax bills which corporations operating in tax haven countries must meet. The crux of this argument is based on the efficient allocation of resources objective (which is a variant of the neutrality objective) from the national perspective, and requires consideration of the best policy mix for achieving this objective.

The Treasurer at the time, Mr Paul Keating, echoed the earlier tax messages of Presidents Kennedy and Carter in his May Economic Statement, delivered on 25 May 1988. The Treasurer's justification for introducing accruals legislation was couched in such policy terms as one of promoting capital export neutrality.

> "Although the economic evidence supporting complete removal of the deferral advantage in all cases is inconclusive and vigorously debated, little can be said against the removal of deferral in cases of blatant tax avoidance and tax-motivated investments. Further, the inequities, distortions and revenue losses arising from the present law give weight to the case for removal of deferral in most other foreign investment situations involving low-tax countries."[84]

(b) *Balance of payments*

By eliminating or reducing the advantage sought from lower foreign tax rates, accrual basis taxation may be expected to discourage capital movement abroad, at least to the extent that tax rate differentials affect the investment policies of multinational corporations. It is this factor, amongst others, it is suggested, that may improve the national balance of payments account in the short run. The downside of this is that it would also diminish foreign earnings and hence repatriation of those funds which would give the capital exporting state potential foreign currency claims. That is, foreign investment leads to increased exports of goods, services and labour by the country of residence, and when the foreign investment matures, dividends will be repatriated to the country of residence, thus improving the balance of payments position in the long run.

The net effect of removing the deferral advantage on the capital exporting country's balance of payments will ultimately depend on the displacement of exports and the rate of repatriation of earnings. Moreover, as indicated above, there are too

80. Asprey Committee Report *supra* note 13, at para. 17.51.
81. Id. at paras. 17.52-17.55.
The Committee is not persuaded that it is an appropriate policy to seek to tax foreign-origin income of tax haven companies and trusts and is very conscious of the complexities and administrative and compliance costs of attempting to do so. It prefers to ensure that the general provisions of the Australian law as to source of income in Australia are effective; that there are adequate provisions in regard to the reconstruction of Australian-origin income of non-residents; and that there are also adequate provisions to prevent the diversion of Australian income to non-residents (at para. 17.55).
82. Musgrave *supra* note 16, at 82.
83. See Statement by the Treasurer in the Consultative Document *supra* note 33, at 4-5.
84. Id. at 5.

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many other variables which also need to be accounted for before a proper study of the effect of accrual basis taxation on the movement of capital may be undertaken. It is beyond the scope of this paper to deal with those variables.

(c) *Labour market effects*

The inconclusive nature of the evidence in relation to the economic impact of eliminating deferral on the domestic economy's balance of payments is even more significant when considering the domestic labour market. In the United States, unions have supported anti-deferral legislation on the basis that domestic production levels will be preserved by use of an accrual basis regime that discourages foreign investment. This argument, it is suggested, assumes that domestic investment opportunities are available and that domestic management will become more attentive to existing domestic activity. Moreover, this also ignores the argument that domestic manufacturers may go abroad in order to obtain access to foreign markets protected by tariff barriers, or in reaction to a threat by foreign manufacturers to an already established export market. Consequently, it is unlikely that accrual basis taxation will safeguard domestic jobs, it is argued, unless markets in the same or similar product lines are found for displaced domestic production.[85]

In a major study by Professor Musgrave it was suggested that tax deferral resulted in a capital exporting bias which in turn reduced the level of income originating in the United States as well as reducing the labour share in national income. This led Musgrave to conclude that there would be a substantial distributional effect adverse to the labour share.[86] Admittedly, the results of this study would have had little bearing on Australia, since Australia is regarded as a net capital importer and at the time of the study the United States was regarded as a net capital exporter.[87] Therefore, prima facie, Australia stood to benefit from the capital exporting bias of other countries. However, the differences in the corporate tax rates between United States and Australia (i.e. 34 percent[88] and 39 percent, respectively) are such as to eliminate any significant US capital export bias *vis-à-vis* investment in Australia.

(d) *Domestic growth*

From the foregoing analyses it is arguable that foreign investment which supplements domestic investment contributes to the growth of the domestic economy, and that tax measures that may distort the flow of foreign investments would be contrary to national growth. However, it is suggested that since domestic investment could be increased by appropriate fiscal action, foreign investment may be a weak alternative to domestic investment as an "engine of growth". Moreover, the national return on most capital invested abroad is lower than that on domestic investment. Thus, to the extent that foreign investment substitutes for domestic investment, it inhibits the rate of growth of national income.[89]

This view of the negative role of foreign investment as an "engine" for domestic growth is confirmed by the Treasurer in the Consultative Statement:

> For investments generating similar rates of return, Australia as a whole benefits more from domestic investments than from foreign investments. Foreign taxation reduces the return to Australia as a whole whereas Australian taxation does not (except for any 'dead-weight' loss associated with tax distortions).[90]

2. Arguments for retaining the tax bias in favour of foreign source income

The above analyses of the arguments raised in support of eliminating the tax bias in favour of foreign-source income (i.e. the beneficial effects that the change would have on domestic investment, employment, exports and the balance of payments) are also relevant in arguing the opposite case.

> "There would no doubt be some dispute about the economic effects of taxing all foreign-source income of Australian residents on an accruals basis and at the same rate as domestic-source income. Those who argue in favour of removing the tax bias for foreign-source income stress the beneficial effects that the change would have on domestic investment, employment, exports and the balance of payments. Those who argue the opposite stress the same points but reach different conclusions about the effects of the changes."[91]

Those who argue against eliminating deferral concur that the objectives of tax neutrality should be the minimum distortion by the domestic tax system of the economic flow of investment funds between, as well as within, countries. This equates to promoting a dual policy of capital import neutrality together with inter-nation equity. Yet, they differ considerably on the rules and policies that promote that objective.[92]

The principal argument of the business community against eliminating deferral is capital import neutrality. This view of neutrality dictates that foreign investors be taxed equally in the source jurisdiction. Accordingly, under the capital import neutrality principles it is suggested that the domestic country should tax income according to source principles or exempt foreign source income from domestic taxation.

Other factors which the business community points out as worthy of consideration when implementing policies that

85. Park *supra* note 67, at 1626.
86. Musgrave, P.B., "Direct Investment Abroad and the Multinationals: Effects on the United States Economy", submission prepared for the Subcommittee on Multinational Corporations and the Committee on Foreign Relations United States Senate (August 1975).
87. The United States is now regarded as the largest capital importing country in the world.
88. US corporation income tax rates are:

Over	*Not over*	*Tax rate*
$ 0	$ 50,000	15%
50,000	75,000	25
75,000	100,000	34
100,000	335,000	39*
335,000		34

The above rates do not include taxes levied by state governments or lower level governments.
* A 5% additional tax rate applies to phase out the benefits of the graduated rates between $ 100,000 and $ 335,000 of taxable income.
Taxable income of certain personal service corporations is taxed at a flat rate of 34%.
89. See Musgrave *supra* note 16, at 17 and 57-58.
90. See Consultative Document *supra* note 33, at 33.
91. Id. at para. 2.3.
92. See Musgrave *supra* note 16, at 117 where the statement of George F. James (from Socony Mobil Company) is cited.

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promote international neutrality are the special risks and institutional burdens associated with foreign investment that are not associated with domestic investment. Moreover, the relevant concept of international neutrality should be the equal treatment of domestic investors abroad and not domestic investors with solely domestic operations and those with foreign operations.[93]

(a) *Capital import neutrality*

For the purposes of the discussion to follow it is necessary to briefly describe the manner in which accruals basis taxation seeks to eliminate deferral. The central theme underpinning accruals basis taxation is the concept of "control". It is this factor which gives the accruals legislation its overreaching effect. The gist of this requirement is that foreign income derived by a foreign entity will be "attributed" to those domestic shareholders who are in a position to cause the foreign entity to distribute the same in accordance with their proportionate share in the foreign entity. Therefore, domestic taxes will, pursuant to such legislation, be levied on the foreign-source income regardless of whether or not the income is distributed. It is this aspect of the legislation which has been the subject of most criticism, particularly where the genuine business activities of foreign entities operating in tax havens are affected.

The attitude of the Business and Industry Advisory Committee (BIAC), which was conveyed to the OECD Committee preparing the 1987 Report on the use of tax havens, was highly critical of CFC-type legislation which was extended to cover all businesses in tax havens, regardless of the nature of the business. The BIAC gave examples of situations where, in its view, economic factors could be advanced for making use of tax havens, and where industry would regard the use of tax havens as legitimate, provided that all the arrangements were operated on a commercial basis and were not artificial contrivances. However, the BIAC accepted that fiscal authorities have a proper reason for concern where transactions are carried out at prices which cannot be justified on "arm's length" criteria or where profits are otherwise diverted without genuine business purposes or objectives.[94]

The BIAC submission also contained the usual arguments in support of companies setting up in tax havens. That is, that much of the use of tax havens was not motivated by a desire to pay no, or little, tax so much as an economic necessity to reduce costs to a "bearable level" in circumstances where the laws of countries are "uncoordinated". They listed instances where they felt it was considered useful or necessary to use tax havens. They included:

- fund-raising companies for international investments – to raise funds competitively on international markets and reduce financing costs (including taxes);
- subsidiary shareholding companies – to receive income from dispersed overseas operations in the form of dividends. Such companies are particularly significant in (i) avoiding costs and delays in repatriating funds which were destined only to be re-exported; (ii) avoiding the high risk of devaluation in some source countries; (iii) correcting misalignments between source and residence countries where the total tax burden varies year by year but is on average the same over a period of years; and finally (iv) protecting investment incentives offered by some source countries.[95]

The other objectionable features of a CFC-type legislation which the BIAC referred to were the compliance burden on taxpayers and the enforcement burdens on tax authorities resulting from the overly restrictive and complicated legislation required to effectively counteract the practice of tax haven use. The BIAC concluded their submission by stating that it would be more beneficial and fair to all taxpayers involved if specific abuses were singled out and legislated against. This, they argued, would ensure that "the cure is not worse than the disease".[96]

The OECD Committee on Fiscal Affairs in a report produced in response to the BIAC submission cited above, attempted to balance revenue raising considerations against business attitudes. They stated that there is no justification for the use of tax haven companies to shelter income from the residence country's tax net. Moreover, the strong secrecy laws present in most tax haven countries are an inducement in themselves to conduct activities in tax havens.

> "The OECD Committee on Fiscal Affairs appreciates some of the problems raised by the BIAC and recognizes that minimizing costs is a legitimate concern of business. However, the Committee considers that these problems do not justify the use of tax havens to shelter income from taxation in the country of residence which bears no relation to the activities carried out in the tax haven. Another important point is that one of the main tax haven characteristics, confidentiality and secrecy, can itself be significant inducement to use tax havens".[97]

The Committee, in supporting CFC-type legislation, referred to the primary objectives which should underlie any comprehensive international tax regime, capital export neutrality and equity. They stressed the point that the use of tax havens itself distorts competition and that the BIAC and other businesses should not use such an argument to undermine the policy objectives underlying such counteracting legislation. They remarked that (i) the use of tax havens affects the neutrality of taxation in economic decisions, and (ii) competition between taxpayers is seriously distorted by the fact that some taxpayers can use tax havens to avoid or reduce tax, while others do not or cannot.

Similarly, the views of the business sector in Australia have understandably concentrated on the capital import neutrality argument. It has been suggested that our regulated labour market, the cost and availability of resources and our distance from export markets makes Australia uncompetitive. Thus, as the argument runs, it is not surprising that Australian companies would wish to establish overseas operations. The availability of cheaper labour and resources, as well as the proximity to markets, offers the initial impetus. The prospect of lower taxes and tax holidays in some countries also allows

93. Id. at 118.
94. OECD Report, "Tax Havens: Measures To Prevent Abuse By Taxpayers" (Paris: OECD, 1987), at 36-37.
95. Id. at 37.
96. Id. at 38.
97. Id.

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for start-up costs to be recovered quickly. Mr Peter Fraser concisely summed up the dislike that most Australian businesses and economists have to the accruals legislation as follows:

> The reality is that our regulated labour market, the cost and availability of resources and our distance from export markets makes Australia uncompetitive. We need foreign capital. Our corporate tax rates are still relatively high and bureaucratic red tape makes the cost of carrying on business in Australia very high. In many cases it is simply not possible for Australian manufacturers to produce widgets at the same price as most manufacturers located in Asia, the United States and Europe. In many cases Australian manufacturers can only compete domestically because of tariff and non-tariff barriers to trade.
>
> Should there be any surprise that Australian companies wish to establish overseas operations. The availability of cheaper labour and resources, as well as the proximity to markets, offers the initial impetus. The prospect of lower taxes, and tax holidays in some countries, also allows for start-up costs to be recovered quickly.[98]

Mr Fraser also reiterated the assertion made by US businessmen some 23 years ago, which is that the relevant concept of neutrality should be equal treatment of domestic investors abroad. He stated that a taxation system which achieves equity and neutrality when viewed only by comparing the position of overseas entities with other home country manufacturers is not a perfect system.[99] Moreover, one of the world's largest accounting firms recently noted that for many multinationals, international taxation continues to be one of the largest single costs:

> The current economic climate has put great pressure on multinationals which expanded rapidly during the 1980s and focused attention on optimizing efficiency by cutting costs and maximizing profits. For many multinationals, international taxation continues to be the largest single costs.[100]

The preceding analysis states that subjecting domestic firms operating abroad to domestic taxation slows their expansion, and thus reduces their capacity to compete with foreign firms by increasing their costs. It has been observed that such an assertion implies the existence of economies of scale. Under the assumptions of economies of scale, market control is gained by the more rapidly expanding firm. However, some people would argue that this assertion alone is not sufficient to warrant exemption of foreign-source income, since it is possible to take advantage of economies of scale in the domestic economy. Moreover, there seems to be no reason why firms operating abroad could not expand out of borrowed funds.[101]

In proposing the new accruals measures, the Australian Government was mindful of the non-tax factors which attract Australian companies to invest in low tax jurisdictions. Such factors include the ability to obtain a supply of natural resources not available in Australia, to obtain low unit labour costs for labour-intensive work or to obtain access to certain markets. They suggested that the level of investment in these low tax jurisdictions by such Australian companies will be unaffected by the new accruals measures. It is only tax-induced investments in low tax jurisdictions that will be affected by the new measures.[102] The New Zealand Government, by contrast, has refused to succumb to the capital import neutrality arguments by not providing an active income exemption in its accruals rules.

Other commentators have similarly found it difficult to be persuaded by the competition argument. For instance, Professor McIntyre noted that there is no organized evidence that would tend to support this theory in the case of genuine businesses abroad.[103] Professor Vann, similarly, was not persuaded by the competition argument for retaining a tax bias in favour of foreign investment income. He observed that if the nature of the competition lies in the competition for share capital, it did not help to resort to the capital import neutrality argument. Firms investing overseas, he noted, are in most cases competing in domestic capital markets, and as such, will only be competitive where they can offer the same rate of return as other firms competing in those markets.[104] Moreover, two of the leading commentators on US international taxation have recently admitted to a complete reversal in opinion by advocating for the complete elimination of tax deferral instead of supporting the current state of play under Subpart F which exempts active income and certain other distributions from current taxation.[105] Such a change in opinion would indicate to some extent, it is submitted, an abandonment of the competition theory in favour of international neutrality.

In light of the foregoing, it appears that the business community's justification for tax haven use is somewhat lacking in credibility by reason of the fact that it implies that by establishing offshore subsidiaries to take advantage of the cheaper labour and resources as well as the tax differential between the foreign country and country of residence, a domestic company will become more competitive internationally. This, it was suggested, will have a marked positive impact on the domestic economy by increasing foreign capital. Such an interpretation of the state of affairs is not conclusively supported by evidence. The debate in the United States, over this very point, is still raging 30 years after Subpart F was first introduced into the Internal Revenue Code. Moreover, the OECD refused to accept such an argument as validly undermining the credibility of CFC-type legislation. Consequently, it would appear that by not providing an active income exemption, the New Zealand Government has avoided the "soul-searching" exercise that the United States finds itself confronting at the moment. The call for change in the Subpart F rules has become stronger with the election of a new President who has promised substantial tax reforms in order to curtail the burgeoning budget deficit.

98. Fraser, P., "Australian Tax Haven Measures", 6 *Australian Tax Forum* (1989), at 99, 102.
99. Id.
100. Ernst and Young *Tax News* (Spring 1991), at 3.
101. See Musgrave *supra* note 16, at 119-120.
102. The Consultative Document *supra* note 33, at 6.
103. See McIntyre *supra* note 25, at 6-86.
104. Vann *supra* note 23, at 3.
105. McDaniel, P.R. and Ault, H.J., *Introduction to United States International Taxation*, 2d ed. (Kluwer: Deventer, 1989), at 120.

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(b) *Effects on the labour market*

Contrary to popularly held views deferral, it has been submitted, has a positive effect on the domestic labour market. The number of jobs in the residence country increase because the foreign subsidiaries tend to use domestically produced products, and market acceptance of goods produced by the foreign subsidiary in most cases promotes acceptance and even sales of the domestically produced goods by the parent company. The argument has been articulated in a US context as follows:

> [T]he number of jobs in the United States is increased as a result of the operations of successful foreign subsidiaries, since (a) in many cases those subsidiaries use United States-produced components and other goods, (b) a large United States-based infrastructure is required to manage the worldwide operations and (c) the market acceptance of the goods produced by the subsidiaries promotes greater worldwide acceptance and in many cases increases domestic sales of the same goods in and exports from the United States.[106]

Others have concentrated on the beneficial effects that multinationals have on employment levels in the country where they have their headquarters (i.e. the home or residence country). In particular, by increasing exports, multinationals increase jobs in the home country. On the other hand, it is observed that the creation of unfavourable conditions for a multinational corporation by the home country which cause the multinational to collapse its foreign affiliates and subsidiaries would lead to a reduction in the output levels of the home country. This is because the demand for raw materials and other goods produced by the home country and used by the multinational's foreign affiliates will disappear. Such employment effects were highlighted in a statement made on 26 February 1973 to the Senate Subcommittee on International Trade, by Peter Flanigan, the Executive Director of the Council on International Economic Policy and Special Assistant to the President of the United States. Mr Flanigan referred to the creation of jobs which are linked directly to the creation of export markets by US multinationals. He said:

> In considering the impact of multinationals on employment in the United States, it is important to note the following facts that are sometimes ignored:
>
> First, regarding exports and jobs created by exports, multinational corporations do not reduce exports but rather increase both exports and jobs ...
>
> Second, regarding imports, US import competition mostly comes not from US multinational corporations but from foreign owned companies. This is especially true in the sensitive cases of textiles, steel, and automobiles. Indeed, the top three US automobile importers by value are Volkswagen, Datsun, and Toyota ... Indeed, the 1970 Commerce Department survey indicates that about 70 percent of the output of foreign subsidiaries of US companies is sold in the country where it is produced, and an additional 23 percent is exported to third countries. Only 7 percent of the multinational corporation production returns as imports to the United States to compete here at home with domestic production ....
>
> Third, in most of the few cases where US and third countries are supplied by American affiliates abroad ... elimination of these plants would not result in increased US output and employment, but in replacement of our output by foreign competitors. Such replacement would probably reduce US employment further since foreign competitors would be less likely to rely on the United States for machinery, supplies, research or marketing requirements...
>
> Fourth, ... evidence indicates that businesses do not normally move abroad to take advantage of low labor costs 60 per cent of US direct investments abroad in 1970 were in Canada and Western Europe, not countries with notably low wage rates.[107]

It should be noted that the fourth point raised by Mr Flanigan regarding evidence as to businesses not moving abroad to take advantage of low labour costs, must be qualified to the extent that subsequent statistics produced by the Gordon Report,[108] indicate a marked growth in the use of tax havens by US corporations. Such statistics, it is submitted, contradict Mr Flanigan's evidence to the extent that labour costs are normally lowest in tax haven countries.

In 1980, the Department of the Treasury, the Department of Justice and the IRS requested that the Special Counsel for International Taxation, Mr Richard Gordon, review and advise them as to the use of tax havens by US persons and present options to be considered for problems this created. In the Gordon Report, it was noted that "[u]se of tax havens by United States persons is large and apparently growing".[109] This conclusion was based on the evidence that between 1968 and 1978 the data showed an increase of almost fivefold in US direct investment in business formed in tax havens and about a two and a half fold increase in investment in non-tax haven businesses.[110]

The statistics produced by the Gordon Report in support of the above conclusion showed that in 1976, 17.6 percent of the total assets of US-owned CFCs were reported as belonging to CFCs incorporated in tax havens. The comparable percentage for 1972 was 16.4 percent; for 1968 it was 12.1 percent. Consequently, at least in this respect the report stated that multinational business use of havens had intensified by over 45 percent in eight years. In some industries, particularly in finance and insurance, CFC assets in the havens as a percent of similar assets in all areas were considerably larger.[111]

106. Aland, R., "The Treasury Report on Tax Havens – A Response", in 59 *Taxes* (December 1981), at 993, 1009-1010. The above comments reflect similar comments made by an officer of a major US corporation and the Chairman and Chief Executive Officer of the General Electric Company in a statement on 6 March 1978 before the House Ways and Means Committee.
107. Multinational Corporations: Hearings Before the Subcommittee on International Trade of the Senate Committee on Finance, 93rd Cong., 1st Sess. 12-13 (1973).
108. Gordon, R.A., *Tax Havens and Their Use by United States Taxpayers – An Overview*, a report to the Commissioner of Internal Revenue, the Assistant Attorney-General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy) (Washington, DC, Department of the Treasury, 12 January 1981), 32041 [hereinafter the Gordon Report].
109. Id. at 32.
110. Id.
111. Id. The tax haven areas covered by the report were the Bahamas, Bermuda, Costa Rica, Netherlands Antilles, other British West Indies (other than Cayman Islands), Panama, Bahrain, Hong Kong, Liberia, Liechtenstein, Luxembourg, Singapore and Switzerland. It is interesting to note that although Luxembourg, Singapore and Switzerland are characterized as tax havens in the Gordon Report, in the Regulations accompanying the Australian CFC legislation, they are characterized as "listed countries". However, Schedule 9 of the Regulations sets out the list of circumstances (i.e. concessions) in those countries which would effectively cause such countries to lose their "listed country" status with respect to such circumstances.

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Taking the analysis one step further, as was pointed out above, if accruals basis taxation creates the catalyst for collapsing foreign subsidiaries, then the domestic labour market could experience a downturn. This is because the source of foreign earnings which could have been repatriated to the domestic economy diminishes as a result of the liquidation of foreign subsidiaries. Moreover, it is unlikely that such collapsed offshore operations would be able to successfully set up domestically because it is unlikely that an investment in a similar domestic industry will generate the same return as that generated in the foreign country, given the high level of labour costs, resource and general start-up costs in Australia.

Consequently, it has been suggested that the risk of accruals basis taxation is that it may "misfire" or "over-kill", and substantially increase the bargaining power of unions. This is because, by taxing foreign investments at the same rate as domestic investment, the option of relocating domestic operations offshore is effectively lost. Therefore, managements lose their flexibility when negotiating with difficult union leaders or even government leaders.[112]

As revealed above, resolution of the above issues turns on the role foreign investment plays in the domestic economy. Proper assessment of the economic effects of foreign investment may also vary in accordance with the type of industry, the firm, the product or service under scrutiny. Thus, it cannot be said with any conviction that foreign investment by Australian companies will in fact assist Australia's domestic economy. By the same token, it is not possible to conclusively state that foreign investment will be discouraged by the operation of the accruals legislation or the FIF measures. This fact was acknowledged in the Consultative Document where it was stated that the reason why the economic analyses reach contrary conclusions is partly because they are based on differing assumptions about the effect of foreign investment on the level of direct investment in Australia.

(c) *Growth in world production*

It has been argued by some that, to the extent that accruals basis taxation creates fiscal barriers to transnational investment, then depending on the alternate domestic use to which such capital could be put, a loss in world production could result because there will be many instances where the investment and its attendant management and technology (commonly referred to as the "dynamic externalities of investment") cannot be employed as efficiently at home as abroad.[113]

The Treasurer in the Consultative Document was mindful of the likely possibility that accruals basis taxation will discourage foreign investment by Australians at Australia's cost. This is because there is a possibility that the total tax (foreign plus Australian) paid on foreign income under the accruals legislation is greater than that paid on similar domestic income. Notwithstanding such a potentially disastrous possibility, the Treasurer refused to extend the operation of the imputation system to the FTCS. Consequently, the current position is that no imputation credits will arise in respect of foreign taxes paid. It was felt that international equity and efficiency principles were best served by the FTCS coupled with the new accruals taxation regime and no imputation credits. The Federal Government, it appears, were not convinced that the additional benefits derived from foreign investments are sufficient to outweigh the loss in revenues by allowing shareholders the benefit of imputation credits in respect of foreign taxes paid.

> "Notwithstanding the economic arguments in favour of a deduction system, international norms have generally favoured a foreign tax credit system (or exemption system for income from comparable-tax jurisdictions) when profits are derived by a company from overseas sources. Australia has followed this practice with the result that Australian companies can choose between domestic and foreign investment opportunities on the basis of before-tax rates of return.
>
> This credit approach can be justified if foreign investment is seen as providing some additional benefits, e.g. by enabling Australian companies to obtain economies of scale or to further develop skills originally acquired in the Australian market. However, no evidence is available to suggest that such benefits are sufficiently great to warrant providing imputation credits for foreign tax paid. Thus, Australia, along with virtually all developed countries, follows the deduction system at the level of the individual shareholder."[114]

(d) *Balance of payments*

Reflecting the reservations of the Asprey Committee expressed in relation to the introduction in Australia of similar rules as Subpart F provisions, one commentator noted that as a net capital importer Australia could benefit from not having accruals rules. This is because the capital export bias created by the lack of accruals legislation could assist in redressing the inevitable long term drain on our balance of payments.

> "[T]ax deferral provides a significant capital export bias. Australia, as a net importer of capital, would have more probability of economic gain in the long term by encouraging its residents to undertake foreign investment. The capital export bias could assist in redressing the inevitable long term drain on our balance of payment."[115]

However, this argument suffers from the same flaws present with other arguments raised in support of the retention of the tax bias in favour of foreign-source income. That is, there are too many variables which have not been accounted for and which would need to be resolved before such an assertion may be proved one way or the other. One such variable is the interrelationship of foreign investment with domestic investment. Another is the repatriation policy of foreign subsidiaries.

It is not surprising to note that the debate over the economic impact of deferral of domestic tax has centred on the country introducing the accruals legislation (i.e. the capital exporting

112. Park *supra* note 67, at 1626-1627.
113. Id. at 1624-1628.
114. The Consultative Document *supra* note 33, at 33.
115. Cohen, G., "Controlled Foreign Corporations..." (Pt II), in *Taxation in Australia* (1985) Vol XIX, at 1034. Mr Cohen concluded:

> If one were to weigh up the likely benefits to Australia from the elimination of deferral against the costs of implementing and enforcing such a legislative scheme, one would conclude that there is no net benefit in the wholesale elimination of deferral. See also *Butterworths Weekly Tax Bulletin* Issue No. 41 (13 September 1990), at 647.

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country) and not on the host country that may also be affected by the introduction of such legislation (i.e. the capital importing country). In order to alleviate such an imbalance it is intended to examine the economic impact on the capital importing country arising from the introduction of tax measures aimed at eliminating deferral by the capital exporting country.

3. Effects of full current taxation on the host country

It is suggested that an accruals regime of taxation would reduce or eliminate the value of the incentives granted by the capital importing state to the domestic shareholder of the CFC (which is resident in the capital importing state). Such incentives (commonly referred to as "tax sparing") are normally offered by the host country with the intention of encouraging reinvestment of profits in the country of income origin. As indicated above, under the accruals regime the country where the shareholders reside will subject the domestic shareholders (who control the foreign corporation) to tax in respect of their proportionate share of the CFC's undistributed profits. The tax foregone by the country of origin is effectively collected by the capital exporting state.[116] Therefore, with or without tax incentives, the foreign enterprise will be taxed at the same rate, if not a greater one.

The preceding discussion raises some interesting questions with regard to the political economics of international taxation, public international law and the sovereignty of states. William Park claims that the United States has always claimed extra-territorial jurisdiction in non-tax matters and that it is unlikely, in the near future at least, that the interests of other states will be acknowledged by the United States as imposing limits on its taxing power.[117] The same author makes the added remark that the affront to sovereignty resulting from an extension of accruals basis taxation would be not unlike that resulting from foreign direct investment controls. The exercise of extra-territorial jurisdiction by the capital exporting state, Park claims, would thwart the host state policy for the economic growth of its corporate creatures.[118] As interesting as this aspect of accrual basis taxation may be, it is unfortunately beyond the scope of this paper.[119]

The other significant effect of an accruals regime of taxation on the capital importing state relates to the effect on direct foreign investment and national welfare. It is generally accepted that direct foreign investment creates an economic benefit for the host country. Among the benefits cited are mobilization of resources, more efficient production of goods and services, and in some cases, a better balance of payments position by reason of increased exports.

In terms of foreign investment in Australia, by way of either debt or equity, the evidence available clearly illustrates that three of our most important sources of investment funds have been the United States, United Kingdom and Japan. In the year to 30 June 1986 investment statistics[120] indicate that about 23 percent of total foreign investment came into Australia from the United States, 21 percent from the United Kingdom and about 15 percent from Japan. More recent data, appearing daily in the financial press, would confirm the emergence of a trend away from reliance on the traditional sources of investment from the United States and the United Kingdom and an increasing dependence on Japan.

Although the source of the foreign investment may have changed, the increase in total foreign investment has not. The total amount of foreign investment into Australia in 1981 was $ 47,343 million, and in 1986 it had increased to $ 138,599 million, i.e. an increase of almost 300 percent over the same period. The Australian accruals legislation should, it is submitted, not have any bearing on foreign investment into Australia, since such legislation is designed to affect capital exports as opposed to capital imports. In addition, it is suggested that business investment spending depends not only on the tax policy of the country, but also on exchange rate policy, government attitudes, labour unions, inflation, proximity to market and a host of other factors.[121]

A further comment on the effects of foreign investment on the host country is pertinent at this stage. In terms of the Australian experience, statistics show that foreign investment in the manufacturing industry over the period 1981-1986 increased by 45 percent whereas foreign investment in the mining industry over the same period increased by 56 percent. The increase over the same period in other industries was only 27 percent.

A country in the position of Australia, with its balance of payments problems, should be looking at encouraging the development of the manufacturing and even mineral processing industries, since it is through the increased activity in those industries that we may begin to reverse the vicious cycle of dependency on imported products, and even create exporting opportunities. To that extent the principles of neutrality may have to be compromised in order to achieve our ultimate goal, i.e. an improvement in the balance of payments situation. Therefore, it may be that the Australian Government will have to discriminate between industries by providing tax preferences (or tax holidays) for those who wish to invest in manufacturing and mineral processing industries. Such discriminatory practices have been installed successfully in various countries around the world (e.g. Singapore and Ireland).

However, there are two sides to the equation. The success or otherwise of a preference system, of the type described above, ultimately depends on the type of tax system which the capital exporting country has in place. It is suggested that the effect of an accruals legislation in the capital exporting country will have a great bearing on whether the Australian Government's decision to encourage investment in manufac-

116. It is not possible to determine exactly whether the tax foregone by the capital-importing state is collected by the capital-exporting state which has CFC-type legislation.
117. Park *supra* note 67, at 1649.
118. Id. at 1637.
119. For a fuller discussion of the sovereignty issue, see Park *supra* note 67, at 1633-1641; and Beveridge, F., "International Dimensions of Taxation", Hull University Law – Studies in Law 1991.
120. Source: Foreign Investment Australia 1985-86, Australian Bureau of Statistics, Canberra, Catalogue No. 5305.0 (Table 20, at 32).
121. See van Wyngen, G., "Impact of International Tax Changes on Australian Investments", 6 *Australian Tax Forum* (1989), at 89, 97.

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turing by providing a tax holiday for those who do invest in such industry, will succeed or not.

Putting the current state of international affairs in perspective, it is noted that out of the eight other OECD countries that have implemented accruals taxation, seven include a genuine business exemption in their rules. New Zealand is the only country without such an exemption. Therefore, this is good news for the Australian Government if they decide to introduce tax preferences or incentives to the manufacturing industry.

The preceding discussion illustrates that a country's interests as an exporter of capital conflict with its interests as an importer of capital, and therefore, to a certain extent, a country like Australia, which is a net capital importer (i.e. a policy taker) should take into account the policies of its trading partners, especially, those which are large capital exporters. The success or otherwise of Australia's international tax reforms depends largely on whether such reforms would cause other countries (especially the large capital exporting countries) to retaliate.

4. Other relevant considerations

The above discussion explored only the economic impact of accrual basis taxation on the movement of capital, from the point of view of the capital exporting nation, the sectoral groups and interest within that nation, as well as the capital importing nation. There was very little discussion of the political and constitutional aspects of accrual basis legislation;[122] the political issues[123] being concerned with the concept of "sovereignty", whereas the constitutional issues (which are closely linked with the political issues), being concerned with the question of "territoriality". The significance of such aspects springs from the fact that there are jurisdictional matters which limit the power of revenue authorities to tax the income derived by a foreign corporation. Basically, a sovereign state may only tax its own residents (or citizens in the case of the United States) who are shareholders of a foreign corporation, but *not* the foreign shareholders of the foreign corporation. The Australian Government recognizes that it has no tax jurisdiction over foreign subsidiaries of Australian companies. Accordingly, it has introduced measures to circumvent the threshold question of jurisdiction by introducing an accruals basis of taxation which taxes the domestic residents with interests in the foreign entities on their proportionate share of the entity's income.

One further problem which results from the growing use of accruals basis taxation is the potential for double taxation where the use of indirect ownership rules by countries that adopt accruals legislation could include the income of a particular foreign entity being subject to more than one country's legislation. At the time the accruals basis regime was being proposed for Australia in May 1988, a real solution to such a dilemma had not been propounded. It was merely suggested that if such a situation were to occur, primary taxation rights would need to be considered in order to prevent the multiple taxation of the income of a foreign entity.[124] It was not until December 1990 that a statutory solution to the problem was proposed in Taxation Laws Amendment Bill (No. 6) 1990 (which received Royal assent from the Governor General on 24 April 1991) in the form of Section 456A. That section provides relief from double taxation where amounts derived by a CFC have been taxed under the accruals system of another country.

D. *Conclusion*

Clearly, more work is needed to determine the role of foreign investment on the domestic economy and the effect accruals taxation would have on the international flow of capital. However, at this stage it appears that the international dimensions of the Australian Government's taxation policies are set at a level which promote national interests at the expense perhaps of international ones. This is evidenced by the fact that the Government has adopted a credit method without extending the operation of the imputation credits system to foreign taxes paid.

As far as the competition theory goes, this is still very much an open question. Proponents of this theory have claimed victory in the form of the active income exemption which was inserted into the accruals legislation after the Consultative Document was released. However, it is not clear whether the insertion of such an exemption amounts to the Australian Government backing down from its original proposal of not including such an exemption, as much as a concession that genuine business income does not undermine the integrity of Australia's source principle of taxation. In view of the New Zealand Government's refusal to include such an exemption in its CFC rules, and recent comments made by some prominent American commentators to the effect that Subpart F rules should be thoroughly overhauled in order to, inter alia, remove the deferral advantage that may be sought in relation to active income, the decision of the Australian Government would appear to be somewhat questionable.

The conclusion (if any) that may be drawn from the arguments discussed above in relation to the removal or retention of tax bias in favour of foreign investment income, is that there are still many unresolved issues. A major issue which has occupied the thoughts of many commentators is defining the exact relationship between foreign investment and the domestic economy. Defining this relationship, it is observed, rests on the implicit assumption of whether foreign investment is a substitute for or a supplement to domestic investment. This is a very complex question to which there is no clear answer.

However, in view of the above discussion it could not be said with any conviction that deferral of domestic taxes in all cases (not just anti-avoidance cases) is harmful to the national interest in the sense that the revenue authorities in all cases

122. For a full account of the political and constitutional impact of the accruals legislation, see Park *supra* note 67, at 1633-1641.
123. For a fuller discussion of the politics of taxing foreign source income, see Bird *supra* note 5, at 172-176.
124. Consultative Document *supra* note 33, at 25.

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would have been entitled to collect revenue where deferral of domestic tax is made possible by use of foreign subsidiaries. Hence, the suggestion that the term deferral is value laden. The mere fact that the economic evidence is inconclusive does not justify any tax preferences for foreign investment. Moreover, given that Australia is committed to a FTCS, then to that extent, it would make sense to have accruals basis taxation. Few people would dispute the fact that accruals basis taxation should be an integral part of the tax arsenal available to revenue authorities in a country which has substantial offshore investments, since it is one of the most powerful (if not the most powerful) arsenal available to revenue authorities in their pursuit of international profit shifting activities. The live issue which is destined to occupy a great deal of time in the future is the question of whether in light of the major amendments to the FTCS, an active business exemption (which is very difficult to comply with and administer) is warranted.

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NEW ZEALAND:

COMPREHENSIVE DIVIDEND IMPUTATION, NEUTRALITY AND DOUBLE TAXATION OF CORPORATE PROFITS

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I. INTRODUCTION

For nearly 30 years New Zealand companies were taxed on a "classical" basis. In an Economic Statement to Parliament on 20 August 1985,[1] the Minister of Finance, Sir Roger Douglas, announced that the Government had decided to introduce dividend imputation to mitigate the double taxation of corporate income arising under the "classical" approach. After considerable consultation, comprehensive dividend imputation was introduced from 1 April 1988.

The objective of this paper is to examine the imputation regime adopted in New Zealand, and to determine whether the regime is capable of achieving the stated objectives when first introduced.

Contents

I. Introduction
II. Rationales for Introducing Dividend Imputation
  A. Financial distress and agency costs from high debt levels
  B. Agency costs associated with non-corporate business vehicles
  C. Increased portfolio diversification costs to investors
III. The New Zealand Imputation System
  A. Historical background
  B. The New Zealand imputation regime
IV. Analysis of the New Zealand Imputation Model
  A. Criteria to assess imputation model
  B. Review of New Zealand imputation model
V. Dividend Imputation with Non-Resident Shareholders
VI. Options for Reform
VII. Conclusion

II. RATIONALES FOR INTRODUCING DIVIDEND IMPUTATION

The Government's statement of 20 August 1985 stated that the classical approach to company taxation gave rise to the double taxation of corporate earnings resulting in higher overall tax rates. This was held to be "unfair as it imposes excessive tax on individuals, especially those on low incomes".[2] Double taxation of corporate income made it more attractive for companies to retain earnings rather than distribute them, resulting in capital being locked into "less productive activities within existing companies".[3] This also gave rise to opportunities for takeover and asset-stripping by other companies resulting "in the accumulation of capital in fewer companies".[4] The classical approach was also held to encourage firms to expand by borrowing, giving rise to higher debt/equity ratios than would otherwise be desirable. It penalized "smaller, innovative companies which, under a more neutral tax system, would have better growth prospects".

By relieving the double taxation of corporate income the mobility of capital will be increased and thus "remove artificial incentives for takeovers". Other benefits cited were:

> It will remove the relative over-taxation of shareholders on low marginal rates of tax. This will promote a widespread ownership of corporate equity in the community. The introduction of full imputation will encourage more firms to seek equity rather than debt finance. Disadvantages faced by new ventures will be reduced, leading to higher investment and employment.[5]

In a subsequent discussion document[6] further problems of the classical approach were identified as follows:

A. *Financial distress and agency costs from high debt level*

The classical approach raises the cost of equity and thus favours the use of debt. As debt levels are raised extra bankruptcy and agency costs arise. Financially distressed companies may by-pass profitable investments because the benefits will accrue to debt rather than their equity holders. Agency costs may also increase from costs incurred in complying with covenants required by lenders, which are likely to become greater when debt levels arise which may constrain a company's operating and investment flexibility. As the cost of new equity is higher than the cost of

1. Douglas (1985).
2. Id. at 6442.
3. Id.
4. Id.
5. Id. at 6443.
6. New Zealand Government (1987).

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retained earnings, classical taxation imposes the greatest burden on rapidly growing companies which need to obtain new equity finance.

B. *Agency costs associated with non-corporate business vehicles*

The classical approach increases incentives for adopting other forms of business organizations such as partnerships, sole traderships and trusts. However, such business vehicles may suffer from increased agency costs associated with monitoring performance and contract compliance.

C. *Increased portfolio diversification costs to investors*

A diversified portfolio would include both debt and equity instruments. If an investor's marginal tax rate is below the corporate rate, diversification into equity securities will incur the cost of lower after-tax returns (adjusted for risk) on equity than would apply to returns from debt.

In the 1987 Consultative Document it was concluded that it was "impossible to measure the magnitude of the efficiency costs arising from tax-induced investment and financing decisions".[7] But it was believed the costs associated with the then corporate tax regime were "likely to be substantial".

Benge and Robinson (1986) also identified similar problems with the classical approach. They concluded "the tax system is likely to provide incentives for economically wasteful activities associated with minimizing taxes which result in a cost to the economy without compensating benefits".

III. THE NEW ZEALAND IMPUTATION SYSTEM

A. *Historical background*

Prior to 1958, dividends received by individual shareholders were exempt from tax, but were taken into account when determining the marginal rates applying to a taxpayer's other assessable income. Assessable non-dividend income was deemed to have been derived after exempt dividend income and was hence taxed at a taxpayer's highest marginal rates.

In 1958 New Zealand adopted the classical approach to corporate taxation and dividends became fully taxable in the hands of non-corporate shareholders. While an intercompany dividend exemption was retained, a number of anti-avoidance provisions were enacted to reduce opportunities to avoid the double taxation of corporate income. Excess retention tax was introduced which imposed additional tax on companies which distributed insufficient income as dividends to shareholders, and other provisions were enacted to tax certain debt securities with equity characteristics as equity securities. Deductions for interest paid on certain convertible debentures,[8] on debentures issued in substitution for equity shares,[9] and on debentures issued on which the rate of interest payable was made with reference to the profitability of the borrower (rather than to arm's length factors),[10] were disallowed in certain cases.[11] Despite opportunities for tax avoidance by substituting pure debt for equity finance under the classical approach there were no tax sanctions based on the debt/equity ratios of taxpayer companies.

The use of trusts in substitution for limited liability companies was addressed by taxing unit trusts as companies. In the 1960s some of these anti-avoidance measures were relaxed. The scope of the excess retention tax was reduced and a more liberal attitude was taken towards the use of convertible notes and other convertible securities.

On a practical level the classical approach had the greatest effect on widely-held companies. Closely-held companies with shareholders/employees could avoid the impact of double taxation by distributing their assessable income to director/shareholders in the form of salaries and directors' fees, which were deductible to the company. This method of "earnings stripping" was accepted by New Zealand revenue authorities subject to only limited legislative restraints.[12]

By the late 1970s widely-held companies had adopted new strategies to mitigate the taxation of distributed earnings. Under the dividend regime then in force, companies could selectively distribute non-assessable capital reserves in lieu of assessable dividends paid from retained profits. These non-assessable capital reserves arose from realized capital profits and share premiums.[13] Distributions from such sources in lieu of assessable dividends became widespread by the early 1980s.

The ability to make such non-assessable capital distributions gave rise to artificial incentives for companies to sell capital assets in order to realize capital gains and to issue shares with low par values and high share premiums.[14] This favoured companies in certain types of businesses, such as those with large real estate holdings and those involved with takeovers and corporate rationalization. In the early 1980s it was common to see new equity share issues being made with artificially low par values and a high share premium to create reserves for non-assessable distributions in later years.

A notable feature of these non-assessable capital distributions was the absence of any restrictions on dividend streaming. By streaming capital distributions to those shareholders who would benefit and paying dividends from revenue reserves for those who would not (e.g. tax-exempts, non-residents) the value of the capital reserves for non-assessable distributions was maximized. Companies were only limited

7. Id. at 27.
8. Income Tax Act (ITA) 1976, Sec. 196. Unless otherwise mentioned all references are to ITA 1976.
9. Sec. 195.
10. Sec. 192.
11. This denial of an interest deduction did not apply where the interest was set by a floating rate, if "the rate of interest payable is determined by a fixed relationship to economic, commodity, industrial or financial indices, or banking rates or general commercial rates". Sec. 192(3).
12. Mainly Sec. 190 which allows the Commissioner to disallow a deduction for excessive remuneration or director's fees paid to shareholders, directors or relatives of the shareholders or directors of "proprietary" companies..
13. Provided the share premiums were paid in cash.
14. Court approval was required to make distributions from the share premium account and the applicant company had to create an undistributable reserve (commonly called the capital maintenance reserve) from retained earnings equal to the amount of the share premium approved for distribution.

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in their capacity to make non-assessable capital distributions by their ability to generate capital profits and cash share premium reserves. It seems reasonable to conclude that these non-assessable capital distributions in lieu of dividends until 1985 helped to mitigate the excesses of double taxation of company earnings for widely-held companies.

As part of the Economic Statement of 20 August 1985 all distributions (whether from capital or revenue sources) were deemed assessable from 21 August 1985 except on winding up. The statement said this would apply "as a short-term measure, until the introduction of a full imputation system".[15] This suggested that non-assessable capital distributions would be permitted again when dividend imputation was introduced but, however, did not occur when imputation was introduced in 1988.[16]

Mainly as a response to the taxation of capital distributions in August 1985, many widely-held companies began to offer shareholders the option of receiving a bonus issue of shares instead of a cash dividend (termed a "bonus issue-in-lieu"). Under the law then applying, such bonus issues were non-assessable. With this option (essentially a selective bonus issue) shareholders could obtain cash by selling their bonus shares on the secondary market. Thus the bonus issue schemes were perhaps an application of the Modigliani and Miller argument that it would be better for companies not to pay taxable dividends but for shareholders to liquidate part of their investments realizing cash in the tax preferred form of a capital gain. Such bonus issues-in-lieu remained non-assessable until 1 April 1988 when a new definition of "dividend" was introduced as part of the dividend imputation legislation which deemed bonus issues in lieu of dividends as assessable income.

B. *The New Zealand imputation regime*

The 20 August 1985 statement was the first indication to taxpayers that the Government intended to address the problem of the double taxation of corporate earnings. In December 1987 a Consultative Document was released outlining proposals for the scheme of dividend imputation, followed by a Comprehensive Report in April 1988. After taking public submissions a final report was released in July 1988 with draft legislation, and later that year legislation was passed with retrospective effect back to 1 April 1988. It is important to note that the same Committee was contemporaneously working on international tax reforms[17] and thus reforms in this area along with the imputation regime can arguably be seen as part of an overall package. The same Committee as part of its report on international tax reform also "endorsed the Government's decision to give priority to the investigation of a capital gains tax".[18]

New Zealand has chosen to mitigate the double taxation of distributed corporate earnings by operating an imputation system, whereby companies paying dividends can attribute the income tax they have paid on their earnings to shareholders when dividends are paid. Thus the shareholders' assessable income comprises not only the cash dividend[19] but the imputation credits as well.[20] Such imputation credits are then credited against the shareholders' tax liability in a similar way as PAYE from salary or wage income.[21]

The ability to attach such credits to dividend payments is determined by the amount of income tax the company has paid on its income and is monitored by a memorandum account called the imputation credit account (ICA), which is required to be kept by all corporate taxpayers for tax purposes.[22] Payments of income tax by a company or the receipt of dividends by the company with imputation credits attached give rise to credits in the ICA, while debits are entered when dividends are paid with credits attached.[23] If a debit balance is obtained at the end of the financial year, income tax for the following financial year must be paid in advance to clear the debit balance.[24]

The amount of credits attached to a dividend is solely left to the discretion of the company. There is no obligation to attach imputation credits even if a credit balance exists in the ICA.[25] The imputation rate can be varied between zero percent up to the top marginal corporate tax rate.[26] If a taxpayer receives a dividend which has imputation credits attached at a higher rate than his/her marginal rate, the excess tax can be used to offset tax liabilities on other income. If there is still an excess of imputation credits left, these can be converted into a tax loss and carried forward to future years.

The New Zealand imputation regime is characterized by complex anti-streaming rules. The intention of the streaming rules is to prevent companies from directing dividends with credits attached to those who can use them while paying dividends without credits to those who cannot, such as tax-exempt shareholders (e.g. charities) and non-residents.[27] A cynic would conclude the New Zealand Parliament wished imputation credits to be "wasted" as much as possible on shareholders who cannot benefit from them. Thus there is an obligation to maintain a constant imputation ratio within an income year; otherwise a penalty debit applies to deem the imputation credits up to the highest rate used during the peri-

15. Douglas (1985), at 6443.
16. This statement plus proposals in Benge & Robinson (1986) suggested in the initial stages provision for non-assessable capital distributions would be preserved. Benge and Robinson at the time their study was published were Treasury officials.
17. Affecting offshore trusts; controlled foreign companies (CFCs) and foreign investment funds (FIFs).
18. Consultative Committee (April 1988), at 6.
19. Ignoring for the moment dividend PAYE.
20. Sec. 394ZC(1).
21. It must be noted that an imputation credit and a PAYE credit are not *exactly* the same as the former cannot be refunded in cash.
22. Sec. 394B;
23. Sec. 394C, D and E.
24. Sec. 394L.
25. This is the major difference between the Australian and New Zealand imputation regimes. Australian companies must frank dividends if they have credits in their imputation accounts.
26. Under Sec. 394G, the maximum imputation rate is determined by the following formula: $\frac{a}{(1-a)}$ where A is the corporate tax rate. If the top individual and corporate tax rates differ at some future time then the maximum imputation rate will be set by the corporate rate not the individual rate. Thus an individual shareholder could have some additional tax to pay, as is currently the case in Australia.
27. New Zealand imputation credits cannot be credited against New Zealand non-resident withholding tax on dividends paid to non-residents (as in Australia), nor can imputation credits be refunded in cash (as in the United Kingdom).

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od.[28] An exemption from this penalty can be obtained on application to the Commissioner provided he is certain that the variation is not part of a tax avoidance arrangement.[29] If the imputation rate varies more than 20 percent between years an explanation must be provided to the Commissioner.[30] In addition, there are provisions to prevent share sale and buy-back arrangements,[31] as well as shareholding continuity requirements where a credit balance exists in the ICA.[32]

A significant feature of the imputation regime is that any income tax paid outside New Zealand cannot give rise to credits in the ICA. This is at variance to the general principle of foreign tax credits for foreign income tax which would apply to the company's income tax assessment under Sections 293(2) and 304.

The OECD (1991)[33] categorizes the methods used by member countries to mitigate double taxation of corporate earnings:

Partial Relief Of Double Taxation				Total Elimination of Double Taxation	
Company Level		Shareholder Level		Corporate Level	Shareholder Level
Split Rate	Partial Dedn	Partial Imptn	Partial Relief	Zero Rate	Full Imputation
Germany*	Iceland*	France	Austria	Greece	Australia
	Spain	Ireland	Canada	Norway	Finland
	Sweden	UK	Denmark		Germany*
			Iceland*		Italy
			Japan		New Zealand
			Portugal		Turkey*
			Turkey*		

* These countries have company taxing regimes which incorporate more than one approach to relieve double taxation.

Thus it can be seen there is no international consensus on the most appropriate method to relieve double taxation of corporate earnings. A number of countries have adopted methods other than tax imputation such as dividend deductions, split corporate rate (depending on whether corporate income is distributed or not) and specific shareholder relief (such as rebates, exemptions). New Zealand's imputation system is classified as "totally eliminating" double taxation by the OECD. Unlike some other countries, New Zealand's corporate rate and top personal marginal rate are essentially the same although this is not recognized in the OECD's study.[34]

The OECD study also shows changes to the corporate tax regimes in OECD countries since 1962.[35] It is interesting to note that some OECD countries (Japan, Belgium, Austria) have moved recently in the opposite direction from relieving double taxation to classical models or partial relief models.

IV. ANALYSIS OF THE NEW ZEALAND IMPUTATION MODEL

A. *Criteria to assess imputation regime*

In both the 1985 Parliamentary Statement and the 1987 Consultative Document a large number of problems were attributed to the classical system of corporate taxation as discussed earlier in this paper. In the 1987 Consultative Document these deficiencies were attributed to two factors:

(1) the taxation of company income at the company rate rather than the shareholders' marginal rate;
(2) additional tax when corporate earnings were distributed.[36]

The OECD (1991) stated the double taxation of dividends accentuated three types of non-neutralities. These were a bias against companies towards other business vehicles, a bias against equity in favour of debt, and lastly a bias against companies using new equity to finance new investments.[37]

Benge & Robinson (1986) identified three basic criteria for the design of an imputation scheme. They were:

(1) Imputation credits should not be given on dividends paid out of income which has not borne domestic company tax.
(2) The benefit of tax preferences should be preserved under imputation. It would be inconsistent with the objective of full imputation to attempt to claw back tax preferences.
(3) When the after-tax income of a company is fully distributed, the total company and personal tax burden levied on it should be the same as that levied on unincorporated business income.[38]

In summary these criteria emphasize the taxation of income derived by companies at their shareholders' rather than the company's marginal rate and that there should be no additional tax impost on income derived through a company and distributed to shareholders when compared to unincorporated enterprises. In the following section the imputation regime adopted in New Zealand will be examined to see whether the regime adopted will meet the objectives sought, and secondly will address the problems identified with the classical approach.

B. *Review of New Zealand imputation model*

The first issue is whether a tax bias remains against companies towards other business vehicles after the introduction of dividend imputation. A theoretical model developed by Mervyn King and refined by the Ruding Committee[39] can be used to assess such regimes. The model is known as the

28. Sec. 394G(3).
29. Id.
30. Sec. 394J(2).
31. Sec. 394ZG(2).
32. Sec. 394E.
33. At 57.
34. Persons receiving state pensions may face a higher marginal rate. The harmonization of the corporate rate (33%) and the top individual rate (33%) was not initially intended as the corporate rate was first set at 28% in 1988 which was equivalent to the middle personal rate. The corporate rate was increased in 1989 from 28 to 33%.
35. At 164.
36. Id. at 4.
37. At 166.
38. At 104.
39. Committee of Independent Experts On Company Taxation (1992), at 381. The Committee refined the model to take into account split rate income tax systems.

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"attempted corporate integration of dividend taxation test" (ACID) which is as follows:

$$ACID = \frac{[1 - m^D]\,[1 - t^D] / [1 - c]}{[1 - m^E]}$$

where:

t^D = tax rate on corporate income if distributed to shareholders.
m^D = individual tax rate on dividends received by a shareholder.
c = gross-up factor of dividends due to dividend imputation provisions.
m^E = individual income tax rate on unincorporated business income.

Applying this to New Zealand a value of 1.0 is obtained indicating no bias against companies in favour of incorporated businesses. This figure compares favourably with other countries as shown in the following table for 1991 data:[40]

EEC Countries		Other Countries	
Belgium	0.61	Australia	1.00
Denmark	0.62	Austria	0.61
France	0.87	Canada	0.80
Germany	0.88	Japan	0.50
Greece	1.00	**New Zealand**	1.00
Ireland	0.90	Sweden	0.70
Italy	1.00	Switzerland	0.70
Luxembourg	0.61	USA	0.63
Netherlands	0.65		
Portugal	0.60		
Spain	0.65		
UK	0.88		

These results suggest that New Zealand has achieved a neutral system of corporate taxation which few other countries have matched. A limitation of the ACID test is that it only considers the tax and tax rates applying to distributions not the actual tax base. While New Zealand taxes business income on the same basis whether earned by company, trust, partnership or sole trader, some other jurisdictions do not and have different tax bases for different business vehicles.[41] Thus the relative neutrality of the New Zealand approach *vis-à-vis* other countries may be better than the results above suggest.

If assessable income is derived from a New Zealand source by a New Zealand company and is taxed accordingly, any subsequent distribution of that income with maximum imputation credits attached will not give rise to any additional tax impost when received by shareholders. Given that the imputation credit and the net dividend are grossed up in the hands of the shareholder and assessed at the taxpayer's marginal rate, then corporate income is effectively taxed at the recipient's marginal tax rate. Thus the taxation is equivalent[42] to the tax payable if the income was derived through other business vehicles. The following example has often been used to illustrate how dividend imputation effectively eliminates double taxation of corporate earnings. The results obtained are consistent with the ACID test ratio of 1.00.

In this example, pre-tax business income of $ 1,000 is derived through a company and distributed to shareholders in the first column and directly by an individual in the second column.

	Income Derived Via Company	Income Derived Directly
Income of NZ Co	$1,000	
less NZ Co Tax	330	
Net Income To Be Distributed	$ 670	
Income of NZ Owner	$ 670	$1,000
+ Imputation Credit	330	
Total Income	$1,000	$1,000
less Imputation credit NZ Tax	$ 330	330
Net Return To NZ Investor	$ 670	$ 670

If the marginal tax rate of the shareholder is in the mid-range (24 percent)[43] the following results are obtained:

	Income Derived Via Company	Income Derived Directly
Income of NZ Co	$1,000	
less NZ Co Tax	330	
Net Income To Be Distributed	$ 670	
Income of NZ Owner	$ 670	$1,000
+ Imputation Credit	330	
Total Income	$1,000	$1,000
less Imputation credit NZ Tax	$ 330 (90)	240
Loss of Low Income Rebate	40	40
Net Return To NZ Investor	$ 720	$ 720

The refund of $ 90 in the first column is dependent upon the taxpayer having other tax liabilities which the excess imputation credits can be offset against. However, business income will be taxed at the shareholder's marginal tax rate.

However, if certain assumptions are changed the neutrality of the New Zealand imputation regime is lost and the ACID ratio will fall below 1.00.[44] These conditions are:

(a) if foreign sourced business income is derived on which foreign income taxes have been paid;
(b) income is distributed which has not borne the full rate of New Zealand income tax.

Firstly, the ACID model assumes a closed-economy model where the income is earned and distributed to shareholders within one jurisdiction. As cross-border investment is common such an assumption is not representative of real world conditions.

Derivation of foreign source income on which foreign income taxes have been paid will place shareholders at a dis-

40. Id. at 177. The figures for Australia and New Zealand were determined by the author.
41. E.g. a capital gain may be taxable if derived by a company but not if derived by an individual.
42. If the shareholder's marginal rate is below the 33% level excess imputation credits can be used to offset other tax liabilities and if excesses still remain, converted into a tax loss.
43. This assumes their total assessable income is between NZ$ 9,500-$ 30,875. While the 24% rate applies from NZ$ 0-$ 30,875 due to a low-income earner tax rebate, a different result will occur if the taxpayer's assessable income is below $ 9,500. In this case income earned through a company and distributed will be liable for more tax than if it was earned directly.
44. The actual extent to which the ratio would fall below 1.00 depends on the specific circumstances of taxpayers.

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advantage if distributed compared to the position if the income had been derived through other vehicles. This is because while all taxpayers obtain a credit against their New Zealand income tax liability for foreign taxes paid[45] foreign taxes are not credited in the dividend imputation account. Similarly, if business income is earned by a New Zealand controlled foreign company (CFC) to which the branch equivalent regime applies,[46] the income will also be assessable to the New Zealand shareholder with a credit given in the same way. If foreign dividends paid to a New Zealand company are subject to withholding taxes in the source country no credits can be passed on to New Zealand shareholders for the withholding tax deducted from the foreign dividend.

The following example illustrates the effect of foreign tax credits:

Pre-tax net business income of $ 1,000 is earned by a foreign branch of a New Zealand taxpayer and $ 250 of foreign income tax is paid.

		Income Derived Via Company	Income Derived Directly
Income of NZ Co		$1,000	
less NZ Co Tax	$ 80		
less Foreign Tax Credit	250	330	
Net Income To Be Distributed		$ 670	
Income of NZ Owner		$ 670	$1,000
+ Imputation Credit		80	
Total Income		$ 750	$1,000
less New Zealand Tax	$ 168		$ 80
Imputation credit	80	248	
Foreign Tax Credit			250 330
Net Return To NZ Investor		$ 502	$ 670

It can be argued that the additional tax burden on shareholders could have been avoided if the New Zealand company had not distributed the earnings. However, the crux of the matter is that considerably more tax is required to be paid as a result of the derivation of foreign earnings through a company structure and despite the imputation provisions, double taxation remains.[47]

It is a deliberate policy decision not to give credit for any foreign taxes paid in the imputation credit account.[48] The reason for this is that by granting credits for foreign tax paid the New Zealand Government believes taxpayers will be indifferent as to what jurisdiction they pay tax in. By granting foreign credits it will result in the New Zealand Government sharing tax revenue with foreign governments which provides no revenue (benefit) to the New Zealand Treasury. Thus incentives are provided for companies to substitute the payment of New Zealand taxes for foreign taxes.[49]

Secondly, the ACID Test Model assumes that all income distributed has already borne the standard corporate tax rate. This assumption may not always be valid and thus again the dividend imputation regime will discriminate against corporate structures in favour of unincorporated entities. Distributions to shareholders may not have borne full income tax at the corporate level due to three main factors:

(1) the existence of tax preferences and timing provisions. These include incentives (forestry) and the loss carry-forward provisions;
(2) differences in the way income is defined for financial reporting and taxation purposes;
(3) derivation of non-assessable capital gains.

Most widely-held companies prepare accounts using accounting standards issued by the New Zealand Society of Accountants. Income determination using these accounting standards will normally produce higher income than is reported for income tax purposes. This is mainly due to differences in depreciation, inventory valuation methods and the reporting of non-assessable capital gains and unrealized gains and losses. While companies are required to use tax effect accounting under New Zealand Society of Accountants' standards,[50] this is only in respect of certain timing differences which are believed to be likely to reverse in a relatively short period of time.

A company's ability to declare dividends is governed by company law rather than tax law. Under company law, companies declare dividends out of earnings determined using financial accounting standards rather than tax accounting rules. Thus, dividends may be declared in a year where tax losses have been reported or the taxable income is less than the aggregate of dividends declared. As a result there will be insufficient credits in the company's ICA to attach imputation credits.[51] Therefore such dividends are subject to further tax in shareholders' hands.

In such cases assessable income is created upon distribution where it did not exist before and thus highlights the differential treatment between companies and unincorporated businesses. The current dividend definition in the ITA uses a transactional regime under which dividends arise when a distribution (or deemed distribution) takes place to a shareholder. There is no requirement for the company to identify which reserves were used to source the dividend payment unlike that for financial reporting and the source of the dividend payment may have little relevance to the assessability of the

45. Up to the level of NZ tax payable on a source-by-source basis.
46. Sec. 245A-P.
47. The differences between publicly and closely-held companies may in practice make a difference. A publicly-held company typically distributes only part of its earnings. Thus if it derives both New Zealand and foreign source income there may be sufficient imputation credits available due to New Zealand tax paid on New Zealand sourced income to attach maximum imputation credits to a partial distribution of earnings.
48. Originally in the *Consultative Document on Full Imputation* (New Zealand Government (1987)) it was proposed to allow a credit in the ICA for foreign dividend withholding tax but that was excluded in the *Full Imputation Report Of The Consultative Committee* (Consultative Committee (April 1988)), upon direction from the Government, at page 9, para. 1.5.4.
49. This policy is best described as "national revenue maximization" although often misleadingly and disarmingly called "national welfare maximization". The policy ignores the double taxation imposed on taxpayers in favour of increasing national tax revenues. See Bird (1987), at 9; Rigby (1991), at 415.
50. Under New Zealand Statement of Standard Accounting Practice No. 12.
51. A company could voluntarily attach imputation credits even if it had no income tax liability but unfortunately this would leave a debit balance in the company's imputation account which would have to be cleared by 31 March. The payment of tax to clear the debit balance would be an advance payment of tax for future income years. No interest would accrue on such tax prepayments.

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dividend.[52] In contrast, unincorporated businesses can distribute both capital and tax-paid income to their owners without incurring any additional tax impost.

The effects of this different treatment for companies and unincorporated entities can be shown by comparing how distributions of realized capital gains and share premiums[53] from companies are taxed in comparison to similar distributions to the owners of unincorporated entities. The following example assumes pre-tax business income of $ 800 and tax-preferred income (non-assessable capital gain) of $ 200 is derived and distributed:

		Income Derived Via Company	Income Derived Directly
Income of NZ Co		$ 800	
+ Capital Gain		200	
less NZ Co Tax		(264)	
Net Income To Be Distributed		$ 736	
Income of NZ Owner		736	$ 800
+ Imputation Credit		264	
+ Capital Gain			200
Total Income		$1,000	$1,000
less	New Zealand Tax	$ 66	$ 264
	Imputation Credit	264	330
Net Return To NZ Investor		$ 670	$ 736

The derivation of capital gains via a company has resulted in a greater tax burden than if such gains had been derived through an unincorporated entity and thus again the company is found to be disadvantaged *vis-à-vis* unincorporated entities.

The next issue is whether imputation has resulted in corporate income being taxed at the shareholders' marginal tax rates rather than at the corporate rate. This issue was given considerable prominence in the 1985 and 1987 discussion documents as well by Benge & Robinson (1986). This issue may be less important given that the top individual marginal tax rate is now relatively low (33 percent) and is the same as the corporate rate. The difference between the individual mid-point and the corporate rate is only 5 percent (33 to 28 percent).[54] The difference between marginal rates when imputation was introduced was higher at approximately 18 percent (being 48 percent to the mid-point on the individual scale of 30 percent).

The top individual rate of 33 percent applies from NZ$ 30,875 per annum, which is fairly low. Persons with lower incomes are unlikely to own large portfolios of equity shares (except possibly for retirees who would face a higher marginal rate anyway with pension tax surcharges) and the improved tax status is not likely to encourage equity ownership to any large degree except in one or two situations.[55] Also, persons controlling private companies have always had the opportunity to have their income taxed at individual marginal rates by paying directors' fees which were deductible against the company's income.

On examination this objective of taxing corporate income at a shareholder's marginal rate has been met in its strictest sense. If the income bears imputation credits in excess of the taxpayer's marginal tax rate the excess credits can be used to satisfy the taxpayer's tax liability in respect of other income. However, in certain cases dividend income is discriminated against and is taxed at a higher marginal rate than is other income for persons with total income under NZ$ 9,500. However, tax-exempts are not so well treated. While charities can wholly carry on business activities which are exempt from tax,[56] in many cases if they derive business income through corporate structures it will result in income being taxed at 33 percent rather than zero percent. There is no scope for tax-exempt entities to obtain refund of imputation credits.

The second and third criteria developed by the OECD are whether the imputation regime has overcome the bias towards debt over equity finance that arises with the double taxation of dividends, and whether neutrality between retained earnings and new equity has been maintained.

As to whether the bias in favour of debt over equity under the double taxation of corporate income has been reduced, the answer is not simple for the reason that debt and equity finance are not equivalent nor are their tax treatments. The answer partly depends on the importance placed on the taxation of dividends and its relevancy to determining the cost of capital. The literature is not conclusive on this issue and two main schools of thought have emerged – the "old" and "new" approaches.[57] Under both approaches it is generally accepted that taxes affect new equity raising and thus imputation will in that case improve neutrality (risk adjusted) between equity and debt finance. However, there is not the same agreement in respect of the tax effects on retained earnings.

Where imputation may improve neutrality is where capital is invested in the legal form of debt while in economic substance the investment bears the risks of equity. For example, an owner of a business may chose to invest capital by way of a shareholder loan rather than by issuing new shares.[58] In some circumstances a range of hybrid-type securities may be used where they are debt convertible into equity at a subsequent date. In these circumstances the double taxation of corporate earnings does give rise to substantial incentives for shareholders to provide capital in the form of a loan rather than equity, and to the extent that this bias is mitigated by imputation, neutrality between debt and equity finance is improved.

52. Companies should be careful to source assessable dividends from revenue sources rather than from capital sources. In certain cases (winding-ups, reductions of capital) companies can return capital reserves as non-assessable distributions and companies should attempt to preserve their capital reserves for those types of distribution.
53. In the case of companies this would be repayment of the par values of the shares and from the share premium account.
54. While the mid marginal tax rate is 24%, due to the abatement of a low income earner rebate the marginal rate is 28% for income between NZ$ 9,500-$ 30,875.
55. Possibly on equities with very high dividend yields which may be regarded as a substitute for debt investments. Several recent share floatations (e.g. Telecom Corporation of New Zealand) have been promoted to small investors on this basis.
56. Sec. 61(27).
57. See Zodrow (1991).
58. It is recognized that non-resident investors can save considerable amounts of income tax by thinly capitalizing foreign subsidiaries using substantial shareholder provided loans.

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An Australian study[59] as to whether the Australian tax system favoured debt concluded with the introduction of imputation that the bias in favour of debt had been reduced although it did comment that this depended on dividends being fully franked and investors were not tax-exempt or preferred. In the Australian context, where superannuation funds were exempt and more recently taxed lightly meant there remained some bias towards debt. The status of non-resident investors would detract from the neutrality between debt and equity finance.

The last of the three OECD criteria was whether there was neutrality between retained earnings and new equity being used to finance new investments. Again it depends on the view one adopts with respect to the taxation of dividends. The new view of dividend taxation advocates that taxes affect new equity raising rather than financing from retained earnings, while the traditional view advocates that both are affected by taxation. In the 1987 discussion document the new position appears to be accepted. Whatever approach is adopted, to the extent that taxes are reduced on dividend distributions the attractiveness of new equity raising will be improved.

In conclusion, only the first of the two deficiencies outlined by the Government has been corrected, i.e. corporate income (income which is assessable at the corporate level) is now taxed at the marginal rate of shareholders, although it must be recognized that additional tax burdens can still arise where non-assessable gains or capital sums are distributed which become assessable to shareholders. Under the OECD's three criteria, two have been met to a partial extent although the exact extent is not quantifiable. Of the three criteria proposed by Benge & Robinson (1986) only the first has been met. The New Zealand imputation regime does not give credits for taxes which have not been paid. Tax preferences cannot be passed on to shareholders and the tax burden of distributed corporate income is not equivalent to the tax payable on the same income earned in the unincorporated sector.

The reality of the current regime is that if companies minimize or avoid the payment of tax at the corporate level, the liability is in essence passed on to shareholders. While it ensures that income which is assessable to income tax at the corporate level does not bear additional tax upon distribution, it does result in additional tax burdens upon distributions which were funded from sources which did not otherwise give rise to assessable income. Proponents of the current regime would argue that this clawback is an advantage and counters the ability of large corporate taxpayers to avoid tax. This theme is developed in the 1987 Consultative Document which states:

> .... any statutory exemption places a great deal of pressure on the tax system by providing incentives to convert other forms of income into the exempt form. Thus, the exemption of tax-preferred dividends may increase the attractiveness of tax avoidance since income exempt from tax at the company level could pass through to shareholders tax-exempt.[60]

It is the author's view that this is a "political" excuse to justify a discriminatory regime. The explicit and implicit preferences mentioned in the 1987 Consultative Document are also available to unincorporated businesses. Clawing back tax preferences available to companies in this way is selective and discriminatory. In the New Zealand context it represents a politically soft option to tax capital gains in an indirect way to avoid enacting an unpopular broadly-based capital gains tax. It is a poor substitute for appropriate anti-avoidance provisions and merely penalizes organizations requiring to aggregate large amounts of capital through limited liability companies to carry on their businesses.

In essence under the imputation regime double taxation is only mitigated if the company has paid company tax and therefore is selective. If the company has tax losses or has enjoyed tax preferences there may not be sufficient ICA credits to extend to shareholders and thus the company's taxation is in effect passed on to shareholders if dividends are declared. In such cases the taxes paid by the shareholders cannot be retrospectively credited back to the company when the company incurs a tax liability in a subsequent year.[61] The importance of this tax "pass-on" phenomenon has not yet been recognized in the literature nor the principal/agency relationships flowing from this. Unfortunately some major publicly-owned companies seem unaware that taxes avoided at the corporate level are now passed on to their shareholders.

While dividend imputation relieves the double taxation of corporate income, it ensures that distributed corporate income is taxed at least once at either the company or shareholder stage. In this regard there was no intention to tax companies on a consistent basis as unincorporated businesses. It is clear the Government intended companies to bear higher tax burdens than unincorporated businesses and to place tax obstacles between companies and their shareholders. It is consistent with the stated objective of "widening the tax base" but not with the "level playing field" principle which has been used to justify many economic reforms in New Zealand. As far as tax policy goes, "level playing fields" are only used to justify increases in tax burdens.

V. DIVIDEND IMPUTATION WITH NON-RESIDENT SHAREHOLDERS

The analysis of the imputation regime in this paper has only considered New Zealand resident shareholders. It is now relevant to consider how imputation affects non-resident investors. The tax treatment of non-resident shareholders is a complex issue and has been widely examined in the literature.[62]

The issue for non-resident investors is how they are to be taxed on distributions from New Zealand companies. In the context of imputation this involves two matters:

59. Bureau Of Industry Economics (1990).
60. Id. at 9.
61. The company does have the choice of attaching imputation credits to dividends when it does not have the capacity to do so and make advance payments of income tax at the end of the imputation year which can be carried forward and offset against future income tax liabilities. Only non-resident shareholders and tax exempts would be worse off. Virtually no listed companies have adopted this practice.
62. E.g. Vann (1989), OECD (1991), Committee of Independent Experts (1992).

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(1) imposition of Non-Resident Withholding Tax (NRWT) on dividends with imputation credits attached; and/or
(2) foreign recognition of New Zealand imputation credits.

The treatment of cross-border dividend flows is probably one of the major problem areas in international tax and one where harmonization has least been achieved. While in many international tax matters the OECD has provided an important role (such as with the Model Double Taxation Agreement) there is little consensus about the mitigation of double taxation of corporate income and the tax treatments of cross-border dividend flows. There are few similarities between any of the corporate tax regimes in the EEC or OECD countries with extremes from purely classical systems (United States, the Netherlands) to full imputation models (Italy, Australia, New Zealand). The recent report of the Ruding Committee in 1992 clearly shows the difficulties in integrating corporate taxation among a group of countries which are already in principle committed to economic integration.[63]

Reform in the area is difficult to undertake unilaterally. Most countries are wary about giving unilateral tax relief to non-resident investors at the dividend level because the tax revenue lost may be clawed back in another state and may not provide the recipient with any advantage. For source countries such a concession is pointless.[64] Further, once unilateral relief has been provided there remains little leverage to obtain similar concessions from other countries.

Corporate taxing regimes often differentiate between cross-border dividend flows from portfolio and direct investments. New Zealand has avoided making such a distinction in its domestic law and double taxation agreements; however, many countries provide for intercompany dividend flows from direct investments to be taxed more leniently than portfolio ones. Source countries may reduce dividend withholding taxes and recipient countries may provide a "grossing-up" provision for intercorporate dividends from direct investments. Under the grossing up provision, dividends received by companies are "grossed-up" by the foreign tax paid in respect of the business income used to fund the dividend distribution. This represents the practice of taxing foreign subsidiaries' income on a deferred basis when income is remitted.

At the portfolio level, few countries have entered into arrangements which allow non-resident shareholders to receive advantage of dividend imputation credits. The United Kingdom and France are the main exceptions, and the UK arrangements are relatively generous given UK investors do not usually receive reciprocal treatment.

The New Zealand treatment of non-residents under the imputation system deliberately denies any benefits to non-resident investors.[65] In New Zealand imputation credits cannot be used to credit against dividend NRWT. This was done partly because such offset (as made in Australia) would not necessarily reduce the tax burden of non-resident investors because residence countries may claw back any tax savings through reduced foreign tax credits. The continued imposition of NRWT in New Zealand may have also been driven by revenue concerns and the knowledge that a review of the international tax regime as it applies to non-residents was still to be undertaken.

Under the current treatment the continued imposition of NRWT is more suitable for non-resident portfolio investors who receive foreign tax credits in their home countries. However, for direct investors (particularly corporate investors) imposition of NRWT is a significant impost which is unlikely to be creditable in their home countries even in those with gross-up provisions for intercompany dividends from direct investments.

Beyond the level of allowing domestic imputation credits to remove liability for NRWT, the more fundamental issue arises of whether foreign jurisdictions should allow foreign imputation credits to be creditable not only to portfolio shareholders (as is the case with UK Advance Corporation Tax) but to allow direct corporate investors to pass foreign imputation credits on to their domestic shareholders. Such cross-border treatment of imputation credits would require specific bilateral arrangements which are not common.

The absence of comprehensive cross-border imputation provisions is likely to be due to a number of factors. These include the wide variations in approaches to the taxation of foreign sourced income and corporate tax regimes. Revenue is likely to be foregone which is a critical factor. Non-discrimination undertakings in many double taxation agreements restrict the scope of countries to enter into bilateral imputation agreements. It becomes difficult to target concessional tax treatment to taxpayers from certain countries without extending it to other treaty countries. In particular the US record on demanding that their investors receive the advantage of foreign imputation systems while maintaining a classical system of corporate taxation themselves is a major impediment in this regard.

The extent to which a country can use unilateral enactments to improve the international interface of their corporate tax regime is best shown by recent changes in the Singaporean corporate tax regime. Until 1991 the Singaporean imputation regime required dividends paid from Singaporean companies to have full imputation credits attached in similar manner to the UK Advance Corporation Tax. Foreign tax credits, capital gains and non-remitted foreign income (which is exempt) was claw backed under the imputation system. However, from January 1991 dividends paid by a Singaporean company will be exempt from tax where they have been paid out of foreign income for which there was insufficient Singaporean tax paid to allow full imputation crediting. These changes are designed to enhance Singapore's position as a centre for regional headquarters and holding companies. The Hong

63. Major cross-border tax problems also arise with investment between Australia and New Zealand. See Shewan (1990).
64. For example, Australia does not impose Non-Resident Withholding Tax on dividends bearing imputation credits. This provides no advantage to New Zealand individual portfolio investors because the Australian tax saved (15% NRWT) requires payment of extra tax in New Zealand of the same amount.
65. To the extent that source countries can unilaterally determine the overall tax regime applying to non-residents. The tax regime applying to non-residents is also determined by their home country although if foreign-sourced income is exempted then in effect their tax liability on that income will be determined by the source country.

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Kong corporate tax regime is also attractive for holding company structures given that the Hong Kong tax system is essentially sourced based.

A number of theoretical studies on imputation in the context of an open economy suggest for widely-held companies dividend imputation may not achieve the objectives sought. An Australian study by Officer (1987) suggests in the context of an imputation regime which benefits only resident taxpayers and with the Australian economy open to world capital markets that imputation will encourage companies to increase their dividend payouts and increase their equity sourced finance, with an increased number of dividend re-investment schemes, rights issues and equity placements. However, because imputation does not give rise to benefits for tax-exempts and non-residents a "client effect" will develop whereby either imputation benefits will be arbitraged or streamed, or that there will be an rearrangement of portfolios by different classes of investors. Officer concludes imputation will bring little benefit to companies. Later Officer (1988) notes that imputation benefits can be traded by non-residents and tax-exempts[66] so that the tax effect will be reflected into share prices.

Bowan, Cliffe and Navissi (1992) completed a theoretical analysis of dividend imputation in the New Zealand context. Under the New Zealand scheme it is difficult for non-residents to benefit from imputation credits attached to dividends received. They conclude if New Zealand share prices are determined by New Zealand investors, imputation will cause equity prices to rise decreasing returns to non-residents. If equity prices are set by non-resident investors prices will not change due to imputation but increase returns to domestic investors leading to a fall in domestically priced non-equity investments which will attract investments from non-resident investors.

Boadway and Bruce (1992) undertake a theoretical study into imputation in an open economy to examine how the arguments used in support of imputation stand up in a small open economy where domestic capital markets are fully exposed. They conclude while dividend imputation is the best way of overcoming the double taxation of corporate income in a closed economy it is not achieved due to the international tax provisions which result in the company tax acting as a de facto source tax.

In summary little has been done to improve the cross-border interface of corporate income flows. These initial theoretical studies suggest that imputation will not provide significant benefits to equity issuers until reforms are made in the international context.

VI. OPTIONS FOR REFORM

It would not be difficult to design a corporate tax regime which would overcome the weaknesses of the current imputation regime highlighted in the earlier analysis. Benge & Robinson (1986) in their study on imputation proposed a regime (called the "Qualifying Dividend Approach" (QDA)) which would overcome many of these deficiencies. Secondly, in 1992 the New Zealand Government enacted the Qualifying Companies (QC) regime for closely-held companies which is very similar to the Benge & Robinson QDA model.

The Benge & Robinson QDA model is designed to meet three basic criteria. These criteria are that imputation credits will not be given on income which has not borne domestic company tax, tax preferences be preserved and the total tax burden on the income of a company when distributed should be equal to that levied on unincorporated businesses.[67]

The QDA works by firstly allowing companies to pay dividends with imputation credits attached at the maximum imputation rate only partial imputation would not be permitted. Any dividends paid in excess of those dividends with full imputation credits would be exempt from tax in the shareholders' hands. Benge & Robinson state that dividend streaming rules would be required so that the ratio of imputed dividends to exempt dividends would be equal across all shareholders. However, they do not require that all dividends be firstly paid with imputation credits attached. They say "so long as the imputation rate equals or exceeds the top personal tax rate, it is not necessary to determine the amount available for tax-free distribution or the order in which taxable and non-taxable dividends must be paid. Shareholders would always prefer qualifying (taxable) dividends and there would be no incentive to distribute non-taxable dividends until the QDA was exhausted".[68] As this is not the case and opportunities for dividend streaming exist, an ordering rule is necessary as has been incorporated in the QC regime.

The QC regime was introduced from 1 April 1992 to improve the taxing regime applying to closely-held companies recognizing that they are in close substitution for partnerships and should be taxed accordingly. It also was the recognition that closely-held companies could more easily overcome some of the restrictions of the imputation regime by regular winding-ups or through income stripping. The regime is very close to Benge & Robinson's QDA approach except that the dividend streaming rules are more stringent which is appropriate given that Benge & Robinson's earlier assumption does not hold.

As with the Benge & Robinson QDA model, only two types of dividend can be paid by qualifying companies.[69] These will either be assessable to shareholders with full imputation credits attached or exempt ones with no imputation credits. There is a requirement to pay imputed dividends where there is capacity to do so ahead of exempt ones. The effect of this segregation is that capital gains, returns of capital and share premium can be returned to shareholders in most cases as exempt dividends. It substantially removes the disadvantage associated with the company vehicle and places it on a similar footing as other business vehicles.[70] There is a restriction

66. Initially permitted in Australia but not New Zealand.
67. Benge & Robinson (1986), at 104.
68. Id. at 94-5.
69. For a detailed discussion of the Qualifying Companies Regime see K. Holmes; "Taxation of Closely Held Companies: The New Zealand Model", 46 *Bulletin For International Fiscal Documentation* (October 1992), at 506-513.
70. The QC regime also has provision for company losses to be directly attributed to the owners of the business in certain cases. Company loss attribution to shareholders is a difficult issue for widely-held companies and is not considered in this article. Certain types of partnerships (ordinary) and sole tradership can offset losses directly while trusts and special partnerships cannot.

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on the amount of foreign sourced income a QC may earn and thus the benefits of foreign tax credits will be preserved in the hands of shareholders only on a limited amount of foreign income. The exact rationale for this restriction is not clear.

Returning to the earlier example where net business income of $ 1,000 is earned by a branch of a New Zealand taxpayer off-shore and $ 250 of foreign income tax is paid under the Benge & Robinson approach and the QC regime the following results are obtained:

	Income Derived Via Company		Income Derived Directly
Income of NZ Co		$1,000	
less NZ Co Tax	$ 80		
less Foreign Tax Credit	250	330	
Net Income To Be Distributed		$ 670	
Income of NZ Owner *		162	$1,000
+ Imputation Credit		80	
+ Exempt Dividend **		508	
Total Income		$ 750	$1,000
less New Zealand Tax***	$ 0		$ 80
Imputation credit	80	80	
Foreign Tax Credit			250 330
Net Return To NZ Investor		$ 670	$ 670

* ($80/0.33) – $80 = $162
** $670 – $162 = $508
*** Assessable Income $242 ($162 + $80) x 33% = $80 less I/C $80 = $0

The next example considers the case where pre-tax business income is $ 800 and tax preferred income (non-assessable) capital gain of $ 200 is derived:

	Income Derived Via Company		Income Derived Directly
Income of NZ Co		$ 800	
+ Capital Gain		200	
less NZ Co Tax		(264)	
Net Income To Be Distributed		$ 736	
Income of NZ Owner *		536	$ 800
+ Imputation Credit		264	
+ Exempt Dividend **		200	
+ Capital Gain			200
Total Income		$1,000	$1,000
less New Zealand Tax***	$ 0		$ 264
Imputation Credit	264	264	
Net Return To NZ Investor		$ 736	$ 736

* ($264/0.33) – $264 = $536
** $736 – $536 = $200
*** Assessable Income $800 ($536 + $264) x 33% = $264 less I/C $264 = $0

Both approaches put companies on a similar taxing basis to the unincorporated sector and thus mitigate the double taxation of business income.

In the context of non-resident investors the above regimes would from a source country perspective reduce the incidence of double taxation of corporate earnings. Ultimately it would depend on the tax regime of the recipient country.

VII. CONCLUSION

At the time dividend imputation was proposed a number of benefits were claimed from the introduction of such a regime. This paper set out to examine the imputation model adopted in New Zealand, whether it is capable of achieving the objectives outlined and overcoming the deficiencies identified with the classical approach.

It is clear that some of the objectives have been met. The regime does allow corporate income to be taxed at a shareholder's marginal tax rate in most cases. It further ensures that income earned by a company is subject to *New Zealand income tax* only once. While the importance of dividend taxation to the cost of equity is subject to considerable debate in the literature it is certain that a reduction of dividend taxes will assist in reducing the cost of equity capital *vis-à-vis* debt. Tests such as the "ACID" test also support a conclusion that the New Zealand imputation regime is comprehensive.

Despite these findings, there are substantial shortcomings in the current imputation regime. The inability to grant imputation credits in respect of foreign taxes paid and limitations on the non-assessable distributions of capital results in a greater tax burden being imposed on distributed income from companies than would have been imposed had the income been derived via non-corporate entities.

It is unrealistic to conclude the failings of the current imputation regime identified in this paper were unintended. The publication of a book through the Victoria University Institute of Policy Studies by Benge & Robinson[71] in 1986 contained a comprehensive analysis of imputation options and identified how the deficiencies highlighted in this paper could be addressed. Thus policy-makers must have consciously decided to digress from the model advocated by Benge and Robinson.

The current imputation regime can be explained in two ways. Firstly, the introduction of imputation would reduce tax revenues and thus this loss would have to be minimized. Secondly, the imputation regime was designed to be part of other tax reform objectives such as denying foreign tax credits to New Zealand residents and extending the tax base – such as to capital gains.

The first explanation must have some validity. Imputation was first mentioned in a Parliamentary statement restricting the ability of companies to make non-assessable distributions to shareholders from capital sources. It is likely that the two were tied together for political reasons to justify an unpopular change in the tax laws and to mitigate the negative political impact of that change. There was considerable delay in enacting imputation after the first announcement in August 1985 and it did not take effect until 1 April 1988 which is consistent with the revenue cost theory. Australia by way of contrast announced its decision to adopt imputation after New Zealand in 1986 but introduced it in 1987 a much shorter period. There has also been considerable delay in reviewing the tax regime as it affects non-resident investors.

There exists other evidence in support of the revenue theory. The imputation regime contains extremely complex stream-

71. The authors at the time of publication were New Zealand Treasury officials and are likely to have been involved with many of the recommendations to Government on imputation.

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ing rules which in essence are designed to make companies "waste" imputation credits on shareholders who cannot use them. Despite the major emphasis placed on the benefits of taxing of corporate income at shareholders' individual marginal tax rates in a number of official documents on imputation, the Government was not prepared to extend this to tax-exempts – a deliberate inconsistency. The continued imposition of NRWT on dividends with full imputation credits attached is another factor particularly when contrasted with the Australian provisions. A large number of adverse changes to the streaming rules in the 1991 Budget is also consistent with the revenue theory.

The second explanation is also valid. The imputation proposals were developed contemporaneously by the same Committee who were developing the international tax regime. There were also expectations in 1988 that future tax reforms would include a capital gains tax and the Committee working on the imputation proposals had also recommended in another report for the government to introduce such a tax.

Therefore policy-makers had an excellent opportunity to design the imputation regime to support other tax reform objectives particularly the "broadening the tax base" and to provide foundations for future reforms such as a capital gains tax.[72] Secondly, under the imputation regime credits for foreign income taxes granted to corporate taxpayers are clawed back resulting in foreign tax credits being a tax deferral rather than a credit. Once corporate earnings are distributed the foreign tax credit is turned into a deduction which is consistent with the national revenue maximization policies mentioned in more recent announcements.[73] Given existing undertakings for New Zealand to give foreign tax credits in current double taxation agreements the imputation scheme is a permissible way of unilaterally revoking foreign tax credits for corporate taxpayers.

The wisdom of such international tax policies are questionable but are beyond the scope of this paper. It is sufficient to say that the imputation regime has important implications for the treatment of foreign taxes and to make foreign investment less attractive for New Zealand investors.

The current imputation regime also claws back tax preferences and taxes capital gains as ordinary income if distributed to shareholders. A statement in the 1987 document (at page 9) supports this analysis:

> It is the Government's long-term objective to continue to broaden the tax base and reduce the importance of tax preferences. In the light of the above considerations, all dividends will be assessable...

The imputation scheme is less effective at enforcing a capital gains tax because the gains are still not taxed when earned but only if distributed. Primarily it prevents distribution of capital gains in substitution for dividends. A recent change in 1992 to the dividend definition allows repayments of certain capital reserves to be non-assessable to shareholders upon redemption or cancellation of shares[74] but these must still not be in substitution for dividends.

Despite the introduction of imputation, the corporate tax regime still imposes a greater tax burden on businesses operated as corporations than on businesses operated as partnerships, trusts or sole traderships. The regime is sustainable because a widely-held limited liability company is the only way large amounts of capital can be aggregated from a large number of investors to fund a large enterprise. Therefore sole traderships and partnerships cannot be substituted for companies in such cases as these are only suitable for smaller owner/operator businesses. A unit trust structure can be substituted for a company but since 1960 unit trusts have been taxed as companies so no tax advantage results. This analysis is also supported by the recent introduction of the "qualifying companies" regime for closely-held companies which recognized that the restrictive aspects of the company tax regime could be overcome by small businesses not incorporating or undertaking winding-ups to distribute capital gains tax-free. Under the QC regime only closely-held companies are eligible to use the QC regime.

While the New Zealand imputation regime has overcome some of the deficiencies of the classical approach, a number of difficulties remain. The analysis in this paper shows that other objectives were sought when the imputation regime was designed, none of which were intended to mitigate the double taxation of corporate income. Many of the wider benefits sought from dividend imputation are not likely to be realized until further changes are made to the regime, a greater international consensus emerges as to the taxation of corporate earnings and more appropriate cross-border imputation provisions are in place. Ultimately this may lie with the United States adopting some approach to mitigate the double taxation of corporate earnings.

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73. New Zealand Government (1991).
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UNITED STATES:

REVENUE RECONCILIATION ACT OF 1993

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I. INTRODUCTION

Congress has enacted the Revenue Reconciliation Act of 1993. The Act was agreed to by a joint House-Senate Conference Committee and passed by both houses of Congress in early August. It was signed into law by President Clinton on 10 August. The Act is the first major tax legislation to be enacted by the United States since 1990, and represents the most significant change in the US tax laws since the Tax Reform Act of 1986.

The major change made by the Act is the substantial increase in the tax rates applicable to individuals, estates and trusts, most of which are retroactive to 1 January 1993. The Act also broadens the tax base for corporations and businesses, and includes a number of provisions that will affect multinational groups. The impact on multinationals will be felt primarily on US-inbound transactions, but a number of the provisions will affect US-outbound transactions as well.

II. INDIVIDUALS, ESTATES AND TRUSTS

A. *Income tax rates*

The Act increases the top income tax rate from 31 to 36 percent and imposes a new 10 percent surtax on higher income individuals, estates and trusts. Although denominated as a surtax, the Act contains no expiration date for the 10 percent tax and it will thus function for practical purposes to create a top marginal rate of 39.6 percent. The thresholds for the 36 percent rate and the 10 percent surtax are as follows:

Type of return	*36% tax rate*	*10% surtax*
Single taxpayers	$ 115,000	$ 250,000
Married taxpayers filing jointly	$ 140,000	$ 250,000
Married taxpayers filing separately	$ 70,000	$ 125,000
Estates and trusts	$ 5,500	$ 7,500

The new rates are effective retroactive to 1 January 1993. Under the Act, however, the thresholds for the 36 percent rate and the 10 percent surtax will not be adjusted for changes in the US consumer price index (CPI) until the 1995 tax year. Individual taxpayers, but not estates and trusts, may elect to pay any increases in their 1993 taxes caused by the new rates in three annual instalments.

In order to backstop the higher individual rates, the Act increases the accumulated earnings tax (AET) and personal holding company (PHC) tax imposed on corporations from 28 to 39.6 percent. The AET prevents taxpayers from retaining earnings in corporate entities rather than distributing such earnings as dividends. The PHC tax performs a similar function with respect to passive income and income from personal services.

The Act also modifies the estimated tax rules for individuals, estates and trusts that have adjusted gross income (AGI) in excess of $ 150,000 for a taxable year. These taxpayers will be required to make quarterly payments in the succeeding year equal

Contents

I. Introduction

II. Individuals, Estates and Trusts
A. Income tax rates
B. Social security benefits
C. Exemptions and deductions
D. Capital gains provisions
E. Alternative minimum tax
F. Social security taxes
G. Estate and gift taxes

III. Corporate and Business Taxpayers
A. Corporate income tax rates
B. Business deductions and credits
C. Investment tax credit proposal
D. Small business expensing
E. Amortization of business intangibles

IV. Investment Provisions
A. Capital gains exclusion
B. Capital gains rollover
C. Capital gains conversion transactions
D. Stripped preferred stock transactions
E. Market discount obligations
F. Mark-to-market for securities dealers

V. International Businesses
A. Transfer pricing initiative
B. Controlled foreign corporations
C. Earnings stripping provisions
D. Multiparty financing arrangements
E. Portfolio interest exemption
F. Foreign tax credit baskets
G. Possessions tax credit
H. R & D source rules

VI. Energy Taxes

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to at least 110 percent of the prior year's tax liability or 90 percent of the current year's tax liability. This modification will take effect for taxable years beginning after 31 December 1993. Taxpayers with AGI of less than $ 150,000 in a tax year can continue to base their succeeding year estimated tax payments on either 100 percent of the prior year's liability or 90 percent of the current year's liability. The Act repeals the special rule that applies to taxpayers who have AGI above $ 75,000 and a net annual AGI increase of $ 40,000 or more.

B. *Social security benefits*

The Act increases the portion of social security benefits that can be subject to income tax. The House proposed an across-the-board increase from 50 to 85 percent, but the Conference Committee agreed to a two-tier structure that increases the inclusion rate to 85 percent only for taxpayers who have provisional income above new thresholds of $ 44,000 for married taxpayers filing a joint return and $ 34,000 for single taxpayers. The provisional income on which the inclusion rate is determined is a modified form of AGI that includes tax-exempt interest, certain foreign-source income and one-half of the social security benefits. The Act retains the 50 percent inclusion rate for taxpayers with provisional income below the new thresholds but above the current thresholds ($ 32,000 for married taxpayers filing a joint return and $ 25,000 for single taxpayers). The two-tier structure is effective for taxable years beginning after 31 December 1993.

C. *Exemptions and deductions*

Upper income individuals are required under current law to phase out the benefit derived from claiming personal exemptions. For 1993 each personal exemption equates to a deduction of $ 2300, and this is phased out by 2 percent for each $ 2500 (or portion thereof) by which AGI exceeds a threshold amount. In addition, upper income individuals are required to reduce certain itemized deductions by 3 percent of the amount by which their AGI exceeds a specified threshold. These provisions were due to expire after 1995 and 1996, respectively, but have been made permanent by the Act. It is estimated that the phase-outs can cause the highest marginal tax rate for upper income taxpayers to exceed 41 percent. The exact percentage depends on individual circumstances.

The Act also places new limitations on the deduction for moving expenses incurred by employees and self-employed individuals in connection with the commencement of work. The deduction will no longer be allowed for meal expenses during the move, for the cost of temporary lodging or house-hunting trips, or for the costs of selling an old residence or purchasing the new one (or for the costs of terminating leases or acquiring a new lease). The minimum mileage threshold for the move is increased from 35 miles to 50 miles. The changes in the moving expense deduction apply to expenses incurred after 31 December 1993.

D. *Capital gains provisions*

The maximum tax rate on long-term capital gains (gains from the sale or exchange of capital assets held for longer than one year) realized by individuals, estates and trusts is not changed by the Act. It thus remains at 28 percent. However, because of the increased differential between the capital gains rate and the higher personal income tax rates, i.e. 28 percent versus 36 or 39.6 percent, the Act adds a number of provisions that are designed to prevent the conversion of ordinary income into capital gains. These are discussed in Part IV below.

In addition, because of the favourable capital gains rate, the Act adds a special rule regarding the treatment of net capital gains (i.e. the excess of net long-term capital gains over net short-term capital losses) under the investment interest rule. This rule limits the deduction of investment interest to the amount of the taxpayer's net investment income for the taxable year. Any excess interest can be carried forward to the next taxable year. Under the special rule added by the Act, net capital gains on investment property are not treated as investment income effective for taxable years commencing after 31 December 1992. Such gains thus cannot increase the amount of the taxpayer's investment interest limitation. This is to prevent low-taxed capital gains from absorbing otherwise disallowed interest expenses. The taxpayer may, however, include net capital gains in investment income if he elects to have such gains taxed at ordinary income rates.

E. *Alternative minimum tax*

The Act increases the alternative minimum tax (AMT) rate applicable to individuals, estates and trusts, and changes the AMT from a flat-rate tax to a two-tier graduated tax. The new AMT rates are 26 percent for alternative minimum taxable income (AMTI) up to $ 175,000 above the exemption amount and 28 percent for AMTI more than $ 175,000 above the exemption amount. The exemption amounts are increased by the Act to $ 45,000 for married taxpayers filing joint returns, $ 33,750 for single taxpayers and $ 22,500 for estates and trusts. The exemption amount for married persons filing separate returns, such as non-resident individuals who are not entitled to file a joint return with their non-resident spouses, is also $ 22,500. The changes in the AMT are effective retroactively to 1 January 1993.

F. *Social security taxes*

The US social security taxes (FICA) paid by employers and employees consist of two separate taxes: a 6.2 percent old age, survivor and disability insurance tax (OASDI), and a 1.45 percent Medicare hospital insurance tax (HI). Both OASDI and HI are currently subject to a wage ceiling above which they do not apply. The Act eliminates the $ 135,000 ceiling for the HI tax, thus imposing the tax on the full amount of salary and wages received. The $ 57,600 ceiling for OASDI is not changed. The HI ceiling will be removed effective for salary and wages received after 31 December 1993.

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G. *Estate and gift taxes*

The Act reinstates the maximum estate and gift tax rate at 55 percent. This repeals the reduction of the maximum rate to 50 percent that took place on 31 December 1992. The reinstated rates are 53 percent for transfers over $ 2.5 million and up to $ 3 million, and 55 percent for transfers over $ 3 million. The tax benefit of the lower graduated rates and the unified credit are phased out at a 5 percent rate for transfers above $ 10 million, with the phase-out completed at $ 21,040,000. The maximum rate on generation skipping transfers is also reinstated at 55 percent. The increased rates apply retroactively to estates of decedents dying after 31 December 1992, and to gifts and generation skipping transfers made after such date.

III. CORPORATE AND BUSINESS TAXPAYERS

A. *Corporate income tax rates*

The Act increases the maximum rate of corporate income tax from 34 to 35 percent for corporations with taxable income in excess of $ 10 million. An additional 3 percent tax is imposed on income in excess of $ 15 million in order to recapture the tax benefit of the 34 percent rate on taxable income below $ 10 million. The 35 percent rate is effective as of 1 January 1993. Corporations whose tax year straddles this date will be required to use blended rates to take into account the portions of the tax year that fall before and after 1 January.

The Act also modifies the estimated tax payment rules for large corporations, i.e. those corporations with taxable income in any of the three preceding years in excess of $ 1 million computed without regard to net operating loss carryovers and capital loss carry-backs. Large corporations are required by the Act to make quarterly estimated payments equal to 100 percent of the current year's tax liability in order to avoid underpayment penalties. Such payments could formerly be based on 97 percent of the current year's liability. The Act also modifies the annualization method used to determine the current year's tax liability. Corporations other than large corporations may continue to make estimated tax payments based on either 90 percent of the current year's liability or 100 percent of the prior year's liability. The corporate estimated tax changes are effective for taxable years beginning after 31 December 1993.

B. *Business deductions and credits*

The Act makes a number of changes in the deductions available to corporations and businesses, including the following:

- the deduction for business meals and entertainment expenses is reduced from 80 to 50 percent;
- the deduction for salaries of the chief executive and the next four highest compensated officers of publicly-held companies is limited annually to $ 1,000,000 each. Exceptions are permitted for commission income and certain performance-based payments. In general, publicly-held companies are defined as those whose equity shares are registered under the Securities Exchange Act;
- the deduction for club dues, including dues for airline and hotel clubs, is eliminated;
- the deduction for lobbying expenses is eliminated.

The last two of the foregoing are effective for expenses incurred after 31 December 1993; the first two are effective for taxable years beginning after such date. Payments pursuant to written compensation agreements that were in effect on 17 February 1993 and all times thereafter, are grandfathered from the $ 1,000,000 salary limitation.

The Act also extends the tax credit for businesses that increase research and development (R&D) expenditures during the taxable year. This credit previously expired on 30 June 1992. The credit is equal to 20 percent of the taxpayer's current year R&D expenses over a baseline amount. The Act extends the credit forward for R&D expenses paid or incurred after 30 June 1992 and through 30 June 1995. The Act adds new rules for determining the baseline amount of R&D expenses for start-up companies.

C. *Investment tax credit proposal*

The investment credit proposal put forward by the Administration for new purchases of business property was dropped from the House version of the bill and thus did not become part of the Act. The proposal was for temporary and permanent credits of up to 7 percent of the cost of new property, with the amount of the credit varying with the property's useful life. The proposal was deleted as part of a trade-off to limit the increase in the top corporate tax rate to 35 percent.

D. *Small business expensing*

The Act increases the amount that small businesses may deduct with respect to purchases of qualifying business property. The current limitation is a deduction for up to $ 10,000 of the cost of new depreciable property placed in service during a taxable year. This deduction is claimed in lieu of depreciation on the new property. The Act increases the annual deduction limit to $ 17,500, effective for property placed in service in taxable years beginning after 31 December 1992.

E. *Amortization of business intangibles*

Treasury Regulations under current law prohibit the depreciation of goodwill. Other intangible assets are also excluded from cost recovery unless the taxpayer can demonstrate that such assets have a reasonably ascertainable useful life. This standard is difficult to meet in practice and has generated considerable controversy between taxpayers and the IRS. In order to eliminate these controversies in future, the Act mandates a 15-year recovery period for most categories of intangible assets. The committee reports recognize that some intangibles covered by the Act will have useful lives shorter than the 15-year recovery period, and that other assets will have useful lives that are longer. Nevertheless, the 15-year period will be mandatory.

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The Act contains extensive definitions of the types of property covered by the new provision. These are referred to as "Section 197 intangibles". In general, they constitute intangibles that are acquired as part of a business rather than self-created or self-generated by the taxpayer. Included are traditional items such as goodwill, going concern value, covenants not to compete, franchises, trade marks, trade names, patents and copyrights. Also included are more esoteric intangibles such as "customer-based intangibles" (market share and customer lists), "supplier-based intangibles" (the value of contractual relationships in place for supply of goods and services), "workforce in place" (the value of an existing skilled or trained workforce) and "information bases" (books, records and operating systems).

A number of intangibles are specifically excluded from the new provision, including off-the-shelf computer software, financial instruments, interests in land and interests in corporations, partnerships, estates and trusts. Also excluded from the Act are certain "separately acquired assets", i.e. assets that would normally be included but which are not acquired by the taxpayer as part of a trade or business. This includes mortgage servicing rights, patents and copyrights, and films, sound recordings, videos and books. The IRS is also permitted to issue regulations for contract rights and governmental licences that are not acquired as part of a business and that have fixed terms of less than 15 years or are subject to cost recovery under a unit of production or similar method. These intangibles can be excluded from the new provision. The committee reports illustrate this with the example of a fixed-term licence that is either non-renewable or renewable on a competitive bid basis that produces an arm's length price. The result of the exclusion in such case is that the taxpayer can amortize the licence over its fixed term rather than the 15-year period required by the Act.

The new amortization rules are effective for property acquired after 10 August 1993. Property acquired after such date is grandfathered if it is acquired pursuant to an earlier binding written contract. Taxpayers may elect, however, to apply the new rules to all intangibles acquired after 25 July 1991. Special anti-churning provisions are included to prevent non-amortizable property acquired prior to the Act's effective date from being converted into post-Act amortizable property. The committee reports to the Act note that there is a severe backlog of cases dealing with intangibles that are pending on audit with the IRS and in the courts. Since these cases will no longer have precedential value, the reports urge the IRS "in the strongest possible terms" to expedite a settlement with the taxpayers. The IRS is to use the principles of the new rules in doing so.

IV. INVESTMENT PROVISIONS

A. *Capital gains exclusion*

In order to target investments in small businesses and new ventures, the Act adopts a capital gains exclusion for "qualified small business stock". A qualified small business (QSB) is defined as a domestic corporation (subchapter C corporation) that meets an 80 percent active business assets requirement and a $ 50 million capitalization limitation. The exclusion permits individuals and other non-corporate taxpayers to exclude 50 percent of the gain realized from a disposition of QSB stock if the stock has been held for at least five years.

A QSB is required to be engaged in a qualified business, which is defined generally as any business other than a professional service business (i.e. health care, engineering, architecture, law, accounting, etc.) or a banking, insurance and finance related business. The QSB may not invest more than 10 percent of its gross assets in real property or more than 10 percent of its net assets in portfolio stocks or securities. Additionally, the stock must be newly issued by the QSB to the taxpayer in order to be qualified for investment. Primary offerings through underwriters are permitted, but secondary offerings by existing shareholders are not. The total amount of capital gain eligible for the exclusion is limited to ten times the tax basis of the stock or $ 10 million from each QSB. One-half of any excluded gain is treated as a tax preference item for purposes of the AMT. The new provision is effective for QSB stock issued after 10 August 1993.

B. *Capital gains rollover*

The Act also permits corporations and individuals a tax-free rollover of capital gains realized from the sale of publicly-traded securities if such gains are reinvested in common stock or partnership interests of a "specialized small business investment company" (SSBIC). The reinvestment in the SSBIC must take place within 60 days after the sale of the publicly-traded securities, and the maximum gain that can be rolled over is $ 50,000 per year for individuals ($ 500,000 lifetime) and $ 250,000 per year for corporations ($ 1,000,000 lifetime). An SSBIC is defined as any corporation or partnership that is licensed under Section 301(d) of the Small Business Investment Act of 1958. The new provision is effective for sales of publicly-traded securities made on or after 10 August 1993.

C. *Capital gains conversion transactions*

As a result of the increased differential between the maximum capital gains rate and the new personal income tax rates, i.e. 28 percent versus 36 or 39.6 percent, taxpayers will have a strong incentive to structure transactions in a manner to realize capital gains whenever possible. In recognition of this, the Act adds a new provision to require capital gains to be recharacterized as ordinary income in transactions that are equivalent to loans in terms of anticipated return and risk. These are referred to as conversion transactions, the hallmark of which is that substantially all the taxpayer's return is attributable to the time value of the investment. Examples are (1) transactions involving off-setting positions with respect to the same or similar property, such as forward stock sales, (2) straddle transactions and (3) transactions that are marketed or sold on the basis that an interest-like return will be taxed as capital gain. The IRS is authorized to issue regula-

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tions specifying other transactions covered by the new provision.

The Act requires gain equal to 120 percent of the applicable federal rate (AFR) on the investment be recharacterized as ordinary income at the time the investment is disposed of. The committee reports illustrate this with the example of stock with a value of $ 100 that is sold forward for delivery two years later at a price of $ 115. If the two-year AFR on the date of the sale is 5 percent, then $ 12.36 of the $ 15 capital gain will be recharacterized as ordinary income (i.e. 120% x 5% compounded on an investment of $ 100 for two years). The Act permits the IRS to reduce the ordinary income amount in appropriate circumstances. There are also special rules for options dealers and commodities traders. The new provision is effective for transactions entered into after 30 April 1993.

D. *Stripped preferred stock transactions*

The Act also adds a provision to prevent the conversion of ordinary income to capital gain on investments in preferred stock that have been stripped of their dividend rights. Such stock functions in a manner similar to stripped bonds or original issue discount (OID) obligations in that the holder receives a yield to maturity that includes an interest component attributable to the discount. However, under current law stripped preferred stock is not subject to the rules that require the discount component to be accrued into income on a current basis. Under the new provision, a holder of stripped preferred stock, including a holder who himself strips and sells the dividend rights, will be required to accrue the discount component into income over the term of the investment. The accrued amounts are to be treated as ordinary income and not as interest or dividends. The accrual formula is similar to that for OID, i.e. the constant yield to maturity of the instrument applied to its compounding issue price. The provision is effective for preferred stock purchased or stripped after 30 April 1993.

E. *Market discount obligations*

Market discount bonds (i.e. bonds acquired in the market after original issuance at a price less than their redemption value) are subject to special rules under current law that require gain on sale or maturity to be treated as ordinary income instead of capital gain to the extent such gain is attributable to the discount component. However, bonds issued on or before 18 July 1984, are grandfathered from this requirement. Purchasers of such bonds may therefore hold them to maturity, or dispose of them in the market, and recognize capital gain. Municipal bonds are also exempt from the market discount rules under current law and thus yield capital gain at maturity or sale.

To further backstop the new higher rates on ordinary income, the Act repeals the grandfather exception for market discount bonds and makes all municipal bonds, regardless of issue date, subject to the market discount rules. This provision is effective for bonds purchased after 30 April 1993. Thus, holders of pre-18 July 1984 market discount bonds who purchased their bonds on or prior to 30 April 1993 will continue to receive capital gain treatment, as will holders of municipal bonds who purchased their bonds on or prior to such date.

F. *Mark-to-market for securities dealers*

Securities dealers are permitted under current law to value their inventory based on cost, market value or the lower of the two – "lower of cost or market" (LCM). Because the cost and LCM methods, together with the exemption that securities dealers enjoy from the wash sale rules, can cause income to be understated, Congress determined that these methods should no longer be available. The Act therefore requires that securities dealers value their inventories at fair market value and that other securities held by dealers outside of inventory be marked to market at year-end and gain or loss recognized accordingly. Exceptions are provided for securities held for investment purposes or as part of certain hedging transactions. The new rules are effective for taxable years ending after 31 December 1993. Income and loss adjustments from the revaluations required by the Act will be deemed to result from a change in accounting method approved by the IRS, and the income or loss taken into account ratably over a five-year period.

V. INTERNATIONAL BUSINESSES

A. *Transfer pricing initiative*

In order to bolster taxpayer compliance in the transfer pricing area, the Act reinforces the penalty provisions that can apply when the transfer price of a transaction is misreported. Two significant changes are made, both effective for taxable years beginning after 31 December 1993. First, the thresholds at which penalties can be imposed are lowered to levels that will impact a greater number of taxpayers than in the past. The new threshold of the 20 percent penalty for "substantial valuation misstatements" is an IRS adjustment of either $ 5 million of taxable income or 10 percent of gross receipts, and the new threshold of the 40 percent penalty for "gross valuation misstatements" is an IRS adjustment of either $ 20 million of taxable income or 20 percent of gross receipts.

These penalties can be avoided if the taxpayer complies with the second change made by the Act, which is that the taxpayer be able to provide the IRS with "contemporaneous documentation" supporting the transfer price reported on the tax return. Formerly, taxpayers only needed to show that they acted with reasonable cause and in good faith in order to avoid the penalties. Congress believed this standard to be too low, as evidenced by a Treasury Department report that the IRS has not attempted to apply the penalties since they were first enacted in 1990. Congress also believed that taxpayers were using *post hoc* arguments to justify tax reporting positions that were taken without regard to appropriate Section 482 standards. The Act therefore requires that taxpayers under audit provide the IRS with documentation showing that the transfer price on the tax return was determined in

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accordance with a methodology approved by the regulations under Section 482 and that the taxpayer's use of that method was reasonable. The contemporaneous aspect refers to the requirement that the documentation must have been in existence at the time the tax return was filed.

If the methodology used by the taxpayer is not a method specified in the regulations, i.e. a method other than the four approved – comparable uncontrolled price method, resale price method, cost plus method or comparable profits method – then the Act requires the taxpayer to demonstrate not only that the use of the unspecified method resulted in a price that clearly reflects income, but also that none of the specified methods would have done so. Thus, taxpayers that use an unspecified method, a so-called "other method", will have an especially onerous requirement as far as the degree of contemporaneous documentation that will be required. The documentation will have to prove that the four specified methods do not produce a transfer price that clearly reflects income, and that the method used by the taxpayer does. For transactions of a type not subject to any of the transfer pricing methods specified in the regulations, the Conference Committee report provides that the taxpayer needs only to establish that no method in the regulations is applicable.

B. *Controlled foreign corporations*

The Act adds a new category of income inclusion for US shareholders of controlled foreign corporations (CFCs). Under current rules, shareholders with a 10 percent or greater interest in a CFC are required to include their pro rata share the CFC's Subpart F income and the CFC's earnings invested in US property. The Act adds a third category, which is retained earnings of the CFC that are deemed to be invested in excess passive assets. The amount required to be included in income and taxed currently is the lesser of (1) the CFC's excess passive assets or (2) the earnings of the CFC that have not been previously taxed as excess passive assets or as earnings invested in US property. Excess passive assets are defined as those that exceed 25 percent of the total assets held by the CFC. Assets are valued for this purpose at their adjusted tax basis used in calculating corporate earnings and profits. Under the Conference Committee agreement, the Act will apply only to earnings of CFCs for taxable years beginning after 30 September 1993. CFCs within one or more chains of ownership of the same corporate group are required to compute excess passive assets on a consolidated basis and apportion the total among the separate members based on their respective earnings. The Act is structured to prevent CFC earnings from being taxed more than once under the different inclusion rules of Subpart F.

The Act also amends a number of the rules for CFCs that are subject to the passive foreign investment company (PFIC) provisions. Such CFCs will now be required to value their assets at adjusted tax basis for purposes of the 50 percent passive asset test. This was formerly elective, but is now mandatory. In addition, CFCs registered in the United States as securities brokers or dealers will now treat securities income as active income purposes of the 75 percent passive income test. This change is intended to make it easier for foreign securities dealers to avoid PFIC status. Experience in this area has shown that foreign brokers and dealers are meeting the 75 percent passive income test with greater frequency than was anticipated at the time the PFIC rules were enacted. Banks and financial institutions enjoy a similar exception under current law, and the committee reports note that they and securities dealers engage in many of the same types of transactions, for example, foreign exchange, interest rate swaps, currency swaps and hedging transactions. The modifications will thus conform the rules for the banking and securities industries.

The Act also amends the same-country exception to Subpart F for dividends received from related foreign corporations. Under the amendment, the exception is not available for dividends paid out of earnings accumulated during periods the CFC did not hold the stock in the distributing corporation either directly or through a chain of ownership. The CFC changes are effective for tax years that begin after 30 September 1993, and for tax years of US shareholders in which or with which such CFC tax years end.

C. *Earnings stripping provisions*

The United States enacted earnings stripping rules in the Omnibus Budget Reconciliation Act of 1989. The purpose of these rules is to prevent the erosion of the US tax base by the use of over-leveraged corporate entities. One aspect that was reserved on, however, was the status of guaranteed debt. The Act removes this reservation and provides that interest on third-party debt guaranteed by a related party will now be treated as disqualified interest. Such treatment will apply even if the unrelated lender is subject to net basis US taxation on its interest income.

The Act broadly defines a guarantee to include any arrangement, direct or indirect, whereby a related foreign person or tax-exempt entity "assures" payment of the indebtedness. The committee reports give an expansive view of the arrangements that are intended to be covered by the new provision, stating that all types of credit support, whether legally enforceable or not, and whether conditional or not, are included if a related party undertakes thereby to maintain the financial viability of the debtor. Comfort letters are specifically included. The committee reports note that even though the impact of the new rules will fall primarily on foreign-based multinational enterprises, it is the view of the Congress that the rules do not conflict with US treaty obligations.

The requirements of a debt-to-equity ratio in excess of 1.5 to 1 and the payment of disqualified interest in excess of 50 percent of the debtor corporation's taxable income are not changed by the Act. The earnings stripping amendments are effective for interest paid or accrued in taxable years beginning after 31 December 1993. Moreover, because the Act repeals the grandfather provision in the 1989 Act (i.e. debt issued on or before 10 July 1989 was exempt), the new rules will apply to interest on all indebtedness outstanding after the close of 1993 regardless of its original date of issuance. The

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effective date provisions denote a particular reversal of the 1989 Act with respect to guaranteed debt. The legislative history to the 1989 Act, which authorized the IRS to write regulations dealing with guarantees, provided that such regulations would be expected to be effective only after the date of publication. Taxpayers who entered into guaranteed debt arrangements in reliance on this proviso will find themselves caught by the new rules.

D. *Multiparty financing arrangements*

The Act grants broad authority to the IRS to draft regulations for the proper treatment of multiparty financing transactions. Such transactions normally include the use intermediate or conduit companies to reduce cross-border withholding taxes, for example where payments are intended to come to rest in non-treaty country jurisdictions. The regulations will address not only back-to-back loans, such as those present in *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), but also other multiparty arrangements that the IRS views as having tax avoidance consequences. The committee reports state that the regulations can also apply to debt guarantees and equity investments and cite with approval the IRS's 1991 technical advice memorandum that applied the conduit theory to a loan backed by equity rather than a second loan. This provision is effective on 10 August 1993.

E. *Portfolio interest exemption*

Present law grants an exemption from withholding tax for interest paid on portfolio obligations of US issuers. The exemption is provided by US domestic law and applies regardless of the availability of a tax treaty. In general, portfolio obligations are corporate and partnership debt issued in registered form and held by persons who own less than 10 percent of the issuing entity. Bearer instruments may also qualify if applicable guidelines are met.

The Act amends the portfolio interest exemption to exclude contingent interest. The committee reports indicate that Congress was particularly concerned about real estate investments structured as debt but carrying an equity interest, i.e. shared appreciation rights or profits participations. Investments of this nature are subject to tax on disposition under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), but payments of the interest related to the equity component can escape taxation under the portfolio interest exception. Congress believed this to be an anomaly and amended the rules accordingly.

Contingent interest is defined by the Act as interest calculated by reference to the receipts, sales, income, profits, assets or dividends of the debtor or a related party. The Treasury is authorized to identify other types of contingent interest by regulations. The new provision is effective for interest received after 31 December 1993, subject to a grandfather provision for fixed-term portfolio obligations issued on or before 7 April 1993, or after such date pursuant to a binding written contract in effect on such date and at all times thereafter. The committee reports state that the provision is not intended to override existing US tax treaties that eliminate or reduce withholding tax on cross-border interest payments.

The Conference Committee made two changes in the Act as approved by the House and Senate. These apply to portfolio obligations that pay both contingent and non-contingent interest. First, only the portion of the contingent payment that exceeds the non-contingent amount will be disqualified from portfolio treatment. The example given is that of an instrument that provides for contingent interest equal to 10 percent of gross profits, subject to a minimum floor of 6 percent fixed interest on the principal amount. In such case, only the contingent interest in excess of the fixed-rate amount will be subject to withholding. Second, for estate tax purposes, the contingent component of the instrument will be deemed to constitute property located within the United States and thus includible in the estate of non-resident taxpayers. The Conference Committee report provides that until the IRS issues appropriate guidance, taxpayers may use any reasonable method to apportion the value of the instrument between its contingent and non-contingent components. The estate tax provision is effective for the decedents dying after 31 December 1993, subject to a grandfather provision for pre-7 April 1993 debt as described above.

F. *Foreign tax credit baskets*

The US foreign tax credit regime relies on a basket system to prevent the cross-crediting of taxes on high and low-taxed foreign source income. Under current regulations, taxpayers in the oil and gas and shipping industries enjoy a special exception which allows them to exclude interest received on working capital from the passive income basket. Such interest instead falls into baskets that function as general limitation baskets for these industries. This allows the cross-crediting of low-taxed interest income with high-taxed extraction or operating income within the framework of the overall 34 percent limitation. Believing that the working capital interest exception unfairly advantages the oil and gas and shipping industries *vis-à-vis* other industries, Congress eliminated it in the Act. The repeal is effective for income earned in tax years beginning after 31 December 1992.

The House version of the Act contained a provision that would have placed royalty income from intangibles in the passive income basket even if such income was derived in the active conduct of a trade or business. This proposal met with wide opposition from industry groups and was dropped from the Act in the House.

G. *Possessions tax credit*

Current law allows a tax credit under Section 936 for income from businesses and investment carried on in US possessions. The Act imposes two new limitations on this credit. The first limitation, referred to as the economic activity limitation, is that the Section 936 credit cannot exceed an amount determined by reference to set percentages of the wages paid in the possession, the depreciation claimed on assets used in the possession, and unless the taxpayer elects to use the prof-

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it-split method for allocating income from intangible property, the income taxes paid or accrued in the possession.

The second limitation, referred to as the percentage limitation, is that the Section 936 credit cannot exceed a fixed percentage of the credit as determined under current law. The fixed percentage is phased in over five years, starting at 60 percent for tax years beginning in 1994 and declining by 5 percent each year thereafter until it reaches 40 percent in 1998. The percentage limitation is in lieu of the economic activity limitation. A taxpayer who chooses to use it must make an election to do so in the tax return for its first taxable year beginning after 31 December 1993. Possession taxes allocable to income in excess of the percentage limitation can be claimed as a tax deduction. The Act permits affiliated taxpayers to compute the new Section 936 limitations on a consolidated basis if they so elect. The aspect of the Section 936 credit that relates to qualified possessions source investment income is not changed by the Act. The new provision is effective for tax years beginning after 31 December 1993.

H. *R&D source rules*

Subject to certain exceptions, current law requires R&D expenditures to be allocated 64 percent to the situs where the R&D activities are performed. That is, 64 percent of the expenditures are allocated to US sources if the R&D activities are performed in the United States, and 64 percent are allocated to foreign sources if the R&D is performed outside the United States. The 36 percent balance is apportioned between US and foreign sources based on either a gross sales or gross income methodology. The Act makes a temporary amendment to these rules by changing the basic and residual allocation to 50 percent each for a one-year period. The new provision will be effective for the first taxable year of the taxpayer that begins after the expiration of the 18-month transition period permitted by Revenue Procedure 92-56. Such taxable year must begin on or before 1 August 1994. The Act does not specify what R&D source rules are to take effect when the temporary period expires.

VI. ENERGY TAXES

The Act imposes a permanent federal excise tax of 4.3 cents per gallon on transportation fuels. An exemption is provided for jet fuels used in commercial aviation. The Administration originally sought to impose a broad-based energy tax on the thermal content of all fuels, but this proved too politically controversial and was dropped.

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NETHERLANDS:
PROPOSED TAX HAVEN LEGISLATION

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Contents

I. Introduction
II. Amendment to the Participation Exemption
III. Earnings stripping Provisions
IV. Preliminary Conclusion

On 16 July 1993 the Ministry of Finance published a draft bill concerning the amendment of the Corporate Income Tax Act (CITA).[1] The objective of this amendment is to achieve a balanced treatment of the international fiscal relationships.

This draft bill was already announced at the time the Ministry of Finance published its memorandum concerning the competitive position of the Netherlands in respect of the tax incentives offered to foreign investors.[2] In this memorandum the Under Minister of Finance ventilated his concern that in maintaining its competitive position the Netherlands was not always receiving its fair share of the total tax take.

The Under Minister's statement is of course not surprising. During the parliamentary debate in respect of the previous amendment of the CITA a motion was adopted to investigate the possibility of introducing tax haven legislation.[3] Additionally, treaty partners have put the Netherlands under pressure to address the issue of the use of tax haven companies. The new tax treaty between the United States and the Netherlands is an example of such pressure.

The draft bill proposes to restrict the exemption method for the avoidance of international double taxation where multinational companies are using tax haven companies. It also attacks the use of finance companies based in tax havens. Furthermore, the draft bill proposes to amend the tax residency rules.

To dispel the anxiety which might be caused by this drastic change in attitude by the Netherlands the Under Minister hastened to add that the Netherlands was not putting an end to its principal choice of the exemption method to avoid double taxation and that the draft bill was to be seen as a consultative document. Comments are therefore welcome and should preferably be submitted before 1 November 1993. The draft bill has already received much criticism indicating that there is indeed anxiety among tax practitioners and multinational companies.

This article describes in broad terms the two most important elements of the draft bill which seem to tackle the use of group companies based in tax haven countries.

I. INTRODUCTION

The Netherlands is often used as the country to place the (intermediary) holding company of multinational companies and as a country to hold group service, finance and/or royalty companies. The reasons for this are fourfold:

- the CITA provides for an exemption of intercorporate dividends and capital gains arising from qualifying participations;
- the Netherlands has an extensive and favourable treaty network;
- the Netherlands does not levy withholding tax on interest and royalties; and
- the tax authorities are willing to issue advance rulings at short notice.

These four – as I would call – tax incentives have in the past afforded the Netherlands a competitive advantage over other jurisdictions. Nowadays this position has been eroded by various measures taken by other jurisdictions and will be further eroded if the draft bill is enacted as proposed.

II. AMENDMENT TO THE PARTICIPATION EXEMPTION

The Netherlands has made the principal choice in adopting the exemption method to avoid double taxation on intercorporate dividends. This method is applied not only in the case of intercorporate dividends but also in the case of intercorporate

1. Press release No. 93/120 of 16 July 1993.
2. Parliamentary documents II, 1992/93, 22.860, No. 2.
3. Parliamentary documents II, 1989/90, 19.968, No. 17.

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future dividends the value of which is reflected in the sales price of the subsidiary to be sold. In other words, a capital gain arising from the sale of a subsidiary is also tax exempt. This exemption of corporate dividends is laid down in the CITA and is known as the participation exemption.[4]

The draft bill proposes to amend the participation exemption. The current participation exemption covers not only participations in Dutch corporate entities but also foreign-based corporate entities. The conditions under which a foreign participation is eligible for the participation exemption are as follows:

- the parent company should hold at least 5 percent of the (voting) shares of the foreign company; and
- the parent company should hold the shares of the foreign company other than as inventory; and
- the parent company should hold the shares of the foreign company other than as portfolio investment;[5] and
- the foreign company should be subject to a form of profits tax.

With respect to the last condition, to date the foreign company should only be subject to a form of profits tax. Whether the foreign company actually pays such tax is irrelevant. Thus participations held in companies based in Jersey, the Netherlands Antilles, Cyprus, etc. which are subject to an offshore tax regime all qualify for the participation exemption if the other conditions are also met. I agree that all of these jurisdictions are known as tax haven countries and are seen by many treaty partners of the Netherlands as suspect. But jurisdictions such as Italy, Belgium and Ireland which also provide for low effective tax rates can hardly be called tax haven countries. Nonetheless, the tax incentives they offer to attract foreign investors and which have been agreed by the EC Commission might be taken away again by the Netherlands under the proposed amendment to the participation exemption.

The Under Minister of Finance states that the principal choice of the exemption method to avoid international double taxation will be maintained. If one indeed subscribes to the principle that double taxation should be avoided by applying the exemption method it is irrelevant whether or not the operation in the other jurisdiction is subject to a high or a low tax rate or whether in fact tax is levied at all. Consequently, the dividend policy of the subsidiary resident in a low tax jurisdiction is not influenced by the tax treatment of such dividends in the hands of the parent company.

Where the principal choice is the credit method to avoid international double taxation it is also irrelevant whether or not tax is levied in the other jurisdiction. However, under a credit system the dividend policy of a company based in a low tax jurisdiction might be such that no dividend is declared at all so as to avoid additional tax take by the tax authorities of the parent company. This incentive not to declare dividends has spurred some of the tax credit countries to introduce tax haven or CFC legislation where undistributed income from controlled foreign corporations is nonetheless subjected to tax in the hands of the controlling company.[6]

In the draft bill the Dutch government has demonstrated a willingness to sacrifice the principal choice of the exemption method. In the bill the Under Minister of Finance is introducing a form of tax haven legislation or CFC legislation which should attack the use of tax haven companies by amending the subject-to-tax test. The way the proposed tax haven rules work is as follows.

The foreign participation is subject to tax if:

- the foreign company is subject to a form of profits tax the effective rate of which is at least 15 percent; or
- the foreign company is subject to a form of profits tax the effective rate of which is less than 15 percent provided the company is carrying on a business as a credit institution or is carrying on a business other than providing group finance, investment activities or activities for which royalties are received.

As can be seen the subject-to-tax test is a test which looks at the effective tax rate. If such rate is at least 15 percent the foreign subsidiary is not a tax haven company. Therefore an annual test will have to be made whether the effective tax rate is at least 15 percent. If the test result is negative then a second test is applied which looks at the activities. If the foreign subsidiary is providing group finance other than as a credit institution then the test result is also negative. Moreover, captive insurance companies or royalty companies will be deemed to be tax haven companies too if the effective tax rate is lower than 15 percent. The captive and royalty company have been thrown in to prevent finance activities being combined with these activities to avoid the tax haven rule.

Therefore, where a Dutch holding company is holding an Antilles finance company operating under the offshore tax regime any dividend received by the Dutch holding company will be subject to tax in the hand of the Dutch parent company. This is also the case for Irish and Belgian finance companies.[7]

The fact that the dividends received would not be eligible for the participation exemption means that there clearly would be international double taxation which could be substantial. The draft bill therefore stipulates that a tax credit can be taken which is equal to 20 percent of the dividend received net of costs. The tax credit is limited to the tax due in the Netherlands, but any unutilized tax credits can be carried forward for eight years.

The example 1 may illustrate the above.

The example demonstrates (column I) that the effective tax rate in the Netherlands is limited to 15 percent on the income received from the Netherlands Antilles, bringing the overall effective tax rate to 18 percent. Under a "pure" tax credit system[8] the overall effective tax rate would have resulted in 35

4. CITA Art. 13.
5. This condition does not apply for subsidiaries resident in one of the EC member states.
6. For instance the United Kingdom, the United States and Japan.
7. The Irish finance company is subject to a 10% special rate, whilst the Belgian finance company acting as a coordination centre will be subject to an even lower effective tax rate.
8. Under a "pure" tax credit system the dividend received is grossed-up with the underlying tax to arrive at a pre-tax figure. This pre-tax figure is then subject to tax in the hands of the parent company against which the underlying tax credit is taken.

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EXAMPLE 1
ANTILLES FINANCE COMPANY

Netherlands Antilles	I	II	III
Profits before tax	100	100	100
Tax @ 3%	(3)	(3)	(3)
Profits after tax	97	97	97
Netherlands			
Other income	13	(187)	113
Dividend	97	97	97
Associated costs	(10)	(10)	(10)
Net income before tax	100	(100)	200
Loss brought forward (b/f)	0	0	(100)
Taxable income	100	0	100
Tax @ 35%	(35)	0	(35)
Tax credit b/f	0	0	17
Tax credit	17	17	17
Tax due	18	0	1

EXAMPLE 2
ANTILLES FINANCE/HOLDING COMPANY

Foreign subsidiary	I	II	III
Profits before tax	100	100	100
Tax @ 0%/15%/15%	0	(15)	(15)
Profits after tax	100	85	85
The Netherlands Antilles			
Gross dividend received	100	85	85
Foreign withholding tax	0	0	(13)
Income before tax	100	85	72
Tax @ 3%	(3)	(3)	(2)
Profits after tax	100	82	70
The Netherlands			
Dividend	97	82	70
Tax @ 35%	(34)	(29)	(24)
Tax credit	19	18	17
Tax due	15	11	7

percent. It further demonstrates the carry forward rules of any tax credit not utilized in prior years due to losses incurred from other operations.[9]

There might, however, be instances where the tax haven company holds subsidiaries in other jurisdictions which are also subject to a form of profits tax. Dividends received by the tax haven company from those subsidiaries may be taxable or exempt from tax. Where the tax haven company would redistribute these dividends to its Dutch parent company the 20 percent tax credit might prove to be insufficient to take account of the income tax already levied. Therefore, the taxpayer may elect for a tax credit equal to the amount of tax actually paid on the profits from which the dividends have been sourced if he can demonstrate that the effective underlying tax is higher than 20 percent. Underlying tax means income tax indirectly incurred by the tax haven company through a foreign subsidiary held by the tax haven company. It is important to note that the underlying tax credit for lower tier subsidiaries does not take into account any withholding tax levied. Moreover, the credit calculated on this basis is limited to 35 percent[10] of the dividend received net of associated costs and is applicable on a per country basis. Mixing of underlying taxes to achieve an effective tax rate of 35 percent is not possible and therefore any excess credit cannot be carried forward.

The example 2 may demonstrate the effects of the proposed rules.

In this example the Dutch parent company would obviously benefit from the 20 percent deemed income tax paid where the subsidiary of the Antilles finance/holding company is hardly paying any tax (column I). Under a "pure" tax credit system the overall effective tax rate would be 35 percent. Where the foreign subsidiary of the Antilles finance/holding company is subject to an effective rate of tax of 15 percent the proposed rules show an overkill. The use of the Antilles finance/holding company is now being penalized despite the fact that the proposed cutoff rate of 15 percent is met (column II). The Dutch parent company would in this case elect for a tax credit equal to the underlying tax. The system becomes even more penalizing where the foreign subsidiary of the Antilles finance/holding company not only pays a corporate income tax of 15 percent, but also has to withhold a tax on the dividend declared to the Antilles finance/holding company. The combined effective underlying tax rate associated with the dividend received by the Dutch parent company is 35 percent which is equal to the Dutch statutory rate! Again the Dutch parent company will elect for a tax credit which is equal to the tax paid by the foreign subsidiary on the income from which the dividend is sourced. Under a "pure" tax credit system like the UK system no UK tax would have been due. Full account would have been taken of the tax paid on the income generated and distributed.

III. EARNINGS STRIPPING PROVISION

It will be clear that the above described amendment to the participation exemption will have an impact on the dividend policy of the tax haven companies. Instead of using dividends as source of finance for future investments of the group, the funds available could also be used in the form of loans. Where these loans are used to generate Dutch taxable income the interest would be a tax deductible item. To circumvent this possibility the bill also introduces a form of an earnings stripping provision.

The bill proposes to limit the deductibility of interest where such interest is being paid to an affiliated tax haven company which does not meet certain tests as follows:

- the first test is to determine whether the interest paid to affiliated companies exceeds the interest received from affiliated companies. If this is the case then the second test applies;

9. The example ignores the carry back of losses to prior years.
10. The Dutch statutory corporate income tax rate. The 40% income tax bracket on the first NLG 250,000 is ignored.

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EXAMPLE 3
LEVERAGED DUTCH OPERATING COMPANY

CASE	I	II	III
EBIT	100	100	100
Interest received	5	5	34
Interest disallowed b/f	0	0	(7)
Interest paid	(20)	(60)	(60)
Earnings before tax (EBT)	85	35	67
Tax @ 35%	(30)	(18)	(23)
Earnings after tax (EAT)	55	17	51
Test 1: Is there a negative interest position?			
Interest received	5	5	34
Interest disallowed b/f	0	0	(7)
Interest paid	(20)	(60)	(60)
Interest position	(15)	(55)	(33)
Test 2: Is the interest paid to an affiliated tax haven company?			
Affiliated tax haven company	yes	yes	yes
Test 3: Is the interest paid higher than 50% of the earnings before interest paid?			
EBT	85	35	67
Add: interest disallowed b/f	0	0	7
Add: interest paid	20	60	60
Adjusted EBT	105	105	134
Allowable interest @ 50%	53	53	67
Interest disallowed b/f	0	0	(7)
Interest paid	(20)	(60)	(60)
Disallowed interest	0	(7)	0
Tax charge	30	18	23

EXAMPLE 4
DUTCH FINANCE COMPANY

CASE	I	II	III
Interest received @10.125%	101.25	91.13	101.25
Interest on deposit @8%	0.00	8.00	0.00
Interest disallowed b/f	0.00	0.00	(51.13)
Interest paid @10%	(100.00)	(100.00)	(100.00)
EBT	1.25	(0.87)	(49.88)
Tax @35%	(0.44)	(17.35)	(17.72)
EAT	0.81	(18.22)	(67.60)
EBT	1.25	(0.87)	(49.88)
Add: interest disallowed b/f	0.00	0.00	51.13
Add: interest paid	100.00	100.00	100.00
Adjusted EBT	101.25	99.13	101.25
Allowable interest @50%	50.63	49.57	50.63
Interest disallowed b/f	0.00	0.00	(51.13)
Interest paid	(100.00)	(100.00)	(100.00)
Disallowed interest	NA	(51.13)	(100.50)

– the second test is to determine whether the interest is paid to affiliated companies resident in tax havens. The same tax haven test is applied as described under II above, albeit the "legitimate" activities test is mitigated. Only in the case where the business mainly consists of providing group finance, investment activities or royalty activities is the third test triggered. Loans provided by recognized insurance companies are not affected. If the test result shows that the interest is paid to a tax haven company then the third test applies;
– the third test determines whether the interest paid to the tax haven company exceeds 50 percent of the profits before interest paid to tax haven companies. If this is the case the excess interest paid cannot be deducted but must be carried forward.

Only interest paid to affiliated tax haven companies is being attacked. A company is affiliated if:
– the Dutch company holds (directly or indirectly) at least one-third of the shares of the tax haven company;
– the tax haven company holds (directly or indirectly) at least one-third of the shares of the Dutch company;
– a third party holds (directly or indirectly) at least one-third of the shares of the tax haven company and the Dutch company.

The proposed earnings stripping rule is therefore triggered if the Dutch company is in a negative interest position, pays such interest to an affiliated tax haven company and the interest paid exceeds 50 percent of the earnings before the interest paid to the affiliated tax company. Any excess must be carried forward.

The example 3 may demonstrate the earnings stripping provision.

In Case I no interest is disallowed because the interest paid is less than 50 percent of adjusted EBT. In Case II part of the interest is disallowed and is carried forward to the following year. Case III demonstrates that interest carried forward can only be used where either more interest income is generated or where the profitability of the company increases.

Although the first test appears to be directed at Dutch companies which finance their Dutch investments with group loans the well-known Dutch finance companies are also covered by this test. Where the borrowing position exceeds the onlending position and (part of) the borrowed funds are provided by affiliated tax haven companies the 50 percent test might prove to be negative such that part of the interest is disallowed. The example 4 may demonstrate this.

In Case I the Dutch finance company has taken up a loan from an affiliated tax haven company and has extended loans to other affiliated companies. Because the Dutch finance company applies a spread of 1/8 of a percent the interest position is positive and consequently the earnings stripping provision is not triggered. However, in Case II one of the group companies has repaid the loan provided and the funds so received have been placed on a deposit accruing a lower interest rate than on the repaid loan. Now the earnings stripping provision is triggered and a large part of the interest paid to the affiliated tax haven company is disallowed. In Case III it is shown that such disallowed interest will increase and will be carried forward indefinitely where the Dutch finance company is again in a balance position. This example clearly demonstrates that the rules have unwanted (?) effects.[11]

11. I have ignored the fact that under the Dutch tax ruling practice of conduit finance companies a matched position is deemed to exist all the time.

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IV. PRELIMINARY CONCLUSION

The proposed amendment to the participation exemption and the earnings stripping provision demonstrates the willingness of the Dutch government to attack the use of group finance companies, captive insurance companies and royalty companies operating in jurisdictions where the effective tax rate is lower than 15 percent. Not only the traditional tax haven countries are attacked but also some of the EC members states such as Belgium (coordination centres) and Ireland (financial services centre) which introduced this special legislation with authorization of the EC Commission. It is interesting to see that the Netherlands has no hesitation to override EC law in this respect.

As demonstrated above the draft bill ventilates a drastic change in attitude by the Netherlands towards multinational companies operating in or via the Netherlands and which make use of companies resident in tax haven countries or in countries with special tax regimes. This change in attitude is caused by a perceived loss of the Dutch "fair" tax share in international relationships and exerted pressure by treaty partners. If the proposed bill is accepted by Parliament it is certain that the competitive tax position of the Netherlands will definitely be lost.

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GERMANY:
NEW THIN CAPITALIZATION RULE

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I. INTRODUCTION

After more than 13 years of extensive discussion and numerous unsuccessful attempts, the German tax authorities finally succeeded in convincing the legislative bodies to enact a thin capitalization rule.[1] It is contained in new Section 8a Corporation Tax Act (Körperschaftsteuergesetz), was passed on 9 July 1993, as part of the Investment Preservation Location Act (Standortsicherungsgesetz) and enters into force on 1 January 1994. Section 8a's principal objective is to counteract the perceived abuse of shareholder debt-financing. The additional revenue generated by Section 8a is estimated at DM 150 million per year. In practice, Section 8a will in particular adversely impact foreign shareholders operating in Germany through a German resident corporate entity. Astonishingly, the thin capitalization rule comes together with further significant changes in the taxation of German businesses aimed at attracting foreign investment to Germany.

This article discusses the objective of the new rule, examines its main elements, analyses the tax consequences of reclassified interest expense and presents some practical considerations.

Contents

I. Introduction
II. Objective of Section 8a
III. Main Elements of Section 8a
A. Structure
B. Scope
C. Safe harbours
D. Third party test
E. Borrowed funds
F. Holding company prilivege
G. Subsection 5 – anti-avoidance
H. Effective dates
IV. Consequences of Dividend Treatment
V. Practical Considerations
A. Exposure analysis
B. Exposure management
VI. Final Remark

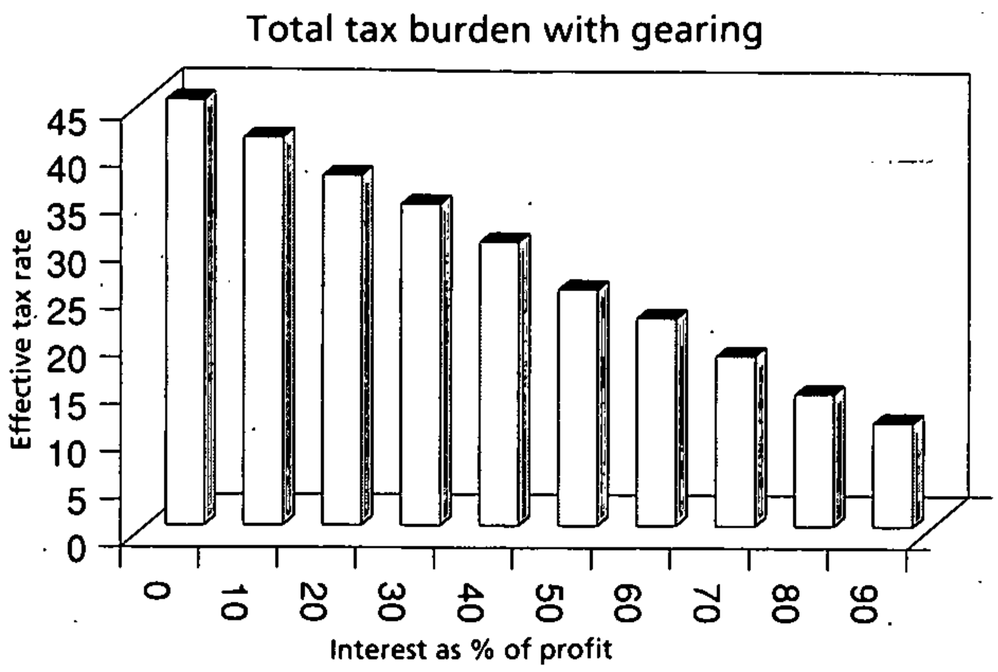
II. OBJECTIVE OF SECTION 8A

The intention is to stop foreign shareholders avoiding tax on their German corporate profits by receiving them as interest which is tax-deductible, rather than dividends which are not.

Under the German imputation system, most domestic shareholders are entitled to a credit for the corporation tax underlying their dividends. They can set this credit against their own tax liability, and if their marginal tax rate is lower than the corporation tax rate, they will receive a repayment of the difference.

Foreign shareholders are not entitled to the imputation credit, so they are unable to reduce the corporation tax burden. In many cases dividends will also be taxed in the shareholder's state of residence and even if credit is given for the German tax suffered, the shareholder often remains stuck with the comparatively high German tax. Thus, foreign shareholders often funded their German subsidiary with debt rather than with equity. Besides the corporate tax savings, debt-financing provides trade tax (Gewerbesteuer), net worth tax (Vermögensteuer) and withholding tax savings.

The table below illustrates the potential income tax savings:



1. Actually, Sec. 8a was drafted by a special experts' working party formed by the Finance Committee of the Bundestag. The working party consisted of professors and representatives of industry associations. Their meetings were attended by representatives of the Federal Ministry of Finance as consultative members.

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Note: The effective tax rate equals the combined 30% corporation tax, 17% trade income tax and 5% dividend withholding tax. The table assumes that interest is fully deductible and is paid without withholding tax.

The 30% corporation tax rate applies on profits distributed on or after 1 January 1994. The trade tax rate depends on the municipality in which the entity operates. 17% is a working average.

III. MAIN ELEMENTS OF SECTION 8A

A. *Structure*

Section 8a consists of five subsections. The first subsection contains the basic principle, i.e. interest expenses on loans from shareholders having a significant interest in the borrower are treated as dividends to the extent the funds on loan from the shareholder exceed a certain proportion of the borrower's equity. Subsection 2 governs the determination of borrower's equity, subsection 3 deals with the significant interest requirement, subsection 4 grants to holding companies as defined a privileged treatment. Finally, subsection 5 extends the application of dividend treatment in situations where the stock in the borrowing corporation is held in a German business or through a partnership.

B. *Scope*

The borrower is a corporation subject to unlimited tax liability. The lender is either

- a shareholder with a significant interest in the corporation, or a person connected with the shareholder, and not entitled to an imputation tax credit; or
- a third party which can have recourse to the shareholder or person connected with the shareholder on the same terms.

The interest is either

- not based on the nominal amount of the loan and the loan exceeds 50 percent of the shareholder's equity in the borrowing corporation; or
- is based on the nominal amount of the loan and the loan exceeds 300 percent of the shareholder's equity in the borrowing corporation, unless the borrower could have obtained the same funds from an unrelated third party on the same terms; or
- the loan is drawn to finance ordinary banking business.

C. *Safe harbours*

Loans up to certain percentages of equity ("safe harbours") are allowed without adverse consequences. These safe harbour amounts are determined by reference to the type of company borrowing the funds and the type of interest payable. The basic distinctions are between qualifying holding companies and other companies, and between fixed-interest loans and loans with profit/turnover related interest payments.

The safe harbours are basically as follows:

Maximum level of debt as a proportion of equity

	Type of interest	
Type of company	Fixed	Dependent on profit/turnover
Non-holding company	300%	50%
Holding company	900%	50%

The calculation of the safe harbour is more complex in situations where a shareholder has made both fixed-interest and profit-dependent loans. In determining the maximum safe harbours, the profit-dependent loan takes priority. Any unused element of the profit-dependent element is available for fixed-interest loans. This allows for very different safe gearing levels, depending on how much profit-dependent loan is advanced.

The legislator intended the profit-dependent loan to take priority, and any unused element of the safe harbour for that loan to be available for calculating the fixed-interest levels. In other words, the difference between 50 percent of the equity and the actual profit-dependent loan should be multiplied by six to calculate the fixed-interest safe harbour.

A few examples:

	Loans-maximum safe harbours		
Equity	profit dependent	fixed-interest	total loan
100	50	–	50
100	–	300	300
100	25	150	175
100	37.50	75	112.50

D. *Third party test*

Payments under fixed-interest loans which exceed the safe harbour limits will not be treated as Section 8a dividends if it can be shown that the company could have obtained the loaned funds on the same terms from an unrelated party or if the loan was drawn to finance ordinary banking business. There is no such third party safe harbour for non-fixed interest loans, so that interest paid on loans exceeding the safe harbour of 50 percent will always be treated as Section 8a hidden distributions.

The third party test applying for fixed interest loans looks at whether the borrower could have obtained the funds under "otherwise equal conditions" from an unrelated third party. The expert's working party commented that the contractual terms will need to be checked in each case together with other relevant circumstances (e.g. the company's liquidity). An interest rate below an arm's length level will lead to no adjustment. An interest rate above an arm's length rate will lead to a requalification of the excess as a hidden profit distribution under Section 8(3) Corporation Tax Act to the extent the funds are within the safe harbour, and under Section 8a(1) if they exceed the safe harbour. Notice that a hidden distribution under Section 8(3) is fully subject to trade tax, whereas at least 50 percent of a distribution under Section 8a is not.

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Whether or not a loan is arm's length will depend on the circumstances in each individual case, and so only general guidance on satisfying the requirements is possible. The shareholders' loan note should be very carefully drafted to correspond as closely as possible with a third party loan. It should preferably be made in circumstances where the borrower is in a position to offer collateral.

If third party evidence is required, it could be obtained from a number of lending institutions; for example, in addition to banks, pension funds, venture capitalists and even private investors (in certain instances) could provide evidence. The evidence will need to be based on normal lending conditions prevailing in the market at the time the loan was made and in the particular capital market from which the funds come. For example, German lending conditions may vary to those in the United States in the amount of gearing offered and security required.

E. *Borrowed funds*

Although not defined in Section 8a, the working party of experts which produced the new section provided some guidance on what it was intended to cover, saying short-term credit (for example, credit for goods purchased and on deliveries) is excluded. The section is therefore open to very wide interpretation.

It seems clear from the text that the borrowed funds in question are only those obtained from the shareholder or connected party or third party with recourse. Genuine third party borrowings are not included for the purposes of calculating safe harbours.

F. *Holding company privilege*

Subsection 4 containing the holding company privilege has three elements:

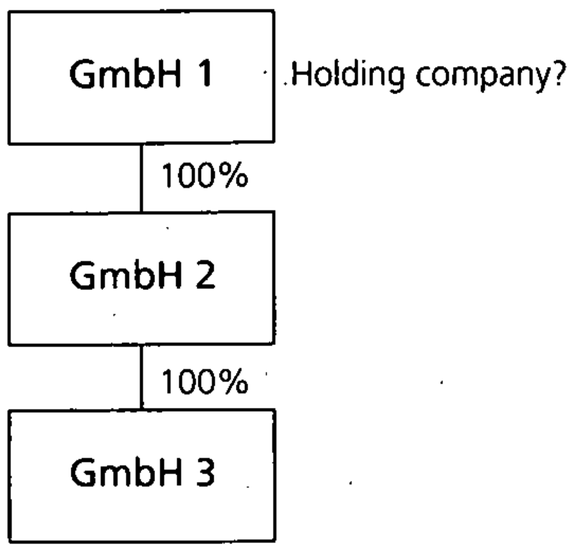
- it provides more generous safe harbours for holding companies;
- it denies safe harbours to subsidiaries of German holding companies;
- it reduces the equity element for calculating safe harbours for corporations which hold participations but are not holding companies.

(1) Holding companies and safe harbours

A safe harbour of 900 percent of equity is granted to corporations where either their main activity consists in holding and financing participations in corporations, or more than 75 percent of their balance sheet assets consist of participations in corporations.

Participation is not defined in the Act, but there is a definition in Section 271 Commercial Code (Handelsgesetzbuch). The central meaning is shareholding, but it is capable of being extended to include partnership interests and possibly also investments. A degree of permanence is required, so shareholding might not be a participation if there is an intention to dispose of it at the time of acquisition or shortly thereafter. The degree of participation is similarly not defined in the Act. Section 271 Commercial Code provides a rebuttable presumption that an interest of 20 percent or more is a participation, but it is clear that in some cases 5 or 10 percent will also suffice. We will have to wait and see how the tax authorities interpret this.

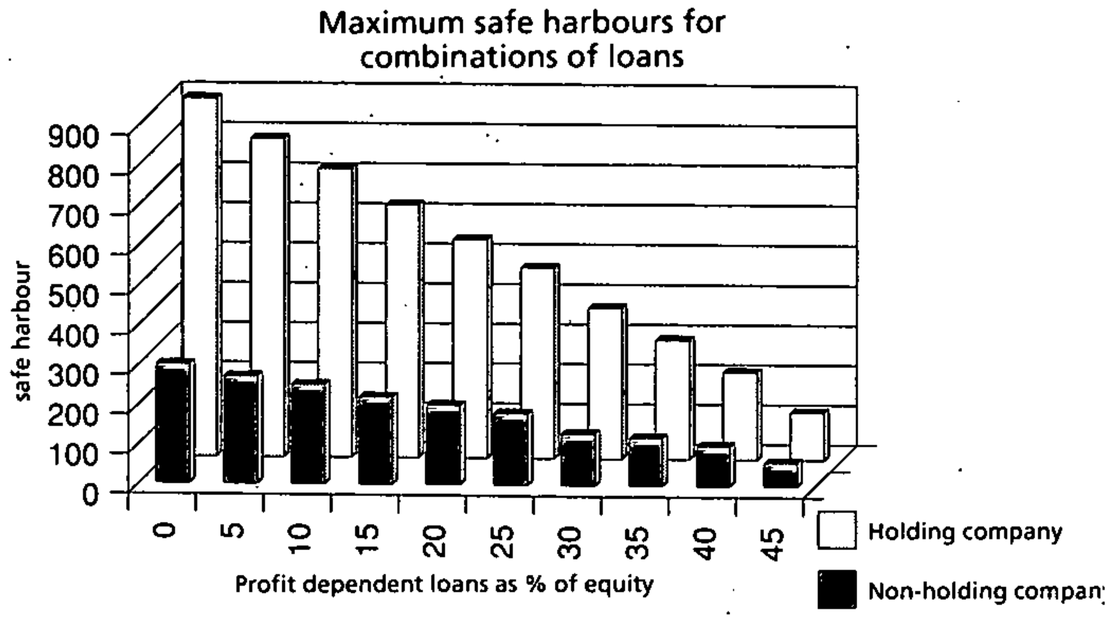
The requirement for participations plural should be noted. It is not clear whether this will also cover three tier situations:



If a qualifying holding company draws both profit-dependent and fixed-interest loans from the lender, the maximum safe harbour is calculated as 18 times the difference between the participating loan and half the shareholder's equity. Taking the same example as before:

		Loans-maximum safe harbours	
equity	profit-dependent	fixed interest	total
100	50	–	50
100	–	900	900
100	25	450	475
100	37.5	225	262.50

The table below illustrates the maximum gearing possibilities:



(2) Subsidiaries of qualifying holding companies

Subsidiaries of a company entitled to the 900 percent safe harbour are granted no safe harbour of their own. Loans granted to them by foreign shareholders, foreign connected persons or unrelated third parties with recourse (regardless of their state of residence) must satisfy an arm's length test; otherwise the interest payments will be treated as hidden profit distributions (excluding normal banking business).

The text does not make this treatment dependent on the debt: equity ratio of the German parent, so for example it would be quite feasible for the parent to be purely equity financed and nevertheless for payments made by the subsidiary to a foreign group company to be treated as hidden profit distributions.

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(3) Non-qualifying holding companies

A holding company does not qualify as a Section 8a holding company if:
- it only has one corporate subsidiary; or
- it has two or more corporate subsidiaries, but its main activity is not the holding and financing of participations in corporations (for example, because it is an active trading company) or the book value of its participations in corporations does not account for more than 75 percent of its balance sheet assets.

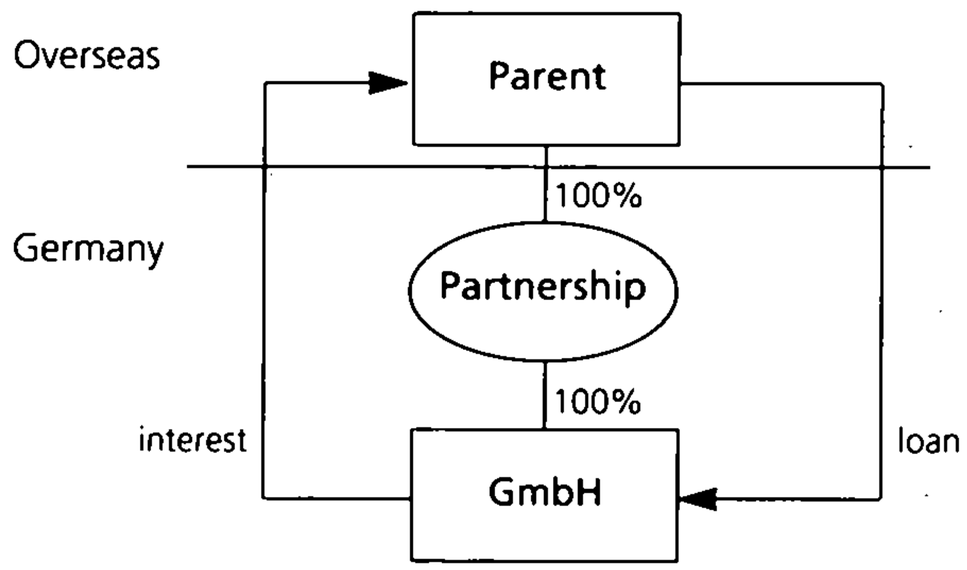
Where this is the case, the equity must be reduced by the book value of the participations in corporations in computing the safe harbour. For German groups consisting of a parent and a single subsidiary, this will usually mean a drastic reduction in the safe harbour.

G. *Subsection 5 – anti-avoidance*

Subsection 5 extends the provisions of Section 8a to cases where foreign shareholders try to avoid the rules by using intermediate non-corporate holding entities.

(1) Partnership or permanent establishment (PE) owning the shares (paragraph 1)

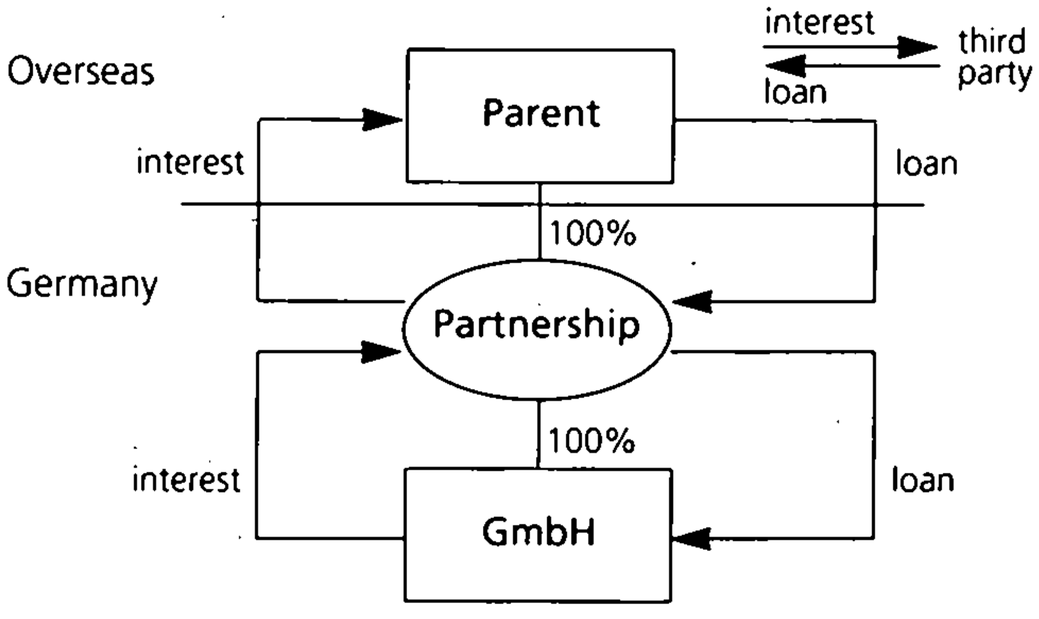
This deals principally with this case:



Dividends paid by the GmbH to the partnership are taxable income of the parent under Section 49(5) Income Tax Act (limited tax liability – effectively taxed as a PE at the branch tax rate of 42 percent (1993: 46 percent)), thus entitling the parent to an imputaton credit under Section 50 Corporation Tax Act.

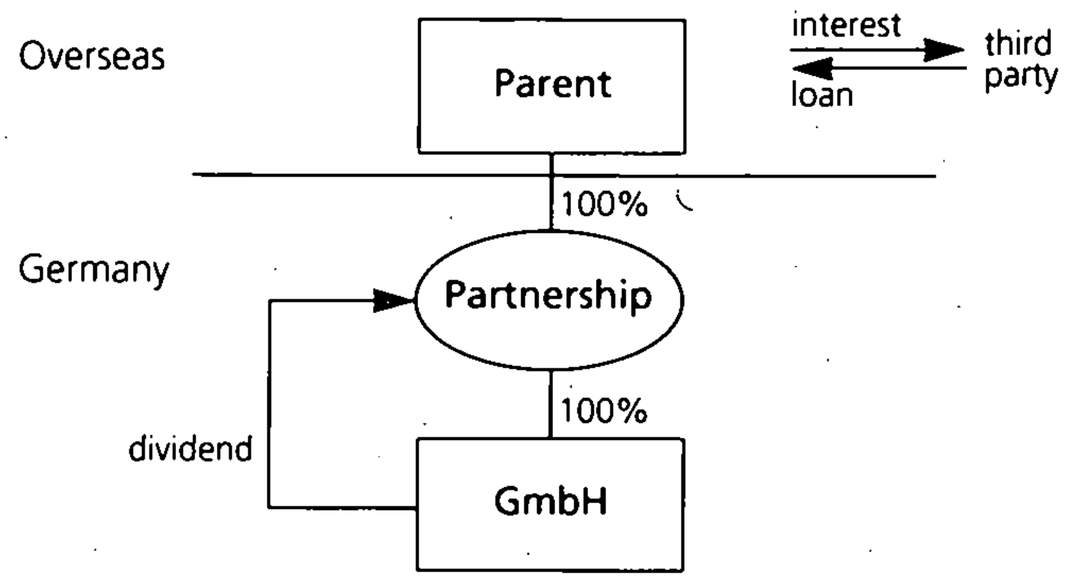
(2) Partnerships owning the shares and debt financed

This deals principally with this case:



The interest received is taxable income of the partnership, and is treated as business income of a German PE under Section 49(1) paragraph 2a Income Tax Act. The parent is allowed to set off any interest cost it incurs on loans taken out to finance the acquisition of partnership assets when computing its German tax liability. Since the interest coupon on the third party loan will usually be higher (or at least the same) than the group financing, this will normally ensure that the interest flows out of Germany without being taxed.

The following structure remains outside the scope of Section 8a:



Again, the dividend received from the GmbH is taxable at the partnership level, but a deduction for the third party interest cost is given, resulting in a part repayment of German tax.

H. *Effective dates*

Section 8a applies to every accounting period in which the German company has outstanding foreign shareholder loans. The rules will first affect accounting periods which begin after 31 December 1993. Special transitional rules apply for profit-dependent loans made before 9 December 1992, but only for accounting periods ending before 31 December 1997. Apart from this exception, all existing loans are caught.

IV. CONSEQUENCES OF DIVIDEND TREATMENT

To the extent interest expense is treated as Section 8a dividend, the consequences will be as follows:
- the borrowing corporation's taxable income is increased by the amount reclassified;
- the additional income together with income from other sources earned in the same year constitutes the taxable income for the year and is subject to tax at a rate of 45 percent;
- an amount equalling the disallowed interest expense is deemed as being distributed net of corporation tax at the 30 percent rate for distributed earnings;
- the deemed dividend is subject to withholding tax at 25 percent or at reduced tax treaty rates.

Noteworthy, the interest expense caught by Section 8a remains deductible for trade income tax purposes. Also, the underlying debt retains its character for trade capital and net worth tax purposes. Thus, debt-financing even caught by

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Section 8a continues to offer potential trade tax and net worth tax savings.

Despite these potential savings, a Section 8a dividend might cost more income tax than a normal dividend. In particular, an extra cost is likely to arise in situations where the taxpayer originally claimed a deduction for the interest expense, but a subsequent examination found the interest as a Section 8a dividend. The level of extra cost depends on the exact composition of the German company's equity capital ("verwendbares Eigenkapital") for tax purposes. In the worst case, a Section 8a dividend will cost 20 percent more withholding and corporate tax than a normal dividend.

Most of the more recently concluded German tax treaties treat income from profit-dependent loan arrangements as dividends for country of source taxation purposes. In addition, Germany reserves the right to impose a withholding tax on such dividends at its domestic rate, currently 25 percent, in case the income from such arrangements is deductible in determining the profits of the German borrower.[2] To the extent this deduction is denied because of Section 8a the borrower will be entitled to reduced withholding tax rates applicable for ordinary dividends. Thus, for instance, a Section 8a dividend to a US corporate lender of a profit-dependent loan also holding directly at least 10 percent of the voting shares of the borrowing company suffers only 5 percent instead of 25 percent withholding tax. If the borrower would not meet the minimum participation requirement, the rate will be 15 percent.[3]

V. PRACTICAL CONSIDERATIONS

A. *Exposure analysis*

As the new rules will apply shortly, all foreign investors with German companies should begin to review their position, assess their potential exposure and consider actions to mitigate adverse impact. This exercise must be repeated for each accounting period. It involves the following steps:

- Identify the borrower: is it a German corporation? If so, is it a qualifying holding company or a subsidiary of a qualifying holding company?
- Identify the lender: is it
  (i) a foreign shareholder?
  (ii) a foreign person connected with a shareholder?
  (iii) a third party?
  (iv) a German resident partnership which also holds the shares?
- Identify the borrowings: are they
  (i) fixed interest?
  (ii) profit-participating?
- Identify available equity for Section 8a purposes, based on the opening balance sheet for the period in question. If the corporation owns participation(s) in other corporations and is not a qualifying holding company, deduct the book value of the participation(s).
- Calculate the safe harbour amount.
- Compare the safe harbour with the maximum amount of borrowings at any time during the year in question.
- If the safe harbour is exceeded and the borrowings are profit-dependent, calculate interest on the excess borrowings and tax exposure.
- If the safe harbour is exceeded and the borrowings are fixed-interest, review whether the loans are at arm's length and gather evidence to support this.
- Determine whether the risk of a requalification of interest is a substantial risk. If so, take avoiding action.

B. *Exposure management*

Obviously, a reclassification of interest according to Section 8a raises the effective German tax rate quite significantly. Furthermore, the group's effective tax rate on German profits will in many cases reach astonishing levels if the lender's state of residence does not follow the reclassification ordered by Section 8a, but continues to treat the interest received as such. In this situation, economic double taxation of the interest that is a Section 8a dividend will almost inevitably occur with little chance to obtain relief, i.e. exemption for the interest income or credit for German taxes underlying the payment. Hence, effective measures avoiding reclassification shall ideally eliminate double taxation as well as result in an acceptable effective German tax rate.

To this end, it may be worthwhile to consider the following suggestions:

- gathering third party evidence;
- injection of new equity;
- redemption or part redemption of loan;
- conversion of profit-participating loan into ordinary loan;
- restructuring to obtain holding company safe harbour;
- conversion of company into a partnership;
- consider debt funding techniques not covered by Section 8a.

VI. FINAL REMARK

Since the first attempt to enact a thin capitalization rule, many have repeatedly raised various observations against it. The concerns relate to the arbitrariness of any debt: equity ratio and likely violation of Germany's obligations arising from tax treaties and the EEC treaty.[4] Whether the courts will join the critics remains to be seen.

Most taxpayers and their advisers consider Section 8a as a rather moderate and reasonable rule. It is probably fair to assume that most foreign investors can live with the current version. However, there is concern that the rules might be tightened in the future if they miss their objective, i.e. curtailing abusive shareholder debt-financing.

2. See for instance French-German tax treaty, Art. 9(9); Swiss-German tax treaty, Art. 10(2)(c).
3. See US – German tax treaty of 1989, Art. 10(2), (4) and (5).
4. See for instance, B. Knobbe-Keuk, "Wieder einmal ein Entwurf zu Sec. 8a KStG", *Der Betrieb* (1993), at 60-66.

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UNITED KINGDOM:

HOLDING COMPANY REGIMES

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This paper was presented at the Dutch-UK IFA seminar held in Amsterdam in June 1993.

Contents

I. The United Kingdom as a Holding Company Centre
A. Advantages
B. Disadvantages
II. The Proposed International Headquarter Company Regime
III. Impact of the EC Parent-Subsidiary Directive
IV. Holding Companies in Offshore Centres Around the EC
V. A Comparison of the United Kingdom with other European Holding Company Centres
A. Dividend relief
B. Capital gains relief
C. Withholding taxes on outgoing dividends
D. Relief from financing costs

I. THE UNITED KINGDOM AS A HOLDING COMPANY CENTRE

Under existing laws, the use of the United Kingdom as a location for an international holding company is notable for some very significant advantages sharply contrasted by major disadvantages. The principle advantages and disadvantages are highlighted below.

A. *Advantages*

Interest and other financing costs relating to the acquisition or establishment of foreign shareholding participations are normally fully deductible to the UK holding company. Subject to appropriate structuring of the financing such costs can also be available for offset against other profits of the UK group.

Provided that profits from foreign participations have suffered corporate and withholding taxes at an effective rate at least equivalent to the UK corporation tax rate (currently maximum 33 percent), the United Kingdom will allow full credit for such taxes against UK taxes so that no corporate taxes are suffered on dividends received. Any participation of 10 percent or more qualifies for this relief and foreign tax credit may extend down an unlimited number of "tiers" of participations.

The United Kingdom does not impose any withholding tax on dividends and the foreign corporate shareholder will not be subject to any further UK taxation on a dividend received, wherever the shareholder is located.

Under certain double taxation treaties the United Kingdom gives a tax credit refund to a foreign shareholder on a dividend. This includes 11 countries where a partial tax refund is given to a corporate shareholder with a 10 percent or more interest in the UK company.

The importance of London as an international financial centre has resulted in many foreign-based groups preferring London as the prime location for a centre of European operations for non-tax reasons.

B. *Disadvantages*

Advance corporation tax ("ACT"), currently at a rate of approximately 29 percent of the net dividend, is payable on all dividends distributed to UK companies and this tax is never reduced by double taxation treaties or the parent/subsidiary directive.

As the United Kingdom operates a credit rather than an exemption system of foreign tax relief the United Kingdom is not suitable for holding shares in companies qualifying for a low tax regime, e.g. Irish companies enjoying the special 10 percent tax rate.

The consent of the UK Treasury is still required for certain transactions by foreign subsidiaries of UK companies.

II. THE PROPOSED INTERNATIONAL HEADQUARTER COMPANY REGIME

In the UK budget on 16 March 1993 the Government announced an intention to introduce new legislation to solve the ACT problem for UK companies acting as international holding companies. This will be through the introduction of a special ACT regime for companies which will be termed "international headquarter companies".

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The international headquarter company will not be a separate class of company but the regime will be available to any UK company which satisfies the following conditions:

- it is at least 80 percent owned ultimately by foreign shareholders;
- there are no more than five shareholders;
- the company receives foreign income to which a foreign tax credit is attached.

The international headquarter company will be able to elect to pay a "foreign income dividend" out of foreign source income to which a foreign tax credit is attached. Such a foreign income dividend will not be subject to ACT, but shareholders will not be entitled to a tax credit in respect of the dividend.

The international headquarter company regime effectively means that dividends from foreign participations could flow through an international headquarter company in the United Kingdom without any UK tax liability provided that the dividends are paid out of profits which have suffered foreign corporate and income taxes at a rate of at least 33 percent.

III. IMPACT OF THE EC PARENT-SUBSIDIARY DIRECTIVE

The parent-subsidiary directive, effective from 1 January 1992, has had a major impact on the choice of holding company location for groups involved in the EC. Because of the nil or low rate of withholding tax on dividends specified in the parent-subsidiary directive, where qualifying conditions are satisfied, holding companies outside of the EC will be at a major disadvantage with respect to receiving dividends from subsidiaries within the EC. This means that they are no longer viable in most cases. Only in the case of Portugal, with its special transitional provisions, do double tax treaties often give better withholding tax relief than the parent-subsidiary directive.

The parent-subsidiary directive has not, however, equalized the holding company regime within Europe so that it will still be important to seek to find the optimum regime for a particular group.

A major issue that has arisen in relation to the parent-subsidiary directive is the position of European groups owned ultimately by non-EC shareholders. Three countries, France, Italy and Spain, have included in their implementation legislation provisions allowing them to refuse to apply the dividend withholding tax exemption under the parent-subsidiary directive in situations where the group is ultimately controlled outside of the EC and it is considered that the structure has been established in order to take advantage of the parent-subsidiary directive.

IV. HOLDING COMPANIES IN OFFSHORE CENTRES AROUND THE EC

An interesting issue in relation to the parent-subsidiary directive is the extent to which it applies to companies enjoying certain favourable tax regimes within the EC. The position in a number of territories is as follows:

- Irish international financial centre companies fully qualify for the parent-subsidiary directive;
- Luxembourg holding companies, i.e. special holding companies enjoying the "1929 regime" do not qualify. However, ordinary Luxembourg companies now enjoy participation exemptions on dividends and capital gains broadly equivalent to those available in other holding company centres such as the Netherlands;
- Gibraltar: the United Kingdom and Gibraltar appear to be of the view that Gibraltar comes within the parent-subsidiary directive and mergers directive and a new type of company, known as the "Gibraltar 1992 company" has been introduced to take advantage of the regime. However, it is not entirely clear from the terms of the directive that such Gibraltar companies can enjoy the benefits.

Madeira is part of Portugal and therefore Madeira companies can potentially enjoy the benefits of the parent-subsidiary directive. It is not clear, however, as to whether those companies enjoying the especially favourable "offshore" regime are within the terms of the directive.

V. A COMPARISON OF THE UNITED KINGDOM WITH OTHER EUROPEAN HOLDING COMPANY CENTRES

The United Kingdom can be compared with other European holding company centres in relation to a number of different holding company "facilities".

A. *Dividend relief*

Of the significant European holding company centres only the United Kingdom operates a foreign tax credit relief system. Belgium, Denmark, France, Germany, Luxembourg and the Netherlands all generally operate an exemption system, at least under treaties. In some cases this exemption may be as to only 95 percent of the dividend (e.g. in Belgium).

B. *Capital gains relief*

The United Kingdom fully taxes capital gains; France taxes them at a reduced rate. Germany currently taxes capital gains at the full rate, but is contemplating the introduction of an exemption. Belgium, Denmark, Luxembourg and the Netherlands all have exemptions for capital gains.

C. *Withholding taxes on outgoing dividends*

Only the United Kingdom has no withholding tax on outgoing dividends without the need to use double tax treaties, the parent-subsidiary directive or other structuring.

D. *Relief from financing costs*

Belgium, Denmark, France and the United Kingdom potentially allow relief for financing costs on foreign participations against other income of the holding company.

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BANGLADESH:

SALIENT FEATURES OF THE 1993-94 BUDGET

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INTRODUCTION

The Minister of Finance, Mr M. Saifur Rahman, presented the 1993-94 Budget on 10 June 1993, and it was enacted as the Finance Act 1993 on 30 June 1993. According to the Minister, this year's budget aims to stabilize the economy, increase the efficiency and size of public investment, restrain current expenditure, increase the revenue earning and private sector development. Emphasis has been placed on investment in human resources. Poverty alleviation is another objective of the Budget.

FISCAL MEASURES

Several important measures are aimed at collecting more revenue, streamlining tax administration and providing relief to both middle and upper-middle class taxpayers.

Highlights of the changes, which are effective from 1 July 1993, are as follows:

- The exemption limit for individual taxpayers has been increased from Tk. 40,000 to 50,000.
- The highest tax rate for individuals has been reduced to 25 percent.
- The corporate tax rate has been reduced from 55 to 50 percent for banks, financial institutions and non-industrial companies whose shares are not publicly traded. For publicly-traded companies the tax rate is 40 percent and for companies whose shares are not publicly traded the rate is 45 percent.
- The present system of imputing income from owner-occupied dwellings has been abolished. To encourage investment in housing the exemption limit for income from property has been increased from Tk. 20,000 to 30,000.
- Currently, the limit for advance income tax relief is set at Tk. 5,000, Tk. 20,000 and Tk. 60,000 for various categories of assessees. The limit has been increased to Tk. 100,000 for all categories of assessees.
- The deduction of income tax at source has been reduced to 2.5 percent (from 3 percent) for contractors in the construction sector, and increased to 10 percent (from 6.2 percent) on service charges earned by manpower export agents.
- The requirement that income tax at source be withheld on all bank mortgages exceeding Tk. 100,000 has been abolished.
- The method of computing capital gains has been changed. Under existing law, capital gains arising from inherited property are calculated on the actual cost of acquisition to the immediate previous owner. Now the capital gain will be calculated on the basis of the market value of the property on the day on which it was inherited.
- An amendment has been made to include in Part "C" of the First Schedule a provision for recognition of an approved gratuity fund.
- An amendment has been made which obliges the authorities, in cases of appeal, to communicate a final assessment notice to an assessee within 30 days of making a decision on an appeal.
- The rate schedule of the wealth tax has been amended; the rates now range from nil to 1 percent of net wealth. Income tax and wealth tax together cannot exceed 30 percent of the total income of an assessee.

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Kranich – Waba – Siegl
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  release 4
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- Skattebestemmelser – Systematisk
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releases 381 and 382
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releases 497 and 498
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Mennel
release 25
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release 159
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- Inkomstenbelasting 1964
  release 240
- Loonbelasting
  release 147
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Mobach
release 205
Gouda Quint/D. Brouwer, Arnhem.

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- Motorrijtuigenbelasting
  release 33

Kluwer, Deventer.

FISCALE WETTEN
release 204
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- Algemene wetgeving inzake douane
  releases 247 and 248
- Belastingheffing bij invoer
  release 442
- Tarief van invoerrechten
  release 100
- Gecombineerde nomenclatuur
  release 79

Kluwer, Deventer.

LEIDRAAD BIJ DE BELASTINGGIDS
Van Soest – Meering
release 123
Gouda Quint/D. Brouwer, Arnhem.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  releases 68 and 69
- Coord. SV/Premieheffing
  releases 22 and 23
- Heffing over uitkeringen en loon
  releases 42 and 43

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
release 287/288
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- Algemene deel
  releases 222 and 223
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  releases 863-866
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  release 157
- Invorderingswet
  releases 46 and 47
- Loonbelasting
  release 550
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  releases 231-233
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SKATTE-NYTT
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CONFERENCE DIARY

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OCTOBER 1993

International Human Resources Planning Conference, San Antonio, Texas, 25-27 October 1993 (English):
Michael J. Bishko, National Director of Expatriate Services, Ernst and Young, 277 Park Avenue, New York, NY 10172, U.S.A., Tel.: 212-773 2595, Fax: 212-773-2550.

International Taxation Management Techniques, Brussels, 25-26 October (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

Tax-efficient corporate organization, Amsterdam, 27-29 October 1993 (English):
Marion Oakley, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, England, Tel.: 44-71-779 8601, Fax: 44-71-779 8599.

NOVEMBER 1993

Asset Protection Planning/Asset Protection Trusts, New York City, 1-2 November 1993 (English):
International Business Communications USA Conferences, Inc., 225 Turnpike Road, Southborough, MA 01772-1749, U.S.A., Tel.: 508-481 6400, Fax: 508-481 7911.

Responding to Government Attacks on Multinationals, New York, 2-3 November 1993 (English):
Ellen Reichenberg, Ernst & Young, 787 Seventh Avenue, New York, NY 10019, U.S.A., Tel.: 1-212-773 5928, Fax: 1-212-977 9359.

Offshore Trust Services, New York City, 3-4 November 1993 (English):
International Business Communications USA Conferences Inc., 225 Turnpike Road, Southborough, MA 01722-1749, Tel.: 508-481 6400, Fax: 508-481 7911.

EC Corporate Tax Directives, Amsterdam, 11-12 November 1993 (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

ITPA Kuala Lumpur/Labuan Seminar, Kuala Lumpur, 15-17 November 1993 (English):
Elizabeth Husband, ITPA Conference Bureau, PO Box 134 Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-762910, Fax: 44-732-763762.

New places – new opportunities: New taxes – new problems, Singapore, 18-19 November 1993 (English):
Asian-Pacific Tax and Investment Research Centre (APTIRC), 2 Nassim Road, Singapore 1025, Tel.: 65-235 1954, Fax: 65-733 1540.

The Legitimate Use of European Tax Havens, Malta, 29-30 November 1993 (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

DECEMBER 1993

International Tax Aspects of Cross-border Financing, Amsterdam, 13-14 December 1993 (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

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CUMULATIVE INDEX – 1993 Nos. 1-9

I. ARTICLES

Canada:
Nathan Boidman:
Tax Developments of Interest to US Tax Advisers 389

Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Reseach Incentives 255

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Denmark:
Bente Moll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

Finland:
Kari S. Tikka:
Fundamental Tax Reform: 25 Percent Rate on Capital Income and Corporate Income 348

France:
Olivier Delattre and Clothilde Fournier:
French Income Tax Developments of Interest to US Tax Advisers 367

Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Germany:
Friedhelm Jacob:
Administrative and Legislative Developments of Interest to US Tax Advisers 383

Hong Kong:
Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283

Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

G.K. Kawatra:
1993/94 Budget 294

International:
Vicki L. Beyer:
Issues raised by International Cooperation in Revenue Enforcement: Directions for the Future 436

Sijbren Cnossen:
What Kind of Corporation Tax? 3

John Hasseldine:
How do Revenue Audits Affect Taxpayer Compliance 424

Ken Messere:
Recent Tax Revenue Developments in OECD Countries and Some Policy Implications 323

John Prebble:
100 Years of Income Tax 59

Stanley C. Ruchelman:
US Tax Considerations in International Derivative Products 235

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Italy:
Simona Belletini:
Tax Treatment of Financial Instruments in Italy 502

Karl Beusch:
1993 IFA Congress in Florence 471

Augusto Fantozzi:
Italy Welcomes Further EC Harmonization

Bruno Gangemi:
Tax Avoidance: The Italian Experience 522

Paolo Ludovici:
The Tax on the Net Worth of Enterprises 496

Guglielmo Maisto:
Implementation of the EC Merger Directive 480

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Andrea Manganelli:
Tax Treaty Developments 529

Andrea Manzitti:
Tax Incentives in Italy 516

Guiseppe Marino:
Taxation of Italian-Based Flows of Interest and Royalties in an International Context 510

Siegfried Mayr:
Implementation of the Parent-Subsidiary Directive 493

Japan:
Alum Bati:
Taxation of Dividends and Interest 202

Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Kazakhstan:
Charles E. McLure, Jr.
Tax Foundation Signs Agreement with Kazakhstan and Russia 444

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Mexico:
Juan Pablo de la Calle Pardo:
Tax Developments of Interest to US Tax Advisers 407

Netherlands:
Paul Sleurink:
Income Tax Developments of Interest to US Tax Advisers 371

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
Charles E. McLure, Jr.
Tax Foundation Signs Agreement with Kazakhstan and Russia 444

James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Singapore:
Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

United Kingdom:
Guy Brannan:
Tax Developments in the United Kingdom of Interest to US Tax Advisers 363

United States:
Melvin S. Adess and Barbara M. Angus:
Knowledge and Technology Transfers to and from the United States – Characterization of Transfers of Computer Software 414

Stephen A. Mihaly:
How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the Best Method Rule of the New Section 482 Regulations 307

Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187

Leif Weizman
New Income Tax Treaty – An Analysis and Prognosis 450

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

Bruce Zagaris:
The US–Netherlands Income Tax Treaty: Tax Collection Assistance and Evidence-Gathering 342

Wim Wijnen:
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC: The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96, 219, 254, 473

IV. CONFERENCE DIARY 39, 149, 285, 347, 413, 492

V. BIBLIOGRAPHY

– Books 49, 100, 150, 226, 297, 354, 462, 535
– Loose-leaf services 51, 103, 154, 231, 302, 465, 540
  – List of addresses of the major publishing houses appearing in the Bibliography 53

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CONTENTS

VOL. 48 NO. 11 **NOVEMBER 1993**

INTERNATIONAL: INTERCOMPANY TRANSFER PRICING REGULATIONS UNDER US SECTION 482 TEMPORARY AND PROPOSED REGULATIONS — 619

Committee on Fiscal Affairs
The January 1993 issue contained the Task Force Report on the proposed Section 482 Regulations. The purpose of that Report was to provide the United States with the collective views of other OECD Member countries on the new Regulations. The Task Force has now issued another Report which considers the issues identified in the first Report that continue to be of concern, sets out new difficulties that Member countries have with the revised Regulations as presently drafted and puts forward a number of recommendations to deal with these difficulties.

UNITED STATES: THE 1993 US TAX ACT WILL AFFECT INTERNATIONAL TRANSACTIONS — 630

Philip H. Spector
On 10 August the final version of the Omnibus Budget Reconciliation Act of 1993 was signed by President Clinton (an overview of the provisions of the Act can be found in the October issue). This article summarizes the principal provisions of the Act affecting international business transactions, identifies taxpayer exposure and suggests possible responses.

UNITED STATES: ENTITY CLASSIFICATION GUIDELINES FOR GERMAN GmbHs — 638

J.G. Rienstra
The Internal Revenue Service has revised its entity classification guidelines for German limited liability companies (GmbHs) in situations of common control by a single corporate group. The IRS now holds that such entities may be classified as either partnerships or corporations. Formerly, GmbHs under common control were automatically required to be classified as corporations.

NEW ZEALAND: APPLYING A SLEDGEHAMMER TO FOREIGN INVESTMENT: FOREIGN INVESTMENT FUND MEASURES — 646

Michael Dirkis
The new FIF regime will affect not only the manner and form of current and future investment, but it will also profoundly affect some of the financial markets in which the funds are placed and the individual enterprises operating within those markets. This article critically analyses the new FIF legislation against its policy objectives. Next month Mr Dirkis will examine the Australian FIF measures.

WHAT'S NEW FROM IBFD?

A Guide to the European VAT Directives:

Commentary on the Value Added Tax of the European Community

The Taxation of Permanent Establishments

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International Transfer Pricing in the Ethical Pharmaceutical Industry

Transfer Pricing Strategy in a Global Economy

The International Guide to Mergers and Acquisitions

European Tax Handbook 1993

and

Tax News Service
Now Weekly!

AUSTRALIA: NEW FIF REGIME: AN INTERNATIONAL COMPARISON	652	*Peter A. Harris* The Australian government recently introduced measures aimed at preventing the deferral of Australian tax through investment in non-Australian controlled offshore funds which do not pursue a full distribution policy. These new measures are both similar and dissimilar to measures existing in the United States and Germany. This article evaluates the Australian measures by focusing on a number of the key elements to the applicability of those measures and compares them to the corresponding elements under the US and German measures.
RECENT LEGISLATIVE DEVELOPMENTS	664	*Friedhelm Jacob* As a follow-up to the article in the July/August issue, Mr Jacob provides an update on the key features of the tax reform package which was promulgated on 17 September 1993.
IFA NEWS	667	
BIBLIOGRAPHY		
– Books	671	
– Loose-leaf services	680	
CONFERENCE DIARY	670	
CUMULATIVE INDEX	682	

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INTERNATIONAL:

INTERCOMPANY TRANSFER PRICING REGULATIONS UNDER US SECTION 482 TEMPORARY AND PROPOSED REGULATIONS

Committee on Fiscal Affairs

I INTRODUCTION

1.1 The problems currently being encountered in the transfer pricing area by the United States are not new and are similar to those encountered by other Member countries of the OECD. The Task Force wishes to emphasise again that these difficulties, which are inherently global in nature, cannot be resolved unilaterally. A multilateral approach is required which builds upon widely accepted principles of international taxation. The recent discussions in the United States regarding the proposed Regulations provide a new approach to the determination of transfer prices that will be considered in the revision of the OECD's guidelines set out in the 1979 report entitled "Taxation and Multinational Enterprises" (hereinafter referred to as the OECD 1979 Report).

1.2 The purpose of the present report, which has been prepared by a special Task Force established by the Committee on Fiscal Affairs of the OECD, is to provide the United States Administration with the collective views of other OECD Member countries on the new Regulations under Section 482 of the United States Internal Revenue Code (hereinafter referred to as the revised Regulations). The report identifies issues set out in the OECD's report "Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations" (hereinafter referred to as the Task Force Report) that continue to be of concern in the revised Regulations issued in January 1993. It also identifies a number of new problems that arise with the Regulations in their present format. The United States was not a member of this Task Force but participated as an observer.

1.3 Once again, the Member countries of the OECD stress that they are prepared to work further with the United States, both bilaterally and in such international fora as the OECD, to address the problems to which the revised Regulations are directed.

1.4 The structure of this report is as follows. Chapter 1 (the present chapter) provides the background to the report. Chapter 2 considers the issues identified in the Task Force Report that continue to be of concern. Chapter 3 sets out new difficulties that Member countries have with the revised Regulations as presently drafted and puts forward a number of recommendations to deal with these difficulties. Chapter 4 provides a summary of the Recommendations and proposals for follow-up.

Legislative Background

1.5 The proposed Regulations issued in January 1992 were intended to provide guidance in implementing the amendment to Section 482 made by the Tax Reform Act of 1986, which requires that consideration for intangible property be commensurate with the income attributable to the intangible. The legislative history stated that this change was intended to assure that the division of income between related parties reasonably reflects the economic activities each undertakes. The legislative history also expressed concern that insufficiently stringent standards had previously been used in determining whether a controlled transfer was comparable to an uncontrolled transfer.

1.6 When the US issued the proposed Regulations, the Department of the Treasury requested comments from treaty partners and from other interested parties to be provided before 23 May 1992. Subsequently this period for comment was extended to July 1992.

1.7 The proposed Regulations aroused considerable interest both among Member countries of the OECD and among companies and practitioners in both the United States and elsewhere. The proposed Regulations were discussed by the Committee on Fiscal Affairs – the main tax policy body of the OECD – at its meeting in June 1992, at which time it was agreed to establish a special Task Force to undertake a detailed examination of the proposed Regulations. The Task Force Report was finalized by the end of December and passed to the US Administration. In January 1993, the report of the Task Force was published by the OECD.

1.8 Many of the Recommendations of the Task Force have been taken into account in the revised Regulations and the Task Force generally welcomes the direction taken. By adopting a more flexible approach to the methods that can be used for the determination of a transfer price and by placing greater emphasis on the facts and circumstances of individual cases, there is now less risk that these Regulations will produce results that are incompatible with the arm's length standard. Nevertheless, there remain features of the revised Regulations that continue to give rise to concerns. This report identifies these problems and attempts to put forward solutions to deal with them.

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II ISSUES OF CONTINUING CONCERN

A. *General comments*

2.1 The Task Force welcomes the substantial changes made by the United States to the proposed Regulations and the fact that the United States adopted many of the recommendations of the Task Force. The Task Force is particularly pleased to see a reaffirmation of the arm's length standard. By putting greater emphasis on facts and circumstances of individual cases, there is less of a risk that the regulations will produce results that are incompatible with the arm's length standard. A number of changes reflect a move towards greater consistency with the arm's length standard such as the removal of the overly restrictive sound business judgment rule, the introduction of the best method rule, and the elimination of the comparable profits method (CPM) as a mandatory check on other methods.

2.2 Other positive changes include increased flexibility, the elimination of a strict priority of methods, the preference for transaction-based methods, the acknowledgement that profit splits can also be a valid method of arriving at an arm's length result, and the fact that more than one method may be used to confirm results obtained under another method.

2.3 The Task Force hopes that the new administration will act swiftly to assure its treaty partners and the international business community that it supports the internationally accepted arm's length standard and the efforts by the former administration reflected in the revised Regulations to establish rules consistent with that standard.

2.4 Some of the concerns identified in the Task Force Report continue to be of concern in the revised Regulations. These issues are discussed in this Chapter. For ease of reference, these issues are presented in the order in which they appear in the Task Force Report.

B. *Compatibility with the arm's length standard*

2.5 One of the main issues raised by the Task Force in connection with the proposed Regulations issued by the United States in 1992 was the consistency of the regulations with the arm's length standard. Of particular concern was the commensurate with income standard applicable to transfers or licenses of intangible property that was added to Section 482 by the 1986 Tax Reform Act. The Task Force Report indicates that to the extent that the implementation of the commensurate with income standard involves the use of hindsight, there is a risk that the arm's length standard will be violated because the application of the arm's length standard depends on the evaluation of the facts and circumstances surrounding transactions at the time they take place. The Task Force Report suggests that the inconsistency between profit approaches used to implement the commensurate with income standard and the arm's length principle could be resolved by limiting the application of such methods to profits that were predictable or reasonably foreseeable by the taxpayer at the time the transaction was entered into. The Task Force concluded that "as long as the objective is to exclude from consideration all events which were not known and could not reasonably have been predicted by the parties at the time the transfer was made, the Task Force would not regard the arm's length standard as necessarily having been breached, although this could raise serious practical problems". The revised Regulations do not take such a narrow approach. (A more detailed discussion of the periodic adjustments provisions is provided in Section H below).

2.6 The Task Force was also concerned about the compatibility of the comparable profits method with the arm's length standard. The Task Force recognized that the use of a comparable profits method may be appropriate as a method of last resort to determine an arm's length price or to check the results obtained under other methods, but strongly endorsed the 1979 OECD Report view that profit comparisons should be made with care and that "exceptional profits or losses" do not necessarily reflect an attempt to use transfer prices as a way to shift profits.

2.7 Although the revised Regulations have reduced the importance of the comparable profits method by eliminating the requirement that it be used to check the application of other methods and by suggesting a preference for transaction-based methods, Member countries are concerned, as discussed further below, that the comparable profits method may in practice become the predominant method used by the IRS. Recommendations with respect to periodic adjustments and the comparable profits method are provided below.

C. *Application of the revised Regulations in the context of a mutual agreement procedure or arbitration process*

2.8 The Task Force Report identifies the application of the proposed Regulations in the context of a tax convention's mutual agreement procedure or arbitration process as one of two fundamental issues affecting international tax arrangements raised by the proposed Regulations (the other being consistency with the arm's length standard). The concern was that the results of the methods prescribed by the proposed Regulations would not be accepted by other countries, which would lead to economic double taxation and a disruption of international trade (e.g. if the United States rejects the application of a method due for instance to the taxpayer's failure to satisfy reporting and documentation requirements, but the US treaty partner considers that method to be most appropriate in the circumstances). The Task Force Report suggests that these concerns could be eliminated to some extent if the United States were to confirm that the US competent authority would not be bound to use the approaches prescribed by the Regulations in attempting to reach agreement with a treaty partner under a mutual agreement procedure of a tax convention, and that the rules of the Regulations would not be required to be applied in the context of arbitration permitted under a tax convention. Such a confirmation was deemed to be consistent with the practice of other OECD Member countries in resolving cases through the use of the mutual agreement procedure. The revised Regulations do not include such a formal confirmation.

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2.9 Because the revised Regulations contain provisions that may conflict with the approaches of other Member countries to transfer pricing, such as the comparable profits method, periodic adjustments, and compensating adjustments, Member countries continue to believe that the United States should provide assurances that it does not consider itself bound to apply the rules set forth in the revised Regulations in the context of a mutual agreement procedure or arbitration process under a tax convention. The Task Force accepts that the Regulations may not be an appropriate place to comment on the application of the Regulations in the context of a mutual agreement procedure or arbitration process provided for in a double taxation agreement. However, it is felt that some form of official confirmation on this issue is needed.

2.10 *Recommendation on application of the revised regulations in the context of a mutual agreement procedure or arbitration process*:

> It is recommended that the United States issue a general policy statement confirming that it will not be bound by the revised Regulations when dealing with a case through the mutual agreement procedure or arbitration process of a tax contention.

D. *Concentration on abusive cases*

2.11 The Task Force acknowledges that positive steps were taken to reduce the importance of the comparable profits method. These steps include the intended expression in the best method rule of a general preference for methods based on stricter comparability (i.e. a preference for transaction-based methods over profit-based methods) and the elimination of the CPM as a mandatory check on the results obtained from application of other methods. However, because of the importance of the concerns expressed in the Task Force Report, the Task Force recommends that the United States clarify that by effectively limiting the scope of the CPM to cases where a transaction-based method cannot reasonably be applied, the best method rule effectively adopts the Task Force recommendation that CPM be used only as a method of last resort. The Task Force continues to be of the view that CPM should be used only in abusive cases and as a method of last resort (for example, CPM may be used in a case where no other method is more appropriate or can reasonably be applied with the result that both the taxpayer and administrations agree that its use on a consistent basis will produce an acceptable result for practical purposes).

2.12 *Recommendation on concentration on abusive cases*:

> For the reasons set forth in the Task Force Report, especially as the Task Force recognizes that the CPM remains at the experimental stage and requires further testing before its precise impact in the transfer pricing area can be determined, it is recommended that to the extent that the CPM is used to determine the amount of the adjustment to be made in a particular case, it should be clarified that it should only be used in abusive cases and as a method of last resort (for example, CPM may be used in a case where no other method is more appropriate or can reasonably be applied with the result that both the taxpayer and administrations agree that its use on a consistent basis will produce an acceptable result for practical purposes).

E. *Priority of methods*

2.13 The introduction of the best method rule to replace the strict ordering of methods and the provision of standards to determine comparability between controlled and uncontrolled transactions are positive developments that make the revised Regulations more flexible for both taxpayers and the IRS. However, the Task Force is concerned that because of the increased flexibility the IRS examiners now have in selecting a method, they may move too quickly to the conclusion that the CPM is the best method. IRS examiners may be inclined to resort to the CPM in most cases because it operates within a standard of comparability that is easier to satisfy than is the case for the other methods identified in the revised Regulations and because the IRS is not required to prove the inapplicability of other methods before using the CPM. Therefore, the Task Force is worried that the CPM will be used routinely and taxpayers will be forced to defend themselves by seeking data establishing the appropriateness of other methods, even though the availability of the necessary data is very limited to them. In particular, in the case of intangible transfers, the comparable uncontrolled transaction method would appear to require a standard of comparability in relation to profit potential that would be very difficult to demonstrate satisfactorily in practice. If this is the case, the result would be to lead examiners too quickly to the CPM in cases involving intangibles. This is an undesirable result in light of the preference expressed for transaction-based methods over profit-based methods (this preference being also relevant to the possible application of a profit-split method as now provided in the revised Regulations).

2.14 Another issue raised by the adoption of the best method rule is whether the revised Regulations would allow "the evidence of all methods to be used in conjunction" as the Task Force previously recommended. It seems that a method may be displaced by another method if that method provides a more accurate measure of the arm's length result. Furthermore, only one method may be used to produce a range of arm's length results.

2.15 The revised Regulations do acknowledge the use of multiple methods but only give guidance if two or more methods produce inconsistent results. This would appear to support a single best method approach rather than an multi-method approach as advocated by the Task Force. Where there is a conflict between the results derived from the application of two or more methods, the revised Regulations suggest taking another method into account. The Task Force approach seems more flexible. Where there are fundamental contradictions between the results of applying two or more methods, the Task Force took the view that an attempt should be made to reach a conclusion that was satisfactory from a practical viewpoint, taking into account the facts and circum-

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stances of the case and also the mix of evidence available provided the results were consistent with the arm's length principle. For example, this would not rule out the possibility of a range of arm's length results, the upper end of which being determined by one method and the lower end of it being determined by another method. An issue that is not clear with respect to the application of the best method rule is whether in providing an analysis of why the method used by the taxpayer is the most accurate measure of an arm's length result, the taxpayer will in practice be required to disprove other methods. This would impose a fairly significant burden on taxpayers. Further clarification on this point would appear to be necessary.

2.16 *Recommendation on the priority of methods*:

> Given the stated preference in the revised Regulations for transactional methods for determining intercompany transfer prices, it would be desirable if such a preference were clearly reflected in the process leading to the choice of a method by examiners.
>
> As recommended in the Task Force Report, the revised Regulations should allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments.

F. *Lack of available data to implement the CPM*

2.17 The Task Force continues to be concerned about the lack of availability to taxpayers and tax authorities of the information needed to apply the CPM. The Task Force Report recommended that the data used to apply the CPM be drawn from information that is available to the public or to which a taxpayer could reasonably be considered to have access or from other information that is available to the tax authorities and that could be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and exchange of information. This issue is not addressed by the revised Regulations and therefore continues to raise the problems identified in the Task Force Report. However, the Task Force recognizes that, in practice, the sharing with taxpayers of data relied upon by the IRS does not appear to have presented problems in the past.

2.18 *Recommendation on the lack of available data to implement the CPM:*

> The Task Force reiterates its initial recommendation that the data used for the purposes of the CPM to determine the arm's length range be drawn from information that is available to the public or to which the taxpayer could reasonably be considered to have access or from other information that is available to tax authorities that could be shared with the taxpayer. All such data used by an examiner in constructing the arm's length range for the purposes of the CPM should be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and exchange of information.

G. *Difficulties in the application and role of the CPM*

2.19 The comparability standard of the CPM is very loose and not defined with sufficient precision. The comparables "need only be broadly similar and significant product diversity and some functional diversity ... is acceptable". Because the comparability standard of the CPM is much looser than the standards under the comparable uncontrolled price, resale price, cost plus, and comparable uncontrolled transaction methods there is a concern that in practice the CPM will become the predominant method. For example, in the case of intangible transfers, the comparable uncontrolled transaction method would appear to require a standard of comparability in relation to profit potential that would be very difficult to demonstrate satisfactorily in practice. An undesirable priority of methods could prevail in practice if the methods other than the CPM are so circumscribed by the revised Regulations that their use became infrequent or exceptional. The United States has indicated that this should not be the case because the operation of the best method rule should favour the use of transaction-based methods requiring more rigid comparability and that the differing comparability standards should be viewed in conjunction with the best method rule.

2.20 In order to avoid an undesirable priority of methods in practice, the revised Regulations should make it clearer that methods that require more rigid comparability are more appropriate methods than are other methods that require less comparability even if the latter relatively satisfy other factors such as data completeness or accuracy of adjustments. This will give emphasis to transaction-based methods, which is what the United States indicated was its intention.

2.21 In addition to the loose standard of comparability, there is no requirement to adjust arm's length result to achieve greater consistency. Constructive operating profits derived from profit level indicators of uncontrolled parties who are only broadly similar would not necessarily achieve an arm's length result. If appropriate adjustments cannot be made to the profit level indicators of the comparable parties, these comparable parties should not be used to determine the arm's length range.

2.22 *Recommendation relating to the application and role of the CPM*:

> It is recommended that the CPM's standards of comparability be more precisely defined, in particular in relation to their interaction with the best method rule.
>
> To prevent IRS examiners from going too quickly to the CPM, it is recommended that the revised Regulations make it clearer that methods requiring stricter comparability are more appropriate than methods with looser comparability standards even if the other factors of the best method rule have been met. This concept may be inherent in the best method rule but should be explicitly stated.

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It is also recommended that adjustments of profit level indicators of comparable parties be required to achieve greater consistency. If appropriate adjustment cannot be made, the party should not be used as comparable.

H. *Application of periodic adjustments*

2.23 The Task Force acknowledges that the revised Regulations take into account part of the Task Force's recommendation with respect to periodic adjustments. As noted in paragraphs 3.64 and 3.65 of the Task Force Report, there may be cases where it is difficult to ascertain the profits that were reasonably foreseeable at the time a transaction was entered into. In such cases, there may be a need to consider whether a retrospective adjustment is required. However, as noted above, the Task Force continues to hold the position that periodic adjustments should be restricted as far as possible to truly abusive cases and to cases where the taxpayer fails to provide the tax authorities with the information reasonably required to support the transfer prices in order to avoid inconsistency with the arm's length standard.

2.24 Transfers of intangibles involving the payment of royalties over periods exceeding one year are different from the sales of goods in two respects: the property transferred is usually more difficult to define and to value than a tangible good for the purpose of using a method that relies on comparables; and, perhaps more importantly, payments for the intangible may span over several years, unlike payments for goods, which are usually lump sums.

2.25 However, the fact that the payment for an intangible takes the form of a multi-year royalty should not change the criteria one uses to determine whether a price is consistent with the arm's length standard. An arm's length price is generally determined at the time a transaction is entered into. If normally in a comparable uncontrolled relationship, parties do not include a price adjustment clause in their long term agreements, a subsequent adjustment to the price by the tax authorities is in conflict with the arm's length principle. If on the other hand parties in an uncontrolled relationship would insert such an adjustment clause, an adjustment should only be made from the year that clause would have come into effect.

2.26 This is not to say that a new arm's length price cannot be determined in years following the initial agreement. If, for example, the parties decide to modify the terms of the agreement and unrelated parties would do the same thing in the same circumstances, or the agreement ceases to reflect the functions actually carried out by the parties, ex post facto, then a new agreement is either formally or de facto in application, and such agreement would require the determination of a proper transfer price. However, determining a new transfer price in such cases is quite different from making adjustments in arm's length prices, in disregard of contractual arrangements between the parties, and exclusively on the basis of the actual income attributable to the intangible.

2.27 The two exceptions to periodic adjustments, although broader than the exceptions provided in the proposed Regulations, continue to be too narrow and of limited use. The set of conditions for avoiding periodic adjustments differs according to whether the comparable uncontrolled transaction method (CUT) or another method was initially used to determine the transfer price. Six conditions must be met when the CUT method is used: four conditions apply when other methods are used. For the most part, the conditions seek to ensure that the controlled agreement between the parties is formal, that the consideration for the first year in which consideration was payable is arm's length, and that the functions performed by the controlled parties have not changed over time. When the CUT method is used, additional conditions require that the controlled and uncontrolled agreements be comparable and that the terms of the uncontrolled agreements not be changed.

2.28 A further condition imposed regardless of the method used is the requirement that the total profits actually earned or the total cost savings realized by the controlled transferee from the use of the intangible in all open years be not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled transaction was entered into. No distinction is made among the different factors that may explain the difference between forecast and actual profits. It seems contrary to the arm's length standard to deny the exception to periodic adjustments merely on the grounds of the size of the unforeseeable profits or savings.

2.29 As a result, ex post adjustments could be made to a consideration – despite the fact that the controlled and uncontrolled agreements remained comparable over the period and the functions performed by the controlled parties did not change over time – only because actual profits proved to be somewhat different from those forecast when the agreement was entered into. An adjustment in such a circumstance seems difficult to reconcile with the arm's length standard.

2.30 No allowance is made for the fact that the difference between actual and forecast profits can be attributable to factors unforeseeable by the controlled taxpayer at the time the transaction was entered into (e.g. market factors like greater/lower demand for the product, greater/lower market price for the product, etc.). To the extent that the contract does not provide for the adjustment of consideration to reflect potential changes in profitability attributable to unforeseen circumstances, tax authorities should not be allowed to second-guess such an agreement. The unexpected profit or loss attributable, for example, to market risk should remain with the party that assumed that risk under the terms of the agreement, generally the manufacturer or distributor.

2.31 The exception applicable to taxpayers that have used the comparable uncontrolled transaction method requires that the taxpayer have access to written agreements relating to the uncontrolled transaction on which they relied to set their transfer prices. This condition is problematical because it will exclude those cases in which the taxpayer is not a party to the uncontrolled transaction.

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2.32 There is also a concern that there is a conflict between the arm's length standard and the provision that allows the district director to make an adjustment to the amount charged for an intangible even where there was a determination in an earlier year that the amount charged for the intangible was arm's length. It is recommended that there be an exception that would preclude the making of periodic adjustments where there were factors beyond the control of any member of the controlled group and these were neither anticipated nor reasonably foreseeable.

2.33 *Recommendation concerning application of periodic adjustments:*

> It is recommended that the Task Force's original recommendation that periodic adjustments be confined to truly abusive cases be adopted. Although it is recognized that the exceptions to periodic adjustments were broadened, the Task Force recommends deletion of the requirement limiting the total profits actually earned or the total cost savings actually realized by the controlled transferee from the exploitation of the intangible in all open years to between 80% and 120% of the foreseeable profits or cost savings, because an adjustment in such circumstances would seem difficult to reconcile with the arm's length standard.
>
> It is also recommended that once a transaction has been determined to have been made at arm's length, adjustments should not be made in later years where there were factors beyond the control of any member of the group and these factors were neither anticipated nor reasonably foreseeable.

I. *Treatment of tangibles with intangible elements*

2.34 The recommendations of the Task Force are largely reflected in the revised Regulations with respect to the treatment of tangibles. However, the methodology to be used to check the transfer price of property that involves both tangible and intangible elements is not clear. The revised Regulations provide that because the methods to be applied to transfers of tangible property do not adequately account for significant, non-routine intangibles that may be transferred or used with the sale of property, it may be necessary to adjust the results obtained using the tangible methods with the "principles" of the intangible methods. A similar statement is made with respect to the transfer of property that includes tangible and routine intangible elements.

2.35 Although the treatment of tangibles with intangible elements has been made much more flexible, it is still not clear whether a can of tuna fish sold under a brand name would fall under the tangible rules. If the brand name is regarded as a significant, non-routine intangible, the results of the application of the tangible method may need to be adjusted with the intangible methods. Further guidance in this area is needed because it is not clear how such an adjustment would be made, particularly given that neither the cost plus nor resale price method would ordinarily apply in the case of transfers of intangibles.

2.36 *Recommendation relating to the treatment of tangibles with intangible elements*:

> It is recommended that further guidance be provided as to how the intangible methods are to be applied in the transfer of property that involves both tangible and intangible elements.

III NEW ISSUES

A. *Comparability standard of the comparable uncontrolled price method (CUP)*

3.1 The revised Regulations seem to have a different, more stringent comparability standard for the CUP method than has been used in the past. The preamble of the revised Regulations explains that "although the text of this rule differs somewhat from its counterpart in the final regulations, the changes were intended to be clarifications of the current standard rather than substantive changes". However, the specific text of the revised Regulations suggests otherwise.

3.2 The revised Regulations provide that "for purposes of the comparable uncontrolled price method, transactions are considered comparable only if the tangible property and circumstances of the controlled transaction are substantially the same as those of the uncontrolled transaction. The tangible property and circumstances of an uncontrolled transaction will be considered substantially the same as those of a controlled transaction only if any minor differences between the transactions either have no effect on the amount charged, or can be accounted for by a reasonable number of adjustments. If there are material differences between the controlled and uncontrolled transactions, other methods must be applied such as the resale price method ..., the cost plus method ..., or the comparable profits method ...".

3.3 Since the CUP is generally preferable to other methods, the Task Force considers that the CUP can be applied even where differences are material, if their effect on the prices concerned is definite and reasonably ascertainable. In fact, the same kind of adjustments may be necessary to reach an accurate comparability of margins and mark-up when the resale price or the cost plus methods appear to be applicable. If such adjustments are not allowed, examiners could move too quickly to other less accurate methods, like the CPM.

3.4 *Recommendation on the comparability standard of the CUP*:

> It is recommended that the comparability standard of the CUP method be amended to allow for material differences if the effect on price is reasonably ascertainable.

B. *Comparability standards of the CUT*

3.5 The CUT method applies to cases where an uncontrolled transaction is comparable to a controlled transaction, in practice when there exists a market in which a comparable intangible is being traded. Three conditions must be met to establish that the controlled and uncontrolled intangibles are com-

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parable. Eight additional factors are examined to determine if the "circumstances" of the controlled and uncontrolled transactions are comparable.

3.6 Among the three conditions required to establish the comparability of intangibles, the third condition may be problematic. The condition requires that both intangibles have substantially the same profit potential, as measured by the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, taking into consideration the capital investment and start-up expenses required, the risks to be assumed and other relevant considerations.

3.7 This requires the taxpayer to establish the profit potential of his own intangible, which may sometimes prove to be highly speculative. It also requires the taxpayer to gather data and knowledge about the uncontrolled intangible in order to establish its profit potential. This may be difficult, if not impossible, to obtain because while the uncontrolled transaction may be an arm's length transaction, it is not necessarily a "public" transaction the details of which are readily available and the uncontrolled transaction may be carried out by a competitor who, understandably, will not be anxious to share the financial aspects of its comparable intangible with its rival.

3.8 Compliance with this condition could prove to be impractical, thus making the CUT method virtually inaccessible to taxpayers, even in cases when uncontrolled intangibles exist and all other conditions are met. When the CUT method cannot be used, it is likely that the IRS would then turn to the CPM, which means, as noted above, that the CPM would become the norm rather than the exception.

3.9 The concern regarding the "profit potential" test could be reduced significantly – without compromising its basic policy purpose – by its being worded in the negative. In other words, a taxpayer could not use a comparable where it ought to have been clear at the outset to the taxpayer that the profit potential from the two properties was so different that the situations could not reasonably be considered comparable. Such a modification would ease the burden of proof of the taxpayer, and would prevent denying use of the comparable where the taxpayer has a reasonable expectation that the profit potential of the controlled and uncontrolled properties is similar, but is unable to actually prove that the profit potentials are nearly equal.

3.10 The eight conditions to determine whether the circumstances of the controlled and uncontrolled transactions are comparable appear to be reasonable if looked at individually but impose a very high standard of comparability when taken together. Information about some of these factors – e.g. uniqueness of property, expected economic life of the property, provisions of third party agreements, etc. – may be difficult, if not impossible to obtain for the controlled taxpayer. The inability to obtain such information, in turn, would preclude meeting the conditions and, thus, prevent the use of the method.

3.11 The concerns regarding the application of the CUT method would be significantly diminished with the retention of the comparable adjustable transaction method included in the 1992 proposed regulations – without the requirement that the results obtained be confirmed with the CPM. Retention of the method would permit adjustments to the sales prices for factors which are quantifiable. Provision for such adjustments is made with respect to transfers of tangible property.

3.12 The CUT method is the most appropriate method to use in the case of transfers of intangibles for which comparables exist. Taxpayers should be given every possible chance to use this method even if the uncontrolled property and transaction are not in every respect comparable. It would be unfortunate if the high standards required for the utilisation of the CUT method were to overly restrict the use of the method to near-perfect cases of comparability and of data availability, when adequate comparables exist.

3.13 *Recommendation on the comparability standards of the CUT method*:

> In order to reduce what might otherwise be an impossible compliance burden, it is recommended that the "profit potential" test of the CUT method be revised to prohibit the taxpayer from using a comparable where it should have been clear to the taxpayer at the time the transaction was entered into that the profit potential from the two properties was so different that the situations could not reasonably be considered to be comparable.
>
> It is also recommended that the comparable adjustable transaction method included in the 1992 proposed Regulations be reintroduced but without the requirement of a check of the results with the CPM. This would provide taxpayers greater access to a CUT method.

C. *Problems with comparability of controlled and uncontrolled transactions*

3.14 In general, the Task Force views the revised Regulations as providing considerable guidance on factors which determine comparability. However, the consideration of alternatives realistically available to a buyer or seller would appear to be making a significant change to the nature of the transaction under review. The revised Regulations provide that allocations will be based on the taxpayer's actual transactions except where a controlled transaction lacks economic substance. However, "the district director may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may adjust the consideration charged in the controlled transaction based on the cost of the alternative, but will not restructure the transaction as if the alternative had been adopted by the taxpayer."

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3.15 As a rule, the determination of transfer prices should be made on the basis of actual transactions and actual business choices. Whilst the Task Force recognizes that the revised Regulations provide that this determination must be based on the taxpayers' actual transactions, there is concern that the examination of alternatives may nevertheless be used to second-guess the appropriateness of bona fide business decisions. The construction of alternative business arrangements for the purpose of determining transfer prices would be, at best, an uncertain enterprise and could prove to be arbitrary. In addition, if alternative transactions are to be considered, many factors other than costs, such as the opportunities and risks involved in production, would need to be taken into account.

3.16 Furthermore, no such statutory or regulatory flexibility may be afforded to the revenue authority in the jurisdiction in which the other controlled corporation resides. Thus, double taxation is likely where an adjustment is based on an alternative transaction that the taxpayer could have entered into.

3.17 Another factor that causes concern and may be inconsistent with the arm's length standard is the first step in the risk analysis. The risk analysis required by the revised Regulations "states that the district director must determine which controlled taxpayer bears the risk which includes a consideration of whether the income earned by [the] controlled taxpayer over a reasonable period of time is commensurate with the risk assumed." The use of hindsight in transfer pricing methodologies, as previously stated, is generally inconsistent with the arm's length standard.

3.18 *Recommendation on the problems with comparability of controlled and uncontrolled transactions*:

> It is recommended that the alternative business transactions realistically available to the taxpayer not be used to second-guess the appropriateness of bona fide business decisions except where the transaction lacks economic substance.
>
> It is also recommended that the use of hindsight be eliminated from the risk analysis required by the revised Regulations.

D. *Adjustments to the midpoint of the arm's length range*

3.19 Application of the arm's length range concept to all transfer pricing methodologies is a welcome development. However, there is some doubt as to whether the general rule requiring adjustment to the midpoint of the range is appropriate. Although the mid-point may be as valid as any other point, it may be unfair to place the taxpayer at the midpoint if there is an uneven concentration of arm's length prices. It may therefore be more accurate to put the taxpayer within the range and towards the end of the range that best reflected the facts and circumstances of the controlled taxpayer.

3.20 *Recommendation relating to adjustments to the midpoint of the arm's length range*:

> It is recommended that the revised Regulations be modified to require adjustments to be made to the point within the range that best reflects the facts and circumstances of the controlled taxpayer.

E. *Profit split approach*

3.21 The Task Force is concerned that the administrative requirements for using the profit split approach may be overly restrictive. For example, where the profit-split approach is the most appropriate of the available pricing methods, a taxpayer should be able to use the method without advance reporting and documentation obligations that are not required for other methods. The Task Force Report discussed the advantages of a profit split approach over the CPM and suggested that the CPM not be treated as a more favoured method. However, under the regulations, the CPM might mistakenly be considered a more favoured method because the profit-split is subject to a higher level of reporting and documentation requirements.

3.22 A profit split is only available if both controlled taxpayers own valuable, non-routine intangibles either developed by the taxpayer or acquired from uncontrolled taxpayers. Therefore, it would not appear to cover more conventional transfers of a single intangible from a parent company to a manufacturing subsidiary in a foreign jurisdiction, or the transfer of more conventional intangibles. Whether the method is appropriate should be a question of fact to be determined in accordance with the best method rule. This approach would require a significant liberalization of the conditions under which the method may be used. Such a liberalization would enable taxpayers that are otherwise prevented from using the CUT method to rely on a profit split, instead of the CPM or other methods, provided the use of a profit split is consistent with the best method rule.

3.23 The revised Regulations reintroduce the basic arm's length return method (BALRM), which raises concerns because it relies on hard-to-find comparable rates of return with respect to every function performed in connection with the intangible sold or licensed, instead of relying on generally known data involving more or less comparable situations. Further, there are doubts as to whether unrelated parties do apply functional analysis to determine a sales price or royalty. Substantial manpower would be needed to perform such an analysis, especially since it should be performed during the full life-time of the intangible and not limited to the time of sale or the outset of the licensing agreement. The revised Regulations' BALRM approach does not remove these difficulties.

3.24 The Task Force acknowledges that more work is necessary to determine the proper application of the profit-split method. This will be done in the context of the revision of the OECD 1979 Report.

3.25 *Recommendation relating to profit splits*:

> The Task Force recommends eliminating the advance reporting and documentation obligations required for the use of the profit split method and applying the best

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method rule to determine whether use of such a method is appropriate.

F. *Difficulties created by reporting prices other than actual prices*

3.26 The revised Regulations allow taxpayers, where necessary to reflect an arm's length result, an opportunity to report the results of their controlled transactions based on prices different from those recorded in their books and records. However, this may result in double taxation or non-taxation of income if the other country does not make corresponding adjustments to account for those made by the taxpayer. The laws of some countries may not permit the reporting of amounts other than the amount agreed to by the parties for purposes of the transaction. This issue requires further study in connection with the revision of the OECD 1979 Report.

G. *Compliance burden on taxpayers*

3.27 The revised Regulations increase the flexibility of the acceptable arm's length methodologies and results on the one hand, but impose onerous procedural requirements on taxpayers on the other.

Although requiring some contemporaneous documentation is acceptable, if seems unduly burdensome to require taxpayers to conduct extensive studies that depend on information that may not be available, before determining each transfer price. The documentation requirements should be realistic and not excessive, particularly in the case of the corresponding regulations governing transfer pricing penalties. Further, a taxpayer should not be deprived of the opportunity to use a method even if the method is not documented before the return is filed.

3.28 Under the revised Regulations, a taxpayer who engages in a variety of businesses will have to examine numerous tax requirements before filing a return that reports transactions with related parties. Requiring taxpayers to perform excessively intricate tax analyses before entering into transactions will distort the normal practice of business and deter international trade and foreign investment, although it is accepted that some appropriate analysis should be required before the taxpayer files its return.

3.29 *Recommendation on compliance burden on taxpayers:*

> It is recommended that a taxpayer's documentation requirements be limited to information to which the taxpayer could reasonably be expected to have access and that there be a limit on the intricate tax analyses required of taxpayers before entering into transactions in order not to disrupt international trade and foreign investment. Further, a taxpayer should not be deprived of the opportunity to use a method even if the method is not documented before the return is filed.

H. *Safe harbour*

3.30 The Task Force recommended that the United States provide a safe harbour for small businesses in order to avoid the compliance burden associated with the use of the comparable profits method. Acknowledging that the concept of safe harbours requires further work by the OECD, the Task Force was reluctant, in view of the limited time available to it, to make any specific recommendations on the safe harbour.

3.31 Under the safe harbour rules of the revised Regulations, no adjustment will be made when a qualifying taxpayer elects the safe harbour provisions. The electing taxpayer is required to determine its taxable income by applying profit level indicators to be published in a revenue procedure by the IRS. Since the profit level indicators have yet to be disclosed, it is not possible to assess them.

3.32 As the Task Force Report mentions, difficulties would arise if a safe harbour provision resulted in the attribution of more profit to the United States than the subsequent application of the arm's length standard would attribute. The preamble of the revised Regulations states that ... some taxpayers may find that the results they achieve under the safe harbour are somewhat less favourable than they could have achieved if they did not elect the safe harbour..." which suggests that the risk of a shift of profits to the United States may be unavoidable. In order to avoid such a result, the Task Force Report suggests adopting an approach "that is likely to give the taxpayer a more favourable result than the strict application of the arm's length standard". It is hoped that the profit level indicators adopted will attempt to achieve such a result.

3.33 There is also concern about the inability to revoke the election to use the safe harbour without the consent of the Commissioner. If such consent is difficult to get, taxpayers will be forced to shift income to the United States to meet the profit level indicator even where it is apparent that their actual taxable income is below the indicator.

3.34 Permanent establishments are excluded from the safe harbour benefits. To the extent that such exclusion may violate the non-discrimination provisions of tax treaties, it should be reconsidered.

3.35 *Recommendation with respect to the safe harbour:*

> It is recommended that the profit level indicators be chosen with a view to providing the taxpayer with a result that is likely to be more favourable than that which would be achieved under a strict application of the arm's length standard and that the safe harbour be applied in a non-discriminatory manner.

IV CONCLUSIONS

A. *Main Recommendations*

4.1 The Recommendations set out below would, if adopted, alleviate the problems with the revised Regulations, as identified in this Report. They would also ensure that the international consensus referred to above would be maintained.

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4.2 The main recommendations are:

Recommendation on application of the revised regulations in the context of a mutual agreement procedure or arbitration process:

It is recommended that the United States issue a general policy statement confirming that it will not be bound by the revised Regulations when dealing with a case through the mutual agreement procedure or arbitration process of a tax convention.

Recommendation on concentration on abusive cases:

For the reasons set forth in the Task Force Report, especially as the Task Force recognizes that the CPM remains at the experimental stage and requires further testing before its precise impact in the transfer pricing area can be determined, it is recommended that to the extent that the CPM is used to determine the amount of the adjustment to be made in a particular case, it should only be used in abusive cases and as a method of last resort (for example, CPM may be used in a case where no other method is more appropriate or can reasonably be applied, with the result that both the taxpayer and administration agree that its use on a consistent basis will produce an acceptable result for practical purposes).

Recommendation on the priority of methods:

Given the stated preference in the revised Regulations for transactional methods for determining intercompany transfer prices, it would be desirable if such a preference were clearly reflected in the process leading to the choice of a method by examiners.

As recommended in the Task Force Report, the revised Regulations should allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments.

Recommendation on the lack of available data to implement the CPM:

The Task Force reiterates its initial recommendation that the data used for the purposes of the comparable profit method to determine the arm's length range be drawn from information that is available to the public or to which the taxpayer could reasonably be considered to have access or from other information that is available to tax authorities that could be shared with the taxpayer. All such data used by an examiner in constructing the arm's length range for the purposes of the comparable profit method should be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and exchange of information.

Recommendation relating to the application and role of the CPM:

It is recommended that the CPM's standards of comparability be more precisely defined, in particular in relation to their interaction with the best method rule.

To prevent IRS examiners from going too quickly to the CPM, it is recommended that the revised Regulations make it clearer that methods requiring stricter comparability are more appropriate than methods with looser comparability standards even if the other factors of the best method rule have been met. This concept may be inherent in the best method rule but should be explicitly stated.

It is also recommended that adjustments of profit level indicators of comparable parties be required to achieve greater consistency. If appropriate adjustments cannot be made, the party should not be used as a comparable.

Recommendation concerning application of periodic adjustments:

It is recommended that the Task Force's original recommendation that periodic adjustments be confined to truly abusive cases be adopted. Although it is recognized that the exceptions to periodic adjustments were broadened, the Task Force recommends deletion of the requirement limiting the total profits actually earned or the total cost savings actually realized by the controlled transferee from the exploitation of the intangible in all open years to between 80% and 120% of the foreseeable profits or cost savings, because an adjustment in such circumstances would seem difficult to reconcile with the arm's length standard.

It is also recommended that once a transaction has been determined to have been made at arm's length, adjustments should not be made in later years where there were factors beyond the control of any member of the group and these factors were neither anticipated nor reasonably foreseeable.

Recommendation relating to the treatment of tangibles with intangible elements:

It is recommended that further guidance be provided as to how the intangible methods are to be applied in the transfer of property that involves both tangible and intangible elements.

Recommendation on the comparability standard of the CUP:

It is recommended that the comparability standard of the CUP method be amended to allow for material differences if their effect on price is reasonably ascertainable.

Recommendation on the comparability standards of the CUT method:

In order to reduce what might otherwise be an impossible compliance burden, it is recommended that the "profit potential" test of the CUT method be revised to prohibit the taxpayer from using a comparable where it should have been clear to the taxpayer at the time the transaction was entered into that the profit potential from the two properties was so different that the situations could not reasonably be considered to be comparable.

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It is also recommended that the comparable adjustable transaction method included in the 1992 proposed Regulations be reintroduced but without the requirement of a check of the results with the CPM. This would provide taxpayers greater access to a CUT method.

Recommendation on the problems with comparability of controlled and uncontrolled transactions:

It is recommended that the alternative business transactions realistically available to the taxpayer not be used to second-guess the appropriateness of bona fide business decisions except where the transaction lacks economic substance.

It is also recommended that the use of hindsight be eliminated from the risk analysis required by the revised Regulations.

Recommendation relating to adjustments to the midpoint of the arm's length range:

It is recommended that the revised Regulations be modified to require adjustments to be made to the point within the range that best reflects the facts and circumstances of the controlled taxpayer.

Recommendation relating to profit splits:

The Task Force recommends eliminating the advance reporting and documentation obligations required for the use of the profit split method and applying the best method rule to determine whether use of such a method is appropriate.

Recommendation on compliance burden on taxpayers:

It is recommended that a taxpayer's documentation requirements be limited to information to which the taxpayer could reasonably be expected to have access and that there be a limit on the intricate tax analyses required of taxpayers before entering into transactions in order not to disrupt international trade and foreign investment. Further, a taxpayer should not be deprived of the opportunity to use a method even if the method is not documented before the return is filed.

Recommendation with respect to the safe harbour:

It is recommended that the profit level indicators be chosen with a view to providing the taxpayer with a result that is likely to be more favourable than that which would be achieved under a strict application of the arm's length standard and that the safe harbour be applied in a non-discriminatory manner.

B. *Follow-up*

4.3 The Task Force believes that with the completion of this Report, it has fulfilled the Mandate given to it by the Committee on Fiscal Affairs to review the US 482 Regulations. Nevertheless, the Task Force feels that it would be necessary to continue the dialogue with the United States on the implementation of the revised Regulations. As noted in the 1993 Task Force Report and by numerous commentaries in the public and private sectors, the impact of the revised Regulations on taxpayers will, to a large extent, depend upon how they are implemented. In particular, the attitude of the IRS auditors will be crucial.

In that context, the Task Force suggests that:
i) it would be useful if the US were to agree to present to the Task Force the guidelines for IRS auditors that are currently being prepared.
ii) at the December 1994 meeting, Working Party No. 6 could devote a half-day session to examining the operation of the Regulations. This review could examine any experience gained with transfer pricing audits (although it is recognized that this is unlikely to be extensive by end 1994) and the compliance experience of taxpayers. BIAC could be invited to participate in part of this session.

4.4 The Task Force also recommends that the Temporary Regulations not be finalized before it completes its review of the OECD 1979 Report.

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UNITED STATES:

THE 1993 US TAX ACT WILL AFFECT INTERNATIONAL TRANSACTIONS

Philip H. Spector

On 10 August 1993, President Clinton signed into law the final compromise version of the Omnibus Budget Reconciliation Act of 1993 (the "Act"). The Act, the result of six months of political struggle, is intended to reduce the US federal budget deficit through a combination of tax increases and spending reductions. The most publicized tax increases target high-income individuals, who now face a 39.6 percent top marginal personal income tax rate.

One of President Clinton's campaign promises was to ensure that foreign companies doing business in the United States pay their "fair share" of US taxes. This politically popular sentiment is borne out in the Act's transfer pricing penalty provisions. However, US multinational companies will feel this bite of the Act's international provisions to a far greater degree than will foreign companies. Moreover, while President Clinton's original economic proposals emphasized the need for capital investment in the United States, some of the Act's provisions may have the effect of encouraging US multinationals to locate or expand operations overseas.

Unfortunately, the Act does not include any of the recently proposed broad simplification proposals, which would dramatically simplify the taxation of US multinationals' overseas income. Instead, the Act adds yet another layer of complexity to these already difficult rules.

This article summarizes the principal provisions of the Act affecting international business transactions, identifies taxpayer exposure and suggests possible responses.

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Contents

I. Provisions Affecting US Multinationals
- A. Partial repeal of deferral of US tax on active overseas earnings
- B. PFIC rules likely to reach more foreign companies
- C. Foreign tax credit

II. Provisions Affecting Inbound Investment and Financing US Operations
- A. Guaranteed debt now subject to "earnings stripping" rules
- B. Contingent interest not eligible for "portfolio interest" exemption
- C. Conduit financing arrangements

III. Transfer Pricing
- A. Transfer pricing penalty provisions expanded

IV. Possessions Corporations
- A. New limitations on Section 936 benefits

I. PROVISIONS AFFECTING US MULTINATIONALS

A. *Partial repeal of deferral of US tax on active overseas earnings*

US persons generally are taxed currently on their worldwide income. In contrast, US tax on earnings of a foreign corporation that is owned by US persons normally is deferred until the corporation pays a dividend. Several US tax regimes reverse this deferral and tax US shareholders directly and currently on the foreign corporation's earnings.

Under the "controlled foreign corporation" ("CFC") rules, US persons that own at least 10 percent of the voting stock of a foreign corporation are taxed directly on certain corporate earnings if such 10 percent-US shareholders own, in the aggregate, more than 50 percent of the corporation's stock (by vote or value). The income taxed to US shareholders includes passive investment income such as interest, dividends, capital gains, rents and royalties, and certain sales and services income from transactions undertaken for or involving related parties (so-called "Subpart F income"). In addition, US shareholders are taxed currently when the CFC increases its investments in certain US property (including loans to certain US affiliates). Before the Act, the CFC rules did not tax US shareholders on the foreign corporation's active business earnings, even if those earnings were accumulated in passive investments.[1]

1. New excess passive asset inclusion

Congress determined that neither the CFC nor the PFIC regimes sufficiently restricts the benefits of deferral in the case of CFCs that accumulate excessive amounts of earnings without reinvesting them in active business assets. The Act

1. However, another set of rules, the "passive foreign investment company" ("PFIC") rules do eliminate deferral in the case of foreign corporations that allow undistributed earnings to accumulate in passive assets to such an extent that the corporation's passive assets equals or exceeds its business assets. See discussion at I.B.

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addresses this perceived deficiency by requiring 10 percent-US shareholders of a CFC to include in income currently the CFC's post-1993 accumulated earnings to the extent invested in "excess passive assets".

Generally, the new amount included by 10 percent-US shareholders is the lesser of: (1) the shareholder's share of the CFC's "excess passive assets" and (2) the shareholder's share of the CFC's current and accumulated earnings. "Excess passive assets" is the amount by which the CFC's passive assets exceed 25 percent of the CFC's total assets. "Passive assets" are assets that produce, or are held for the production of, passive income, such as dividends, interest, royalties and rents. All assets are valued by reference to the average of their adjusted basis at the end of each quarter of the year. For purposes of these provisions, only earnings for taxable years beginning after 30 September 1993 are taken into account. Also, a complex series of rules avoids double inclusions of the same earnings under the three CFC inclusion schemes (See the following Example for an illustration of the operation of the new rules).

EXAMPLE

Operation of the New Excess Passive Assets Rule

Assume that a US corporation owns all of a CFC's stock, that this is the first year of the CFC to which the new rules apply, and that the CFC's assets, post-1993 earnings and profits, and Subpart F income are as follows:

Total assets	100
Passive assets	40
Excess passive assets (40 minus 25% of 100)	15
Year-end post-1993 accumulated E&P	25
Subpart F income	5
Amount includible under new excess passive rule	10

The US shareholder has two inclusions under the CFC rules: a Subpart F income inclusion of 5 and an excess passive asset inclusion of 10. The latter inclusion is the lesser of two amounts. The first amount is 10, the amount by which the excess passive assets (15) exceed amounts previously included (or treated as included) under the new rule (5). For this purpose, the current Subpart F inclusion of 5 is treated as an amount previously included under the new rule because these $ 5 of earnings would have been taxed under the excess passive asset rules if the Subpart F income rules did not apply first. The second amount is 20, the excess of the year-end post-1993 accumulated E&P (25) over amounts previously included (or treated as included) under the new rule (5). At the end of the year, 15 is the amount deemed previously included in the US shareholder's income under the new rule, and the accumulated E&P of 25 remains unaffected by the income inclusions.

2. Look-through and CFC chain rules

Under a look-through rule, a foreign parent CFC is treated as owning a pro rata portion of the assets of 25 percent-owned subsidiaries. In addition, excess passive assets are determined on an aggregate basis for each CFC in one or more chains of related CFCs linked by more than 50 percent stock ownership with a top-tier CFC. Thus, a US multinational using a central holding company to own several chains of CFCs must treat the holding company and its CFC subsidiaries as one company for purposes of applying the excess asset test. If the CFC group taken as a whole has excess passive assets, this excess is allocated among the CFCs based on each CFC's proportionate share of the group's earnings. This allocation is significant because it can result in a deemed dividend from a CFC that holds no passive assets. The purpose of the CFC group rule is to prevent avoidance of the new inclusion by having one CFC transfer passive assets to another related CFC that owns little passive assets.

3. Working capital is a passive asset

Working capital is treated as a passive asset. A CFC that requires substantial working capital invested in liquid assets, even temporarily, could trigger inclusions under the new rule. Many companies require working capital in excess of 25 percent of total assets for legitimate non-tax business reasons (e.g. to acquire new inventory, or in the case of a service business that owns few fixed assets). The new rules will affect such companies, and others, even if they hold excess passive assets only temporarily. For example, the rules can apply to a company engaged in an active business that disposes of its assets and holds the proceeds for a short period before investing them in another active business. Similarly, the rules may apply to a company in its first taxable year if it is not able to invest its initial capital quickly enough in active assets.

4. Assets valued at adjusted basis

In determining "excess passive assets", passive assets and total assets are valued by reference to their adjusted basis rather than fair market value. Active business assets (e.g. machinery and equipment) often have a depreciated basis. Passive assets, on the other hand, are generally not depreciable, and will have an adjusted basis close to fair market value. A CFC with substantial depreciated assets can have "excess passive assets" even though the value of its passive assets does not exceed 25 percent of the value of its total assets. Foreign manufacturing subsidiaries with large amounts of substantially depreciated active assets could be affected by the rule.

5. Certain expenditures added to total assets

Since CFCs frequently invest in activities that generate intangible assets that have no tax basis, the Act has special rules to increase the amount of the CFC's total assets for certain research expenditures. These rules can mitigate a CFC's excess passive assets by increasing the CFC's total assets. The amount of a CFC's total assets is increased by (i) qualified research expenditures including cost-sharing payments (but net of reimbursements) that the CFC made during the current year and its two prior tax years, (ii) three times the royalties the CFC paid (other than to related foreign persons) for the licensing of intangibles that are used in the CFC's business operations, and (iii) the unamortized portion of the present value of lease payments made by the CFC under a lease of 12 years or more of tangible personal property used in its business.

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6. CFC investments in US property

As under present law, the amount by which a CFC's investment in certain US property has increased from the preceding year is a deemed dividend to its 10 percent-US shareholders (Section 956). The Act revises the formula for calculating the increased amount invested in US property. Most importantly, the increase will now be based on the average amount of US property held at the end of each quarter, rather than the amount held at the end of the year. As a result, it will be more difficult for a CFC to fund US affiliates with short-term loans (which are considered investments in US property) without triggering a deemed dividend. Also, because of the quarterly average, CFCs that affirmatively use Section 956 at the end of the year (e.g. to draw out foreign tax credits carried in deemed dividends) must substantially increase the amount invested in US property to obtain the desired Section 956 inclusion.

The Section 956 rules have been modified so that a US shareholder will no longer have an income inclusion greater than its actual investment in US property, as was possible under prior law when the CFC's earnings fluctuated but the amount invested in US property remained the same.

7. Other changes to the CFC rules

• The "same country" exception, which excludes from Subpart F income dividends and interest received by a CFC from a corporation organized in the same country as the CFC, no longer applies to dividends attributable to profits accumulated while the recipient did not hold (directly or indirectly) the stock of the payor corporation, including any period when the recipient was not in existence.

• As under present law, US taxpayers are allowed to increase their foreign tax credit limitation when a CFC distributes income that was previously taxed directly to the US shareholder. Under the Act, the amount of the increase will be calculated by reference to a single "excess limitation account", rather than by reference to the complicated separate calculations required under present law.

8. Effective date

The new excess passive asset inclusion and the other changes to the CFC rules are effective for taxable years of CFCs beginning after 30 September 1993 and for taxable years of US shareholders in which or with which the CFC's taxable year ends. There is no transitional rule that would allow CFCs a reasonable amount of time to adjust their asset holdings before the passive asset rules take effect.

9. Planning for the excess passive assets regime

The creation of the third level of income inclusions under Subpart F will require additional tax planning by US shareholders and their CFCs. US shareholders of CFCs will probably not be affected by these new rules if they reinvest those earnings in non-passive income-generating activities, even if the earnings are loaned to related foreign entities investing those funds in similar activities. Nonetheless, given the complexity of these rules, US shareholders will have to constantly monitor the composition of their CFCs' assets and income streams. US shareholders may want to consider increasing the rents and royalties that their CFCs now pay (subject to arm's length standards) as a way of increasing total assets and mitigating the amount of the CFC's excess passive assets (see I.A.5 above).

B. *PFIC rules likely to reach more foreign companies*

A US person that owns stock in a foreign corporation that is a "passive foreign investment company" ("PFIC") must either (1) include currently in income its share of the PFIC's total earnings, or (2) defer such inclusion and pay an interest charge on the amount deferred when the income is realized (e.g. through actual or deemed distributions by the PFIC or through gains from selling PFIC stock). A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year is passive income, or (2) 50 percent or more of its total assets consist of assets that produce, or are held for the production of, passive income.

1. Adjusted basis must be used by CFCs

Under prior law, assets were generally measured by their fair market value, but corporations could elect to use adjusted basis. Valuation at adjusted basis ordinarily would increase the likelihood of PFIC status because the value of active assets often exceeds their depreciated basis.

The Act requires assets to be measured only by reference to their adjusted basis for purposes of determining the PFIC status of a CFC and the impact on its 10 percent-US shareholders. Foreign corporations that are not CFCs may still elect to measure assets by either fair market value or adjusted basis, as may CFCs with respect to less than 10 percent-US shareholders. The use of adjusted basis to measure assets will likely cause many more CFCs to become subject to the PFIC rules.

On the positive side, for purposes of the asset test, a foreign corporation's total assets are increased for certain research expenditures and rent and royalty expenses, in the same manner that total assets are increased for purposes of the "excess passive assets" inclusion rule described at I.A.5.

2. PFIC relief for securities dealers

The Act provides relief from the PFIC rules for some foreign securities dealers by excluding from the definition of passive income interest, dividends and other income derived in the active conduct of a securities business by certain registered securities brokers or dealers.

C. *Foreign tax credit*

1. Research expense allocation

The Act extends for one additional year the following scheme for allocating research and experimental expenses between US and foreign sources:

– First, research expenses are allocated entirely to income from one country or geographical area if they were

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incurred to meet local legal requirements and cannot reasonably be expected to generate income outside that location;

- Second, 50 percent of any remaining research expenses, to the extent attributable to research performed within the United States, is allocated against US source income, and 50 percent of any remaining expenses attributable to research performed outside the United States is allocated to foreign source income; and
- Last, any remaining research expenses are allocated between US and foreign source income on the basis of either the ratio of US and foreign gross receipts from sales of products to which the research relates, or the ratio of the taxpayer's US source gross income and foreign source gross income, except that the amount allocated to foreign sources under the gross income method must be at least 30 percent of the amount that would have been allocated to foreign sources under the gross sales method.

2. Shipping and oil and gas investment income

The Act prevents cross-crediting of foreign taxes on foreign oil and gas and foreign shipping income by placing certain income from investment of working capital in the "passive income" separate limitation category. In addition, any income that qualifies as both passive income and as oil or shipping income will from now on be treated as passive income. The changes will be felt primarily by oil companies and shipping companies with significant passive income.

II. PROVISIONS AFFECTING INBOUND INVESTMENT AND FINANCING US OPERATIONS

A. *Guaranteed debt now subject to "earnings stripping" rules*

"Earnings stripping" refers to the practice of transferring the earnings of a US subsidiary to its foreign parent in the form of tax-deductible interest payments. Many US tax treaties exempt interest payments from US withholding tax. Repatriation of earnings in the form of dividends is not as tax efficient because dividend payments are not deductible by the US subsidiary and tax treaties do not eliminate the US withholding tax on dividends.

Convinced that foreign companies were abusing the tax advantages of capitalizing their US corporate affiliates with debt rather than equity, Congress in 1989 limited the ability to "strip" earnings out of a US corporation through interest payments. The means was a limitation on the deductibility of interest paid to related lenders that are exempt, in whole or in part, from US tax on the interest received. The current "earnings stripping" rule disallows a current deduction for interest paid or accrued to related persons not subject to US tax on the interest received, but only to the extent that the payor's net interest expense exceeds, generally, 50 percent of the payor's operating cash flow, and only if the payor corporation's "debt-equity ratio" is greater than 1.5 to 1 on the last day of its taxable year.

1. New guarantee rules

Before the Act, only loans made by foreign related parties were subject to the earnings stripping rules because Congress concluded that only related parties were able to contract with themselves to arrange an artificially high debt capitalization. The rules have been avoided by some foreign-controlled US corporations by substituting unrelated party debt guaranteed by the foreign parent for a borrowing by the US corporation from its foreign parent. The Act focuses on this financing technique and subjects the guaranteed debt to the earnings stripping rules.

Specifically, any interest paid or accrued in tax years beginning after 31 December 1993 to an unrelated lender on debt for which there is a "disqualified guarantee" will be subject to the earnings stripping rules, unless the lender is subject to US withholding tax on the interest. Four observations:

- Very rarely will the lender be subject to US withholding tax on the interest. The lender will likely be a US bank that is subject to net basis taxation (rather than withholding tax) or a foreign lender entitled to a treaty exemption from withholding tax.
- The rules apply whether or not the unrelated lender is subject to full US net basis tax on the interest received.
- These rules apply whether or not the foreign related party guarantor would be eligible for a treaty exemption from US withholding tax if the interest had been paid directly to it.
- As discussed below, the scope of what constitutes a "guarantee" is extremely broad.

There are two exceptions to the guaranteed debt rules, both of limited practical application. First, debt guaranteed by a foreign related party controlled by the borrower (upstream guarantees) is not subject to the earnings stripping rules. Thus, borrowings from a foreign subsidiary would be subject to the earnings stripping rules, but third party borrowings guaranteed by a foreign subsidiary would not. Second, the rules do not apply if the foreign related party guarantor would be subject to US net basis taxation if it had received the interest directly. This exception appears limited to situations in which the guarantor is a foreign person engaged in a US trade or business to which the interest, had it been received by the guarantor, would have been attributable.

2. Definition of "guarantee"

A "disqualified guarantee" is defined to include any arrangement under which a related party directly or indirectly assures, on a conditional or unconditional basis, the payment of the borrower's obligation. Congress intends that the term be interpreted broadly enough to encompass any form of credit support. This includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability. It includes an arrangement reflected in a "comfort letter", regardless of whether the arrangement gives rise to a legally enforceable obligation. If a guarantee is contingent

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upon the occurrence of an event, the rules apply as if the event had occurred.

The definition of guarantee is broad enough to include arrangements that, while not legally enforceable as guarantees, may have the economic effect of supporting the borrower's credit. If, for example, a foreign parent deposits with a foreign bank an amount equal to the amount borrowed from that bank by its US subsidiary, the deposit would likely be viewed as a disqualified guarantee. As another example, suppose a US subsidiary borrows from its foreign parent, which in turn borrows from the public. Although the parent-subsidiary borrowing may technically be subject to the current earnings stripping rules, some commentators had hoped that the IRS would treat this arrangement as a public borrowing by the US subsidiary and not subject to the rules. Now, the arrangement might be viewed as a public borrowing by the US subsidiary that is guaranteed by its foreign parent. It should also be noted that the rules will apply to publicly-held notes directly issued by th US subsidiary and guaranteed by the foreign parent.

3. Effective dates

The effective date provisions of the provision are unusual. When Congress enacts legislation affecting the taxation of debt instruments, there is typically an exception (a so-called "grandfather") for debt issued before announcement of the proposal and frequently for debt issued after the announcement but under a commitment entered into before the announcement. Under the Act, however, interest on all debt guaranteed by a foreign related party, whenever issued, will be subject to the provisions in tax years beginning after 1993.

In addition, the Act retroactively makes the original 1989 earnings stripping rules applicable to all related party debt obligations issued before 11 July 1989. Most debt issued before that date had been "grandfathered" under the original 1989 legislation.

4. Reaction and retaliation

By extending the earnings stripping rules to unrelated party debt, the rules have been removed from the original policy notion that related parties could contract with each other to pay interest that is deductible by the borrower and not taxable to the lender. Now, the rules apply even if interest is paid to a fully taxable US bank or to taxable US holders of securities issued by a US corporation and guaranteed by its foreign parent.

The new rules are bound to invite retaliation from foreign governments. The rules appear to violate the non-discrimination clause in most US income tax treaties to the effect that a US enterprise owned by treaty partner shareholders cannot be "subjected in [the United States] to any taxation or any requirement connected therewith that is other or more burdensome than" the taxation and related requirements to which a US-owned US enterprise would be subject. A borrowing by a US subsidiary of a US-owned corporation and guaranteed by the parent would not be subject to these rules. Moreover, although many US trading partners have thin capitalization rules that arguably provided some legitimacy for the original earnings stripping legislation, we are not aware of any analogous foreign rules treating unrelated party debt guaranteed by a related person as the equivalent of related party debt. Notwithstanding these arguments, Treasury officials have taken the position that the guarantee rules do not violate non-discrimination clauses.[2]

5. Planning to mitigate earnings stripping

To avoid the impact of the earnings stripping rules, many US borrowers will need to refinance guaranteed debt. More generally, strategies to avoid these rules include replacing debt with preferred stock and effecting sale- and leasebacks for assets that are now debt-financed. Both of these strategies could improve the borrower's debt-equity ratio and reduce interest expense.

B. *Contingent interest not eligible for "portfolio interest" exemption*

US source interest income earned by a foreign corporation or non-resident alien individual is subject to a 30 percent gross basis withholding tax, unless the income is attributable to a US business conducted by the recipient, or an exemption under US law or a tax treaty applies. An important US law exemption from the withholding tax on interest applies to "portfolio interest" received by foreign persons. Generally, portfolio interest is any US source interest (including original issue discount) that is not attributable to a US business conducted by the recipient and (1) is paid on an obligation that is either in registered form, or is in bearer form but satisfies certain requirements, and (2) is not received by a 10 percent-owner of the issuer of the obligation, taking into account shares owned by attribution. In addition, the exemption is not available for certain bank loans and in certain other circumstances.

Under prior law, foreign investors had a strong incentive to structure US investments that have equity participation rights so that the returns were characterized as interest income that is eligible for the portfolio interest exemption, rather than other forms of income. For example, a foreign owner of a note that pays interest contingent on appreciation in US real property was subject to US income tax if he sold the note, but if he held the note and received payments under its terms, the interest could be exempt portfolio interest. Congress determined that the portfolio interest exemption should not be available in such cases.

1. Contingent interest defined

The Act makes the portfolio interest exemption inapplicable to certain "contingent interest" received by foreign persons.

2. See letter from Roger C. Altman, Deputy Secretary of the Treasury, to James A: Harmon, 8 September 1993, reprinted in *Highlights & Documents* (17 September 1993). Mr Altman states that the provision does not subject similarly situated corporations to dissimilar treatment because a loan guaranteed by a foreign parent can erode the US tax base, while a loan guaranteed by US parent cannot; hence, a US-owned corporation is not "similar" to a foreign-owned corporation. Query whether non-discrimination clauses have any value at all if a US-owned subsidiary is *per se* dissimilar to a foreign-owned subsidiary, thereby justifying dissimilar treatment. Mr. Altman also defends the provision on thin capitalization grounds, the same defense to treaty violation claims asserted when the original legislation was enacted in 1989.

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Such interest will be subject to US withholding tax unless a treaty exemption is available. Contingent interest is defined broadly, but numerous exceptions are specified.

Contingent interest includes interest determined by reference to any of the following attributes of the debtor or any person related to the debtor: receipts, sales or other cash flow; income or profits; or changes in the value of property. Thus, for example interest that is computed as a percentage of the borrower's profits would not be entitled to the tax exemption for portfolio interest.

In addition, contingent interest includes interest determined by reference to any dividend, partnership distribution or similar payment made by the debtor or a related person. For example, interest is contingent where its receipt by the foreign investor is contingent upon the payment of a dividend to the shareholders of the corporate borrower.

Only the contingent portion of interest is disqualified from portfolio treatment. If the interest rate on a note is stated in terms of the greater of either of two amounts (e.g. 6 percent of the principal amount or 10 percent of gross rents), only one of which is a contingent amount, it appears that only the excess of the contingent amount, if any, over the minimum fixed amount would be disqualified.

Although the statute is not specific, it seems clear that interest based on formula tied to an index of interest rates (e.g. LIBOR plus one) is not contingent interest for purposes of this provision.

2. Exceptions: interest not considered contingent

An obligation that otherwise qualifies for the portfolio interest exemption will not be disqualified merely because it possesses one or more of the following features:

• *Borrower default*. Interest is not contingent merely because its payment can be impaired by a default on the debt obligation by the borrower.

• *Timing contingencies*. Interest is not considered contingent merely because the timing of the interest or any related principal payment is subject to a contingency. For example, assume that the terms of a debt obligation provide that if the borrower has insufficient cash to make an interest payment, the borrower may defer the payment, but this does not eliminate the borrower's liability for the deferred amount. In this case, the interest is not considered contingent.

Interest on securitization investments, such as certain mortgaged-backed obligations, can also come within this exception. For example, if the maturity of an interest in a REMIC or other collateralized instrument is dependent upon prepayments on the underlying mortgage obligations (or other collateral), the interest received on the investment would not be treated as contingent because of this feature.

• *Non-recourse debt*. Portfolio interest treatment is not denied under the Act solely because the interest is paid on non-recourse or limited recourse indebtedness. For example, this exception would apply where a corporation issues a limited recourse debt instrument that pays fixed interest and is secured by the corporation's trade receivables or operating assets.

• *Interest determined by non-contingent interest*. Interest also is not denied portfolio treatment under the Act if all or substantially all of it is determined by reference to certain other amounts of interest that is not described as contingent above (or by reference to the principal amount of indebtedness on which such other interest is paid). This exception is targeted to securitization structures where debt obligations (e.g. mortgages) serve as the collateral for the instrument owned by the investor, or where the interest received by the investor is otherwise dependent upon cash flow from the underlying obligations. If the interest on the underlying obligations is not considered contingent under the rules of this provision, then the interest received by the investor is not contingent.

• *Interest linked to actively traded property*. Interest is not contingent, and is eligible for portfolio interest treatment, if it is determined by reference to changes in the value of (or any index of the value of) any "actively traded property". Based upon proposed regulations, actively traded property generally would include any personal property, including stock (other than stock in a US real property holding corporation) for which there is an established financial market (e.g. a national or foreign securities exchange, a domestic commodities board of trade).

Portfolio treatment also is not denied if the interest is determined by reference to the yield (or any index of the yield) on such actively traded property. However, this exception does not apply if the property is a debt instrument that itself pays contingent interest, or the actively traded property is stock or other property that represents a beneficial interest in the borrower or a related person.

• *Hedging transactions*. Interest is not denied portfolio treatment solely because the borrower or a related person enters into a hedging transaction to reduce the risk of interest rate or currency fluctuations with respect to the debt. For example, portfolio treatment is not denied in the case of a debt instrument that pays interest in an amount determined by reference to the value of a commodities index merely because the debtor hedges its interest rate risk on the debt by acquiring an offsetting position in commodities which produces a cash flow that correlates with the interest payments. As another example, portfolio treatment is not denied in the case of a debt instrument that pays interest in an amount determined by reference to the value of a stock market index merely because an affiliate of the debtor holds stock which is publicly traded on that market.

The IRS is given authority to describe additional categories of contingent interest and to exempt additional types of interest from denial of portfolio treatment. In addition, Congress expects the IRS to challenge inappropriate taxpayer use of the exceptions specified above.

3. Relationship to tax treaties

Interest that is classified as contingent interest and ineligible for the "portfolio interest" exemption may still qualify for an

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exemption from US withholding tax under a tax treaty. The new rule does not override existing treaties that reduce or eliminate US withholding tax on interest.

4. Effective date

The provision applies to interest received after 31 December 1993. It does not apply, however, to any interest paid or accrued on indebtedness with a fixed term that was issued on or before 7 April 1993, or was issued after such date pursuant to a written binding contract in effect on such date and at all times thereafter before the indebtedness was issued.

C. *Conduit financing arrangements*

The Act authorizes the IRS to issue regulations recharacterizing any multiple-party financing as a transaction directly between two (or more) of the parties where necessary to prevent tax avoidance.

This provision is designed to give the IRS broader powers to attack transactions using "conduit" entities. Where three parties have engaged in a chain of transactions, the IRS and the courts have at times ignored the "middle" party as a mere "conduit" and imposed tax as if a single transaction had been carried out between the parties at the ends of the chain.

A classic example of a conduit arrangement is a back-to-back loan. For example, foreign party A wishes to make a loan to US borrower C, but the interest payments made by C to A would be subject to US withholding tax. Instead of a direct loan to C, A makes a loan to foreign party B, which is eligible for a treaty exemption from US withholding tax. B, in turn, makes a closely matching loan to C. This type of transaction has been recharacterized as a direct loan by A to C. The IRS reached a similar result in cases where the back-to-back related party debt obligations are not closely matched so long as the intermediary entity does not obtain "complete dominion and control" over the interest payments. The IRS has taken a similar position where an unrelated financial intermediary is interposed between the two related parties as lender to one and borrower from the other, and the intermediary would not have made or maintained the loan on the same terms without the corresponding borrowing. In a recent ruling, the IRS held that interest payments by a US company to a related, treaty-protected financial intermediary may be treated as payments by the US company directly to the foreign parent of the financial intermediary even though the matching payments from the intermediary to the parent are not interest payments, but rather are dividends.

The IRS' own positions on conduit arrangement are ambiguous and inconsistent. A coherent set of principles is difficult to discern. A single uniform set of rules addressing these issues would assist taxpayers and the IRS. However, the regulatory authority granted to the IRS in the Act specifies that the IRS will not be bound, in developing regulations, by the standards on which the IRS' prior guidance has been based. This broad power may make this area of the law even less predictable than it already is. Hopefully, whatever rules the IRS develops will apply prospectively only.

III. TRANSFER PRICING

A. *Transfer pricing penalty provisions expanded*

The Act's transfer pricing provisions focus on penalties for violating arm's length pricing rules and on documentation requirements, rather than on substantive arm's length pricing formulas.[3]

To encourage taxpayers to adhere to arm's length transfer pricing, present law imposes penalties for tax deficiencies attributable to transfer pricing adjustments. A 20 percent penalty applies to underpaid tax attributable to transfer pricing adjustments that increase tax liability by more than $ 10 million. A 40 percent penalty applies where the Section 482 adjustment increases tax by more than $ 20 million. The penalty may also apply if other tests are met, but in no case is the penalty imposed if the taxpayer establishes reasonable cause for the underpayment.[4] Under proposed regulations, reasonable cause could be established if the taxpayer makes a reasonable effort to accurately determine a transfer price, and the taxpayer reasonably believes that its transfer pricing methodology produces an arm's length result. The Act lowers the penalty thresholds and makes it more difficult to establish reasonable cause.

1. Lower threshold for imposing penalty

Under the Act, the 20 percent penalty will apply where increased tax liability attributable to Section 482 adjustments exceeds the lesser of $ 5 million or 10 percent of the taxpayer's total gross receipts for the year. The 40 percent penalty will apply where the increased tax liability exceeds the lesser of $ 20 million or 20 percent of gross receipts. The new threshold based on gross receipts has no minimum dollar floor. As a result, small taxpayers who formerly were protected by the $ 10 million threshold (now $ 5 million) may become subject to the penalties under the new gross receipts test.

2. Contemporaneous documentation required to establish reasonable cause

Under the Act, the reasonable cause exception to the penalties is broken down into two rules: one applies when a specific transfer pricing method set forth in IRS regulations is used; the other applies when an "other" method is used.

The reasonable cause exception to the penalty will apply if: (1) it is established that the taxpayer determined its price in accordance with a specific pricing method in IRS regulations and the taxpayer's use of that method was reasonable; (2) the taxpayer has documentation (in existence at the time the return was filed) that sets forth the determination of the price in accordance with that method and establishes that the use of

3. Transfer pricing methodologies are addressed in temporary regulations issued in January 1993. See Ruchelman, "Transfer Pricing Regulations Issued in the United States," 47 *Bulletin for International Fiscal Documentation* (April 1993), at 187. The Act does not contain the formulary transfer pricing proposal which would have required foreign corporations to report as taxable income an amount equal to at least 75% of gross receipts. See Foreign Income Tax Rationalization and Simplification Bill of 1992, introduced on 27 May 1992.

4. The penalties do not apply to adjustments in transactions between foreign corporations (including CFCs) unless one of the corporation's own US source income or effectively connected income is adjusted.

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that method was reasonable; and (3) the taxpayer provides such documentation to the IRS within 30 days of a request.

The exception also would apply when the price was *not* determined in accordance with a specific pricing method if:

(1) the taxpayer establishes that none of the specified methods was likely to result in a price that would clearly reflect income, that the taxpayer used another pricing method to determine such price and that other pricing method was likely to result in a price that would clearly reflect income;
(2) the taxpayer has documentation (in existence at the time the return was filed) that sets forth the determination of the price in accordance with the other pricing method and that establishes that the requirements of (1) above were satisfied; and
(3) the taxpayer provides such documentation to the IRS within 30 days of a request.

In the case of a transaction to which none of the regulations' pricing methods would ordinarily apply, then the reasonable cause exception is available if the taxpayer merely establishes that the transaction is of a type for which no methods are specified in the regulations. If, however, the transaction is one to which a specified method could apply and the taxpayer uses an "other" method, then, as described above, the taxpayer will need contemporaneous documentation to prove that every method specified in the regulations produces a less satisfactory transfer price: an extremely burdensome requirement.

A taxpayer will not be treated as having reasonable cause for any portion of an underpayment attributable to a Section 482 transfer price adjustment unless the taxpayer satisfies these requirements. Thus, the penalty is automatic and there is no defense unless the taxpayer has contemporaneous documentation as described above. This is quite a change from prior law, where reasonable cause was a fairly low good faith/reasonable belief standard, which could be met by reliance on counsel or a return preparer to whom there had been full disclosure of the relevant facts. However, Treasury Department officials have stated that the IRS must use discretion in applying the penalties, and noted that the IRS "has not historically been aggressive in imposing penalties".[5] Although it appears that no taxpayer has yet paid the existing 20 percent and 40 percent penalties, very few tax years subject to the penalties have been audited.

IV. POSSESSIONS CORPORATIONS

A. *New limitations on Section 936 benefits*

Section 936 was enacted to foster economic development in US possessions, and Puerto Rico in particular. Section 936 essentially eliminates all US tax on a US corporation's income from operations in a possession. Two categories of income are exempt from US tax: active business income derived from the conduct of business in a US possession, and income from investment of active business income, which must be derived from certain investments in a US possession or in designated Caribbean Basin countries.

To qualify for Section 936 benefits, a corporation must (1) derive at least 75 percent of its gross income from active business operations in a US possession over a three-year period and (2) derive at least 80 percent of its gross income from sources within a possession during that same three-year period.

Puerto Rico tax laws encourage capital investment by providing corporate tax exemptions and relief from Puerto Rico withholding tax on dividends paid by US subsidiaries operating in Puerto Rico to their US parents. The combination of US and Puerto Rico tax exemptions has encouraged many major US multinationals to establish manufacturing and other operations in Puerto Rico through US subsidiaries ("possessions corporations").

Certain industries, the pharmaceutical industry in particular, have taken advantage of Section 936 by shifting income attributable to intangible assets (e.g. patents and secret formulas) to possessions corporations operating in Puerto Rico. Congress is concerned that in many instances, these operations generate substantial tax-free income but create few jobs in Puerto Rico and do not involve large amounts of local capital investment.

1. Two alternative limitations

Under the Act, Section 936 benefits for a possession corporation's active business income are determined as under prior law, but are subject to either of two alternative limitations. Section 936 benefits for investment income are not changed by the Act.

One alternative limitation for active business income, the "economic activity limitation" (described below), is based on factors that reflect economic activity in US possessions. The other alternative is a prescribed percentage of the benefits that would be allowed if calculated under present law. The percentage is 60 percent for 1994 and is phased down to 40 percent for 1998 and later years. The taxpayer has the option of choosing either limitation, but once the percentage limitation is chosen, it generally must be used for all later years.

2. Economic activity limitation

Under the economic activity limitation, the tax exemption for business income cannot exceed the sum of:

(1) 60 percent of certain wages paid to employees for services performed in a possession and certain allocable fringe benefit expenses,
(2) a designated percentage of depreciation deductions claimed for regular tax purposes with respect to qualified tangible property located in a possession and used by the possessions corporation in its active business (15 percent of depreciation deductions for short-life, 40 percent of deductions for medium-life and 65 percent of deductions for long-life qualified tangible property), and
(3) a portion of the income taxes the possessions corporation pays to the possession not in excess of an effective 9 percent rate, but only if the corporation does not use the "profit split" method for allocating income from intangible property between possession source and non-possession source income.

5. Comments of Carol Doran Klien, Acting International Tax Counsel, reported in "Transfer Pricing Penalties are Discretionary, Treasury Official Says", *Highlights & Documents* (13 September 1993).

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UNITED STATES:

ENTITY CLASSIFICATION GUIDELINES FOR GERMAN GMBHS

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I. INTRODUCTION

The Internal Revenue Service ("IRS") has issued revised entity classification guidelines for German GmbHs in cases where the GmbH is wholly owned by members of a controlled group of corporations. The IRS had formerly ruled that such entities would in all events be classified as corporations.[1] The position of the IRS had been increasingly criticized, and in Revenue Ruling 93-4,[2] the IRS has modified it in key respects. Under the ruling, a commonly controlled GmbH may be classified as either a partnership or a corporation depending on the applicable provisions of its memorandum of association. The new ruling will apply to GmbHs organized on or after 18 February 1993.[3]

Unincorporated business entities are classified for US federal income tax purposes using the *Kintner* regulations issued in 1960.[4] These regulations classify an unincorporated entity as either a corporation or a partnership on the basis of six characteristics. The distinction between partnerships and corporations is vital in planning for joint ventures and foreign branches since partnerships permit *de facto* tax consolidation, i.e. flow-through of operating results and tax attributes, in situations where corporate consolidation would not be possible. In addition, the use of an entity with corporate-type limited liability is often a *sine qua non* for non-tax business reasons. Foreign entities, such as German GmbHs, that can combine these features from a US point of view are thus a matter of great interest.

Contents

I. Introduction
II. The *Kintner* Regulations
III. Classification of Foreign Entities
IV. Revenue Ruling 77-214
V. Lack of Separate Interests Analysis
VI. Revenue Ruling 93-4
A. Continuity of life factor
B. Free transferability factor
C. Centralized management factor

II. THE *KINTNER* REGULATIONS

The six characteristics used in the *Kintner* regulations to distinguish partnerships and corporations are: (1) the presence of associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests.[5] The *Kintner* regulations classify an entity as an "association" (and hence as a corporation)[6] for US tax purposes if it has a preponderance of these characteristics. Because associates and the objective to carry on business are common to both corporations and partnerships, the regulations provide that they are to be treated neutrally. Classification is thus determined on the basis of the four remaining characteristics, and an entity is classified as a corporation if it has a preponderance of these, i.e. more than two. An entity is classified as a partnership if it has two or fewer.[7]

III. CLASSIFICATION OF FOREIGN ENTITIES

In the case of unincorporated entities created under foreign law, the IRS determines tax classification in the same manner as in the case of US domestic entities. However, in determining whether the *Kintner* characteristics are present or absent, the local law of the jurisdiction where the entity is organized is applied and, to the extent necessary, the organizational agreement of the foreign entity is construed in accordance with that law.[8] If local law and the organizational agreement indicate that a preponderance of the non-neutral *Kintner* characteristics are present, the entity and its members will be subject to US tax rules as if the entity were a foreign corporation.

Due to the wide variety of foreign entities and the variations in the laws under which they are organized, the IRS takes the position that all foreign entities, even

1. Revenue Ruling 77-214, 1977-1 C.B. 408.
2. 1993-3 I.R.B. 5 (19 January 1993).
3. GmbHs organized prior to 18 February can continue to use their current classification if they had reasonably relied on the IRS's former position and they or their members file their first tax returns after 18 February consistent with that classification.
4. Treas. Reg. § 301.7701-2 and -3. The regulations take their name from the taxpayer in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).
5. These six factors were identified as indicative of corporate status by the US Supreme Court in *Morrissey v. Commissioner*, 296 U.S. 344 (1935).
6. The technical classification as an association does not make a practical difference under the Internal Revenue Code since associations are within the category of entities that are treated and taxed as corporations. See IRC Sec. 7701(a)(3).
7. Each of the remaining four characteristics is accorded equal weight. *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1.
8. Rev. Rul. 73-254, 1973-1 C.B. 613. In addition, Treas. Reg. § 301.7701-1(c) provides in part as follows:

> "Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which the organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets."

Rev. Rul. 73-254 applied the same analysis to foreign entities.

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those nominally incorporated, must be tested under the *Kintner* regulations. This is the case regardless of the label attached to the entity by the foreign jurisdiction involved.[9] The use of the *Kintner* regulations to evaluate an entity on the basis of identifiable and substantive aspects, rather than formalistic ones, is intended to ensure consistency and predictability in the US classification of foreign entities. A difficulty exists, however, for foreign limited liability companies, and that is that the IRS will not generally issue private letter rulings on their classification if they are commonly controlled by a single corporate group.[10]

IV. REVENUE RULING 77-214

The IRS first addressed the tax classification of a German GmbH in Rev. Rul. 77-214.[11] The IRS held in that ruling that a GmbH can assume characteristics of both corporations and partnerships. With respect to the two neutral *Kintner* factors of associates and an objective to carry on business, the IRS held that these were automatically present by virtue of the governing German law (the "GmbH-Gesetz"), and that two of the non-neutral *Kintner* factors, namely centralization of management and limited liability, were also automatically present. Limited liability is present in the case of a GmbH because the GmbH-Gesetz limits the rights of third-party creditors to the assets of the GmbH.[12] For the remaining non-neutral factors, i.e. continuity of life and free transferability of interests, the IRS held that flexibility allowed by the GmbH-Gesetz in drafting the memorandum of association permitted these factors to be either present or absent. Under this analysis, the IRS concluded that a GmbH could in theory be classified either as a partnership (if both remaining factors are absent) or as a corporation (if either remaining factor is present). The IRS has subsequently issued private letter rulings classifying GmbHs both as partnerships and as corporations, depending on the circumstances, and one US court has classified a GmbH as a corporation.[13]

The controversial aspect of Rev. Rul. 77-214 was its analysis of the continuity of life and free transferability factors in the context that the members of the GmbH – two US subsidiaries – were commonly controlled by a single US parent. In the IRS's view, the common control element changed the analysis that would apply if the members had each been able to act in accordance with its own economic interest. This became known as the lack of separate interests analysis. There were, however, doubts about the legal underpinning of the analysis, and special difficulties arose because the same situation had been present in a ruling issued two years earlier, and implicitly present in a ruling issued later, both involving US domestic partnerships, and the IRS did not express any reservations on the common control element.

The earlier ruling, Rev. Rul. 75-19,[14] dealt with a domestic partnership that was organized by four subsidiary corporations using a state statute that corresponded to the Uniform Partnership Act ("UPA").[15] Without significant discussion, other than noting that the subsidiary corporations had been created for independent business reasons and that the transaction was not entered into for tax avoidance purposes, the IRS concluded that the status of the entity as a partnership would be respected for US federal income tax purposes. The reason for this result was that the provisions of the UPA preclude a partnership from having a preponderance of the *Kintner* characteristics. Specifically, the UPA precludes the characteristics of continuity of life, centralized management and limited liability. Lacking three of the corporate factors, a partnership subject to a UPA-type statute in the United States cannot have a preponderance of corporate characteristics regardless of how the remaining factors are analysed. The second and later ruling, Rev. Rul. 83-156,[16] involved a US partnership formed by first- and second-tier subsidiaries of the same parent. The IRS did not directly address the classification issue, but implicitly recognized the status of the partnership in analysing the underlying transaction.

The situation in Rev. Rul. 77-214 involving the German GmbH was virtually identical to Rev. Rul. 75-19 except that the law governing the entity was the GmbH-Gesetz rather than a state UPA statute. As discussed above, the IRS determined that both neutral *Kintner* factors and two of the non-neutral factors were automatically present under the GmbH-Gesetz. For the remaining two factors, the IRS applied the lack of separate interests analysis and found them present as well. This holding was made notwithstanding that the memorandum of association for the GmbH contained provisions which, in a UPA context, would have been sufficient to avoid these characteristics. For the continuity of life factor, the IRS held that the provisions in the memorandum would not be given substantive effect because there were no "separate interests" that could enforce the provisions in the memorandum. For the free transferability of interests factor, the IRS held that limitation on transfers contained in the memorandum, which applied to the subsidiaries, could be overcome by the parent as it saw fit.

V. LACK OF SEPARATE INTERESTS ANALYSIS

The rationale underlying the IRS's lack of separate interests analysis was that the parent and subsidiary companies

9. Rev. Rul. 88-8, 1988-1 C.B. 403 (entity organized under UK Companies Act of 1985 classified as a partnership for US federal income tax purposes where the Act and Memorandum of Association prevented a preponderance of the *Kintner* factors).
10. Rev. Proc. 93-3, 1993-1 I.R.B. 71, 77 (Sec. 3.01(47)) (4 January 1993) (20% independent ownership required).
11. Literally translated, Gesellschaft mit beschränkter Haftung is "company with limited liability".
12. GmbH-Gesetz Sec. 13(2). Limited liability under the *Kintner* regulations is the concept that the members or shareholders of the entity are not personally liable for third-party claims against the entity beyond the amount of their required contributions. In other words, if the creditors do not have a right to seek personal satisfaction against the members if the assets of the entity are insufficient to meet the creditors' claims, then the entity has limited liability. Treas. Reg. § 301.7701-2(d). The GmbH-Gesetz clearly causes this requirement to be met.
13. See, e.g. PLR 9001018 (6 October 1989) (GmbH classified as a partnership); PLR 8012063 (27 December 1979) (GmbH classified as a corporation); *Barnette v. Commissioner*, 63 TCM 3201 (1992) (GmbH classified as a corporation).
14. 1975-1 C.B. 382.
15. Partnerships are formed in the United States under the laws of the individual states. The state laws generally conform to the Uniform Partnership Act, with minor variations.
16. 1983-2 C.B. 66.

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formed a single economic grouping with respect to matters involving the GmbH. The IRS did not ignore the separate corporate existence of the subsidiaries as such, but its holding had the same practical effect as far as the *Kintner* factors were concerned since the IRS maintained that the subsidiaries would not be able to act independently from the parent. In the case of the free transferability factor, the analysis also appeared to take on aspects of agency, the IRS stating that the parent company could make the transfer decisions on behalf of the subsidiaries. Where this authority derived from, apart from the stock ownership, was not made clear.

There are a number of difficulties with the separate interests analysis in the context of Rev. Rul. 77-214. First, separate corporate entities, and more to the point in the context – the assets they hold, cannot generally be disregarded by the IRS absent a showing of tax avoidance, lack of business purpose, sham transaction or a like tax device. The cases in this area are legion, with perhaps as many findings one way as the other. Nevertheless, as a general matter, the IRS is required to have justification beyond the mere fact of stock ownership in order to recharacterize a transaction or rearrange the way that corporate groups choose to hold their assets.[17] The IRS implicitly recognized this in Rev. Rul. 75-19 when it gave credence to the four subsidiaries in that ruling. In addition, the IRS acknowledged that the subsidiaries controlling the GmbH in Rev. Rul. 77-214 had in fact been organized for valid business reasons, and these reasons were broader than merely holding the interests in the GmbH. This should have made the case for disregarding the subsidiaries' ownership a difficult one under the established precedents.[18] The IRS has been careful to argue, however, that it is not disregarding the existence of the subsidiaries as such, but only their ability to make independent decisions about the interests in question.[19]

Secondly, it is arguable that there are in fact separate interests present in the case of commonly controlled partnerships. The officers and directors of the subsidiaries have responsibilities to the partnership, and responsibilities to their own creditors and business relations as well, that are separate from those of the parent company. It is possible, for example, that one of the subsidiaries in Rev. Rul. 77-214 may have found itself in conflict with its co-partner or its parent company with respect to outside creditors, and would have been required to act independently.[20]

Thirdly, the IRS has thus far applied the lack of separate interests analysis in the international context but not in the domestic context. This raises questions under the non-discrimination clauses of US tax treaties. Under the US–German treaty, for example, discrimination would occur if the application of a different standard resulted in additional taxes or compliance burdens being placed on the GmbH.[21] As an illustration, if the GmbH in Rev. Rul. 77-214 had a US branch operation, it would be subject to the US branch profits tax if it were classified as a foreign corporation, but not if it were classified as a foreign partnership.[22] The government asserted in a litigated case involving the separate interests analysis that the *Kintner* regulations had been drafted in reference to domestic entities and should be applied differently to foreign entities. The court rejected this argument, but noted that the IRS could draft regulations specifically targeted at foreign entities if it chose to do so.[23]

VI. REVENUE RULING 93-4

The IRS re-examined the application of the separate interests analysis in Rev. Rul. 93-4. It holds in this ruling that the analysis will no longer be applied to the continuity of life factor, but it reaffirmed the earlier conclusion on the application of the analysis to the free transferability factor. The IRS recognized, however, that free transferability can be avoided if appropriate provisions are included in the memorandum of association, and so its holding has made it possible for free transferability to be avoided notwithstanding the common control element. The IRS also states in Rev. Rul. 93-4 that it will apply the same standards to the classification of foreign entities as for unincorporated domestic entities, thus clearing up the double standard argument discussed above.

A. *Continuity of life factor*

Continuity of life is the concept that an entity is not dissolved by reason of a disability or incapacity that arises in its individual members or shareholders, for example, death, resignation, bankruptcy or retirement.[24] Dissolution in this sense refers to an alteration in the relationship between the members of the organization as determined by local law. In a general partnership formed under a UPA-type statute, there is a

17. See e.g. *Moline Properties v. Commissioner*, 319 U.S. 436 (1943) (corporation organized for valid business purpose cannot be disregarded).
18. The courts have generally refused to disregard a subsidiary formed to hold a partnership interest where the subsidiary was not merely a shell company. See *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971); *Divine v. United States*, 62-2 USTC ¶ 9632 (W.D. Tenn. 1962). Cf. *Noonan v. Commissioner*, 52 T.C. 907 (1969), *aff'd* 451 F.2d 992 (9th Cir. 1971) (subsidiaries holding interests in partnership disregarded where formed for no purpose other than tax avoidance).
19. The distinction would seem to be a fine one. Presumably the IRS would still tax the subsidiaries on any gain from a sale of the interests.
20. The *McKee* treatise on partnership taxation notes that upon bankruptcy of one of the members of the controlled group, outside creditors could force a termination or liquidation of the entity regardless of the wishes of the parent company. *See* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, at ¶ 3.06[5][b] (2nd ed. 1990). Other commentators have offered additional reasons why commonly controlled entities may indeed have separate interests. See Spudis and Wilczynski, "Entity Classification When a Purported Partnership is Ultimately Owned by One Corporation", 69 *Taxes* (1991), at 659, 661-662.
21. US–Germany tax treaty, Art. 24. The GmbH would be a protected entity by the treaty since the term "nationals" is defined to include all legal persons, partnerships and associations that derive their status from the laws of the contracting states. See Art. 3(1)(h)(bb).
22. IRC Sec. 884.
23. *MCA Inc. and Universal City Studios Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982), *rev'g* 502 F. Supp. 838 (C.D. Cal. 1980). The *MCA* case involved entities that were jointly owned 95% by a Netherlands corporation (CIC) and 5% by an employee trust formed under Netherlands law (a Stichting). Since there was not a complete identity of ownership between CIC and the Stichting, the IRS's separate interests analysis was not tested by the court. At issue in the *MCA* case was whether the foreign entities would flow through certain rents and royalties to CIC as subpart F income. Under the law in effect at the time of the case, this would only occur if the foreign entities were classified as corporations for US tax purposes.
24. Treas. Reg. § 301.7701-2(b). Only one of the listed events is required to cause dissolution in order to prevent continuity of life. See McKee, *supra* note 20, at ¶ 3.06[4][a].

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mutual agency relationship between each partner and each of his or her co-partners.[25] The removal or disability of any one of the partners alters the mutual agency that exists among all of them, and this occurs automatically by virtue of the UPA itself. If the remaining partners agree to continue together after such an event, they do so in a "new" partnership that is a distinct entity from the old partnership. Dissolution is distinguishable from liquidation and winding-up of the organization's affairs, which is not required.[26] The *Kintner* regulations provide that there may be a dissolution and thus an absence of continuity of life even though the business is continued by the remaining members.[27]

The relationship among the partners of a partnership formed under a UPA-type statute is of course fundamentally different from the relationship among shareholders in a GmbH. There are, for example, no provisions in the GmbH-Gesetz that create or define a mutual agency relationship between GmbH shareholders. Nevertheless, the GmbH-Gesetz does provide for the dissolution of a GmbH under given circumstances. These are set out in Section 60(1), and include completion of a defined term, shareholder resolution, court decree and bankruptcy of the GmbH.[28] None of these events, however, refers to or includes disabilities that arise among the shareholders in their individual capacities, and none apart from completion of a defined term is automatic or self-executing.[29] There is thus no meaningful similarity between Section 60(1) and the provisions in the UPA which provide that the death, expulsion or bankruptcy of any partner automatically causes dissolution of a partnership,[30] and it is therefore clear that Section 60(1) is not sufficient to give a GmbH limited life under the *Kintner* regulations. However, Section 60(2) of the GmbH-Gesetz provides that the memorandum of association may set forth dissolution events in addition to those listed in Section 60(1), and the language in this respect is unrestricted.

The IRS recognized in Rev. Rul. 77-214 that the GmbH-Gesetz, presumably Section 60(2), allows flexibility in drafting the memorandum of association, and that if the dissolution events listed in the *Kintner* regulations were included in the memorandum, a GmbH would lack the characteristic of continuity of life. However, in the commonly controlled context, the IRS held that the provision would have no substantive effect because there was no separate interest that could compel a dissolution if one of the listed events occurred. The IRS was of the view that the controlling entity could continue the GmbH indefinitely by ignoring the dissolution events. It is this position that the IRS retreated from in Rev. Rul. 93-4, holding that the presence or absence of separate interests will no longer be considered relevant to determining whether an entity has continuity of life. Thus, if the memorandum of association for the GmbH provides that the bankruptcy, resignation or expulsion of any shareholder will automatically cause dissolution of the GmbH, without further action being required, then the GmbH will be considered to lack continuity of life notwithstanding that the shareholders of the GmbH are under common control.[31]

B. *Free transferability factor*

Free transferability of interests is the concept that shareholders in a corporate entity may normally transfer their shares on an unrestricted basis. Specifically, the *Kintner* regulations provide that free transferability of interests exists in the corporate sense if all the members of the entity, or those owing substantially all the interests, can assign their rights and substitute new members for themselves without the consent of the other members. The regulations also provide, however, that free transferability does not exist if, under local law, the transfer of an interest causes a dissolution of the entity.[32] The key to the presence of free transferability is thus the right of substitution of membership in the organization, and the key to the absence of free transferability is the technical dissolution of the entity if a transfer occurs. A dissolution clearly takes place in the case of transfers subject to the UPA since, as discussed above, the transfer of an interest in the partnership will cause an alteration in the mutual agency among the existing partners.[33]

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25. For example, each partner is the agent of the partnership (UPA Sec. 9), each partner binds the partnership by his admissions and representations (UPA Sec. 11), each partner binds the partnership by any notice he receives (UPA Sec. 12), each partner binds the partnership by any wrongful acts (UPA Sec. 13), and each partner is jointly and severally liable for the debts of the partnership (UPA Sec. 15).
26. Sec. 29 of the UPA defines dissolution as follows:
The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.
27. Treas. Reg. § 301.7701-2(b)(2).
28. Sec. 60 of the GmbH-Gesetz provides as follows:
Reasons for Dissolution
(1) The Company with limited liability is dissolved:
1. With the expiration of the period of time determined in the articles of association;
2. by a resolution of the shareholders; unless otherwise determined in the articles of association, this requires a majority of three fourths of the votes cast;
3. by a court decision or by a decree of the administrative court or of the administrative agency in the case of §§ 61 [Dissolution by Court Decision] and 62 [Dissolution by Administrative Action];
4. by the institutions of bankruptcy proceedings; if the proceedings are terminated after conclusion of a compulsory settlement or are terminated upon motion of the debtor in bankruptcy, then the shareholders may decide to continue the company;
5. with the final order of the court of register by which a defect of the articles of association has been determined pursuant to § 144 a of the Law regarding Matters of non-contentious Jurisdiction.
(2) The articles of association may determine other reasons for dissolution.
This translation and the others herein are from Mueller, *GmbH – German Law Concerning the Companies With Limited Liability*, Fritz Knapp Verlag, Frankfurt am Main (3rd ed. 1977) (hereinafter "Mueller"). An additional text that includes an English translation of the GmbH-Gesetz and a discussion of its provisions is Oliver, *The Private Company in Germany* (MacDonald & Evans Ltd: Plymouth, England, 1976) (hereinafter "Oliver").
29. The *Kintner* regulations provide that the fact that dissolution occurs at the completion of a defined term does not mean that the entity lacks continuity of life. Treas. Reg. § 301.7701-2(b)(3).
30. UPA Sec. 31.
31. The IRS has ruled privately that a commonly controlled société en nom collectif ("SNC") lacked continuity of life where the applicable law provided that the bankruptcy of any member would automatically cause dissolution of the SNC. PLR 9122074 (6 March 1991). The IRS did not apply the lack of separate interest analysis in this ruling.
32. Treas. Reg. § 301.7701-2(e).
33. As noted in the text, the transfer of an interest within the meaning of the *Kintner* regulations involves the substitution of the new member in the entity in the place of the old member. This is distinguishable from a mere assignment of a member's interest in the profits and assets of the entity. The UPA provides that a partner may assign his or her interest in the partnership, but that the assignee does not thereby become entitled to participate in the management or affairs of the partnership. An assignment without substitution does not cause a dissolution of the partnership. UPA Sec. 27.

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With respect to the transfer of shares in a GmbH, the GmbH-Gesetz generally provides for free transferability, subject to the observance of certain formalities, but also allows for transfers to be restricted by the memorandum of association.[34] This was the case in Rev. Rul. 77-214, where the memorandum provided that a shareholder could not transfer its interest in the GmbH without the written approval of the other shareholders. This is the same approach taken in partnerships in the United States to prevent free transferability factor from being present and, on the surface, would satisfy the *Kintner* regulations. However, because of the common control element, the IRS held in Rev. Rul. 77-214 that free transferability existed because the parent could make all transfer decisions on behalf of the subsidiaries. For this reason, the IRS concluded that there was no meaningful restraint on the transfer of the interests even though the memorandum of association contained a consent requirement. The IRS reaffirmed this conclusion in Rev. Rul. 93-4, stating that there must be the possibility of an impediment to a transfer in order for free transferability to be absent.

The IRS went on to acknowledge, however, that the flexibility permitted by the GmbH-Gesetz allows provisions to be placed in the memorandum of association that either prohibit transfers of interests altogether or provide that the GmbH will be dissolved if a transfer takes place. If transfers are prohibited altogether, free transferability cannot exist in a corporate sense under the *Kintner* regulations. Alternatively, if transfers are permitted, but cause an automatic dissolution of the GmbH, then there is no right of substitution for the transferee shareholder since the continuing GmbH is a "new" entity, and this again prevents free transferability under the *Kintner* regulations.[35] The IRS thus concluded in Rev. Rul. 93-4 that if the memorandum of association contains either of these provisions, the GmbH will be considered to lack free transferability of interests notwithstanding the common control element.

C. *Centralized management factor*

The IRS took the position both in Rev. Rul. 77-214 and Rev. Rul. 93-4 that centralized management is automatically present in the case of a GmbH. The IRS did not offer an analysis on this factor beyond stating its conclusion. While partnership status can be assured under Rev. Rul. 93-4 by including the appropriate provisions in the memorandum of association, tax planners who desire greater flexibility on the continuity of life factor or, more likely, on the free transferability factor, will have to turn their attention to centralized management.

The concept of centralized management is that authority for managing the affairs of an entity is vested in persons who can make decisions without obtaining the prior approval of the members or shareholders. The analogy is to the board of directors in a corporate setting. The test for centralized management under the *Kintner* regulations is whether "any person (or any group of persons which does not include all the members) has continuing *exclusive* authority to make the management decisions necessary to conduct the business for which the organization was formed" (emphasis added).[36] "Exclusive authority" is defined by the regulations to mean "sole authority".[37] The regulations further provide that centralized management does not exist if the managers merely perform ministerial acts as agents for the members.[38]

In the case of a limited partnership formed in the United States, centralized management is not deemed to exist if the general partner (who is himself a member of the partnership) owns a substantial interest in the entity. The theory in this case is that the general partner is viewed as acting on his own behalf and not simply in a representative capacity for the other members.[39]

The GmbH-Gesetz contains a number of provisions that have a bearing on the centralized management factor. Foremost is Section 52, which provides for a supervisory board to be appointed to oversee the managing directors. This board functions in a manner similar to a corporate board of directors. The creation of a supervisory board is optional, however, except for special situations mandated elsewhere in German law.[40] Whether or not a supervisory board is appointed, Section 6(1) of the GmbH-Gesetz requires the appointment of one or more managing directors to manage the affairs of the GmbH,[41] Section 35 provides that the GmbH is represented by these managing directors "in and out of court", and Section 36 provides that the GmbH is bound by the actions taken by the managing directors on its behalf.[42] All the fore-

34. Sec. 15 of the GmbH-Gesetz provides as follows:
Transfer of Shares
(1) The shares are transferable and inheritable.
(2) Shares which a shareholder acquires in addition to his original share remain separate shares.
(3) The assignment of a share by shareholders requires a contract in notarial form.
(4) Notarial form is also required for an agreement creating the obligation of a shareholder to assign his share. However, an agreement concluded without observation of this form becomes valid by a contract of assignment concluded pursuant to the foregoing paragraph.
(5) The articles of association may make the assignment of shares dependent upon additional conditions, in particular upon the consent of the company.

35. Treas. Reg. § 301.7701-2(e)(1)(last sentence).
36. Treas. Reg. § 301.7701-2(c)(1).
37. Treas. Reg. § 301.7701-2(c)(4).
38. Treas. Reg. § 301.7701-2(c)(3).
39. See e.g., *Glendser Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942)(centralized management lacking where general partners owned 41% of total interests in a limited partnership). The IRS will issue an advance ruling that centralized management is lacking in a limited partnership if the general partners own 20% or more of the total interests in the partnership. See Rev. Proc. 89-12, 1989-1 C.B. 798, 801 (Sec. 4.06) and Rev. Proc. 91-13, 1991-1 C.B. 477, 480 (Question 16).
40. Supervisory boards are mandatory for capital investment companies, for GmbHs that are engaged in certain types of German industries, notably coal and steel, and for GmbHs that have a substantial work force and are required to comply with the labour co-determination laws, i.e. to appoint employees to management positions and board participation. See Mueller, *supra* note 28, at 8-10.
41. Sec. 6 of the GmbH-Gesetz provides as follows:
Managing Directors
(1) The company shall have one or more managing directors.
(2) Shareholders or other persons may be appointed as managing directors. The appointment shall either be made in the articles of association or pursuant to the provisions of the Third Title.
(3) If the articles of association provide that all shareholders shall be entitled to the management, then only the shareholders belonging to the company at the date at which this provision is adopted are considered as appointed managing directors.
42. Sec. 36 of the GmbH-Gesetz provides as follows:
Nature of the Representation
The company is entitled and obligated by the legal transactions performed in its name by the managing directors; it is irrelevant whether or not the transaction is expressly performed in the name of the company or whether it follows from the circumstances that it was to be performed on behalf of the company according to the intention of the parties.

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going would tend to indicate that a GmbH may have a management structure similar to that of a US corporate entity.

On the other hand, the GmbH-Gesetz contains a number of provisions that permit substantial flexibility in the way a GmbH can be managed. As noted above, the appointment of a supervisory board is generally optional. Furthermore, with respect to the managing directors, Section 6(2) provides that the shareholders can appoint either themselves or any other persons they designate. If the shareholders appoint themselves, or at least those among themselves that own a substantial interest in the GmbH, then centralized management would be lacking since such persons would not be acting in a representative capacity as required by the *Kintner* regulations.[43]

Even in cases where separate managers are appointed, and thus serve at least nominally in the representative capacity that is indicative of centralized management, the GmbH-Gesetz includes an variety of additional provisions that can be used to limit their powers. Section 45, for example, provides that the shareholders can be granted rights over control of the company and the conduct of its affairs to the extent provided by the memorandum of association.[44] Also, Section 46(6) specifically permits the shareholders to decide on appropriate measures for the "control and supervision" of the managing directors.[45] Whatever is decided, Section 37 requires the managing directors to act only within their designated scope of authority.[46] There is no limitation elsewhere in the GmbH-Gesetz on what rights the shareholders can exercise over management other than that they may not conflict with law.

One commentator takes a broad view of the restrictions that can be placed on the managing directors by the foregoing provisions, stating that the managing directors can be required to obtain the consent of the shareholders for individual or general items of business, that the shareholders may refuse to consent to actions proposed by the managers and that the shareholders may take the initiative in directing the managers to take specific action in the business of the GmbH.[47] This would indicate that even in cases where separate managers are appointed, their powers can be so restricted as to limit them to acting directly in accordance with the wishes of the shareholders in all but ministerial matters.

The foregoing provisions would indicate that *Kintner* requirements for centralized management can be negated under the GmbH-Gesetz either by granting direct management of the GmbH to the shareholders or their agents or by stating in the memorandum of association that the shareholders are to have control over all material decisions made by managing directors. The IRS has accepted these factors as negating centralized management in prior cases. The *Kintner* regulations, for example, contain an illustration of an organization with 25 members who meet monthly to make business decisions for the organization on a majority vote basis, and the regulations conclude that centralized management is lacking in this situation.[48] Furthermore, in a revenue ruling involving a trust, the IRS found the absence of centralized management where the trustee could not make managerial decisions (other than ministerial ones) without first obtaining the unanimous approval of the trust beneficiaries.[49]

Notwithstanding the foregoing, the IRS has found centralized management to be present in the case of limited liability companies ("LLCs") formed under certain state statutes in the United States.[50] Based on the IRS rulings, these statutes come in two varieties as far as the centralized management factor is concerned: first, those that provide that management of the LLC must be vested in one or more designated managers (Colorado), and second, those that provide that management of the LLC is vested in the members in proportion to their ownership interests unless the LLC agreement expressly provides for a separate manager (Delaware, Florida, Illinois, Nevada, Virginia, West Virginia, Wyoming). In the ruling for the first type, the IRS held that centralized management was present even though the members had elected themselves to be the managers, which was permissible under the LLC statute, since the authority to make management decisions rested in them in their capacity as managers and not in their capacity as members. This conclusion appears to be based on the structure of the LLC statute, the IRS stating that the members did not, solely by virtue of being members, possess management authority. In the rulings for the second type, the IRS has held that centralized management was present in the cases where management of the LLC was vested in des-

43. Sec. 6(3) of the GmbH-Gesetz recognizes that all the shareholders can be designated as managers.

44. Sec. 45 of the GmbH-Gesetz provides as follows:
Rights of the Shareholders in General
(1) The rights of the shareholders in matters of the company, as well as their exercise, in particular with respect to the conduct of the business follow from the articles of association except for statutory provisions to the contrary.
(2) In the absence of special provisions of the articles of association the provision of §§ 46 to 51 shall apply.
The provision of Secs. 46 to 51 deal with specific shareholder rights, shareholder meetings, voting rights and minority rights.

45. The German text of Sec. 46(6) provides that shareholders may decide on "die Maßregeln zur Prüfung and Uberwachung der Geschäftsführung". The *Mueller* text translates this as "the measures applicable to the examination and supervision of the management". See *Mueller*, *supra* note 28, at 57. The *Oliver* text translation is "control and supervision" of the management. See *Oliver*, *supra* note 28, at 75.

46. Such limitation is not effective, however, against third persons. GmbH-Gesetz Sec. 37(2).

47. See *Mueller*, *supra* note 28, at 8.

48. Treas. Reg. § 301.7701-2(g) Example (7). The example involves an investment organization, and describes the management structure as follows:
> The business of the organization is carried on by the members at regular monthly meetings and buy or sell action may be taken only when voted by a majority of the organization's membership present. Elected officers perform only ministerial functions such as presiding at meetings and carrying out the directions of the members.

As discussed in the text, the provisions of the GmbH-Gesetz are broad enough to permit a similar management structure.

49. Rev. Rul. 57-607, 1957-2 C.B. 887. Trusts are subject to the classification under the *Kintner* regulations in a manner similar to partnerships, although there are of course differences in the way the factors are analysed. See Treas. Reg. § 301.7701-2(a). The *Morrissey* case cited in note 5, *supra*, wherein the Supreme Court first identified the six corporate characteristics, involved the classification of a trust rather than a partnership.

50. The revenue rulings issued to date on LLC statutes include Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyoming); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Virginia); Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Colorado), Rev. Rul. 93-30, 1993-16 I.R.B. 4 (Nevada); Rev. Rul. 93-38, 1993-21 I.R.B. 4 (Delaware); Rev. Rul. 93-49, 1993-25 I.R.B. 11 (Illinois); Rev. Rul. 93-50, 1993-25 U.R.B. 13 (West Virginia); Rev. Rul. 93-53, 1993-26 I.R.B. 7 (Florida).

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ignated managers but not in the case where it was vested in the members. [51]

There is also an earlier private letter ruling that precedes the above rulings, where the IRS reviewed a LLC statute that provided that management was vested in the members of the company in proportion to their capital contributions unless the articles of association provided otherwise. The LLC statute also provided that the company was obligated for liabilities incurred on its behalf by the members if they retained the management function. The IRS held that this combination made the LLC sufficiently similar to a general partnership formed under the UPA to be lacking in centralized management.[52]

The issue raised by these rulings, and more particulary by Rev. Rul. 93-4 in the case of GmbHs, is whether the *Kintner* test for centralized management was intended to be a pragmatic one that asks whether an entity is managed by its members (or is instead managed by designated managers), or whether it was intended to be a formalistic test that focuses on the presence or absence of statutory management *per se*. There are indications in the regulations themselves that the test was intended to be a pragmatic one, but there is enough ambiguity to leave the matter in doubt. To the extent that a formalistic requirement exists, the analogy drawn is to a corporate-style board of directors that excludes the members from acting on behalf of the organization.

Where the GmbH-Gesetz fits into all of this is not clear, and in fact it is probably somewhere in between the two alternatives presented by the LLC statutes discussed above. While Section 6(1) clearly mandates the appointment of a managing director, Section 6(2) permits the shareholders to appoint themselves to this capacity within the ambit of the memorandum of association, so their management status flows from the organizational document for the entity rather than from an annual election procedure as is the case in the Colorado statute. Presumably, the memorandum can provide that shareholders, and only shareholders, may be appointed as managing directors, and indeed that all shareholders *must* be appointed managing directors.[53] In the latter situation, the management function would flow automatically from membership in the GmbH. In addition, as discussed above, there are other provisions of the GmbH-Gesetz that allow considerable flexibility in the way that the management authority is defined and carried out. There is Section 45, for example, which provides that the shareholders *qua* shareholders can have whatever rights over the affairs of the GmbH that the memorandum of association provides them with, and Section 36, which binds the GmbH for action taken by the managing directors who, again by virtue of the memorandum, would be deriving their capacity as managers directly from their capacity as shareholders. Seen in this light, the provisions of the GmbH-Gesetz allow the management structure to be brought close to the UPA model for a general partnership.

Whatever the merits of the foregoing, the IRS has determined for the present that a GmbH does in fact have centralized management. A representative from the IRS recently stated in correspondence that the IRS is studying whether an LLC organized in the United States that has a separate manager position designated by statute can *ever* lack centralized management.[54] A final IRS's conclusion that this is the case for domestic LLC's will probably seal the fate for GmbHs as far as the IRS is concerned. Upon judicial review, however, the IRS position would have to be tested against the specific language of the *Kintner* regulations, which require a representative management of less than all the members in order for centralized management to exist. It would appear to be at odds with this, and also with the analysis that the IRS applies to limited partnerships formed in the United States. A limited partnership is required to have at least one general partner to manage its affairs, and it is clear under the *Kintner* regulations that centralized management does not automatically result from this. The general partner is also, by necessity, a member of the partnership, but the authority it has to manage the partnership's affairs derives from its capacity as a general partner and not automatically from its membership interest.[55]

An IRS position that limited liability companies, including GmbHs, automatically have centralized management if the manager position is designated in the underlying statute also seems to have little to do with the basic test for centralized management, which, if the pragmatic view is adopted, is simply whether or not the managers are acting in a representative capacity. This cannot be the case if all the members are themselves managers, regardless of how this came to be – whether by appointment, election or designation in the statute or the memorandum of association.[56] In one of the seminal classification cases, the Court of Claims noted that centralization of management *per se* is common to both corporations and limited partnerships, and that therefore the focus of the inquiry should be on the "representative" aspect of the test rather than on the "centralized" aspect. In other words, since both entities have management that is undoubtedly centralized, that is, held either by less than all the members or by designated managers, then centralization itself is immaterial in making a distinction between the two, and the focus should instead shift to whether there is any representative aspect.[57] The same reasoning would hold true in trying to distinguish between corporations and GmbHs.

51. Where managers comprising less than all the members have been designated, centralized management should not be present in the representative sense if the designated managers own a significant membership interest in their own right. This question was not addressed by the IRS in the LLC rulings, although it has been recognized in the limited partnership context. See *supra* note 39, and accompanying text.
52. PLR 9010027 (7 December 1989). Private letter rulings by the IRS do not have precedential value.
53. Under Sec. 6(3), if the memorandum provides that all shareholders are to be designated managers, this would only apply to shareholders of the GmbH on the date the memorandum is adopted. Subsequent amendments to the memorandum would be necessary to achieve the result suggested in the text.
54. Letter from Susan Pace Hamill, Attorney Advisor, Office of IRS Assistant Chief Counsel (Passthrough and Special Industries), published in *Tax Notes*, 8 March 1993.
55. That is to say, not automatically from its economic interest in the profits and capital, which, disregarding the risk element, could be represented by either a limited or general partnership interest.
56. While the IRS may argue that the members may, at their option, remove themselves at a later time and appoint someone who will act in a representative capacity, the presence of the *Kintner* factors is generally made based on the facts as they exist at the time of the determination. Other *Kintner* factors, such as free transferability, can also be affected by subsequent changes in the memorandum of association, but this is not taken into account unless and until such changes are made.
57. *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

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Even if the IRS withdraws from the position that centralized management is automatically present under the GmbH-Gesetz, it may continue to argue that the situation in a commonly controlled GmbH, as was present in Rev. Rul. 77-214 and Rev. Rul. 93-4, is different, and requires the application of a lack of separate interest analysis. What will follow from this is less clear. If the conclusion is that the management authority of the members is to be ignored, and instead placed in the commonly controlling parent, then centralized management should be viewed as absent since the ultimate economic owner is also the managing owner. On the other hand, the IRS may argue that the controlling parent has the management function, but that the members are deemed to be the economic owners of their interests for all other purposes, in other words that the parent is managing the GmbH in a representative capacity for the members. This latter approach is fraught with the same difficulties that are inherent in the separate interests analysis to begin with.[58] In addition, the application of the theory goes further in the centralized management context since it requires the IRS to deny that subsidiaries within a controlled group can have any independent management function at all. The better result would be for the IRS to abandon the separate interests analysis altogether.[59]

58. See Section V above.

59. Other commentators have reached a similar conclusion regarding efforts to apply an economic analysis to US entity classification. See Davis and Lainoff, "US Taxation of Foreign Joint Ventures", 46 *Tax Law Review* (1991), at 185:

> The difficulty faced by the Service is that at its most fundamental level, Revenue Ruling 77-214 threatens to expose the shaky foundation upon which the U.S. entity classification scheme is built. In applying a separate interests analysis, the ruling attempts to look behind the legal relationships of the venturers and instead to examine their true economic relationship. The emphasis on economic substance is misplaced in the context of entity classification, however, because the rules for taxation of partnerships as compared to corporations are themselves arbitrary and have little dependence on the economics of the relationship. In such an environment, a determination of "substance" when classifying an entity is illusory.

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NEW ZEALAND:

APPLYING A SLEDGEHAMMER TO FOREIGN INVESTMENT: NEW FOREIGN INVESTMENT FUND MEASURES

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I. INTRODUCTION

1992 and 1993 saw New Zealand implementing its final approach to the taxation of foreign investment funds. It replaced New Zealand's original Foreign Investment Fund (FIF) legislation. Although the legislation had been introduced in April 1988, it had never operated. The Government had twice deferred its start date, pending inquiries into its operation. In the 1992 budget[1] the New Zealand Government announced the withdrawal of this existing legislation and the introduction of a new FIF regime. These new measures, introduced on 17 December 1992, became law (received the Royal Assent) on 1 April 1993.[2]

In this article I propose to critically analyse the new FIF legislation against its policy objectives. Given large amounts are invested offshore by New Zealand investors, these measures will have a marked effect on the manner and form of current and future investment. The measures will also have a profound effect on some of the financial markets in which the funds are placed and upon individual enterprises operating within those markets. My approach will be to identify the scope of each regime, its operational date, the existence of exemptions and the FIF income calculation methods. However, I will discuss first the reasons why the former measures were withdrawn. This will provide a base from which the new measures can be evaluated.

II. PROBLEMS WITH THE FORMER MEASURES

The initial 1988 scheme for taxing FIFs was derived from the application of the same principles adopted in respect of the controlled foreign company (CFC) regime (i.e. an attributed foreign income regime). Under this regime Section 245R of Income Tax Act (NZ) 1976 (NZ Act)[3] (which defined a FIF interest) required portfolio investors to possess financial information of the entity's effective foreign tax rate, the percentage of distributed profits and the composition of its assets. However, these information requirements created substantial compliance difficulties for small investors who frequently lack the detailed financial information necessary to comply with these requirements.

Even when the necessary financial information was available for use, its inaccuracy resulted in the calculation of the income base of a FIF being substantially underestimated. This arose as accounting standards vary between countries. Also, accounting standards usually incorporate 'conservative' asset valuation and profit calculation principles. The net result was that holders of FIF interests were taxed on an attributed income amount less than the actual income, which resulted in reduced tax collections.

From the technical side the regime was also ineffective when FIF income was sheltered in lower tier entities. Thus, given all these difficulties, the 1988 FIF measures were the subject of widespread criticism and their repeal was inevitable.

Contents

I. Introduction
II. Problems With the Former Measures
III. What is Targeted by the New Measures?
IV. When Do the New Measures Have Effect?
V. What Investments are Now Caught?
VI. How is the Legislation Structured?
VII. Exemptions from the Measures
A. Residency
B. Jurisdiction exemption
C. Small investor exclusion (de minimis rule)
D. Foreign employer-sponsored superannuation exemption
E. Attributable taxpayer exemption
F. Life assurance policies
G. Trading stock
H. Conclusion
VIII. How is Attributed Income of the FIF Income Calculated?
A. Branch-equivalent method
B. Accounting profits method
C. Comparative value method
D. Deemed rate-of-return method
IX. Taxation of Foreign Life Assurance Policies
X. Avoidance of Double Taxation
XI. Penalties
XII. Conclusion

1. 1992 Budget Papers (NZ), 2 July 1992, at 75-86.
2. Income Tax Amendment Act (No. 2) 1993 (No. 17 of 1993).
3. Income Tax Act (NZ) 1976.

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III. WHAT IS TARGETED BY THE NEW MEASURES?

The target of the new measures differs substantially from that originally stated. The New Zealand Government, through earlier statements, indicated that the FIF regime would be targeted at tax deferral through interests held in foreign entities resident in low tax jurisdictions, and conversion of accumulated income into capital receipts (which are tax free in the investors' hands).[4]

However, in the 1991 budget the Government announced that it would review its policy in light of the following principles:

- that foreign source income earned by residents should generally be taxed;
- that compliance costs should be minimized;
- that the tax base should be protected; and
- that the tax system should not be biased in favour of investment overseas.

After an independent study of the compliance costs and a Governmental review of public submissions on the underlying policy framework of the regime, the Government restated the object of its measures as being to balance the

> "...interests of maintaining the revenue base, providing New Zealand residents the opportunity to develop international markets and business opportunities, and reducing tax distortions which otherwise encourage the export of capital and jobs from New Zealand".[5]

It was further stated that

> "The proposals should bring more closely into line the tax costs of overseas and domestic investments. This should encourage New Zealand investors to invest where capital is employed most efficiently; that is, where the before-tax return is highest."[6]

Thus, these policies are substantially different from those previously stated of targeting tax deferral through interests held in foreign entities, resident in low tax jurisdictions. They represent a major policy switch from mere anti-avoidance measures to measures which have the dual purpose of anti-avoidance and offshore investment control.

IV. WHEN DO THE MEASURES HAVE EFFECT?

The new FIF regime will apply to income derived in the 1992-93 income year in respect of FIF interests acquired on or after 2 July 1992. However, it will only apply from 1 April 1993 in respect of interests owned before 2 July 1992.[7]

Although the legislation has now been formalized, there were major delays between the announcement of the policy in the 1992 budget, and its implementation as legislation. The result of this ad hoc policy development is that taxpayers have been unaware for six months of the precise details of the legislation as it applies to FIF interests acquired after 2 July 1992. However, the introduction in December 1992 of the legislation has meant that taxpayers did know the details well in advance of their current holdings being affected.

V. WHAT INVESTMENTS ARE NOW CAUGHT?

Under the revised measures a new wider definition of an interest in a FIF was introduced. An interest in a FIF is defined[8] to be any interests held by a resident in a foreign company and includes interests or entitlements to:

- any benefits from foreign life insurance policies;
- any benefits from a foreign superannuation scheme; and
- entities specified in Part B of the 16th Schedule of the NZ Act.[9]

As the definition does not require taxpayers to possess large amounts of financial information to determine whether an interest in a FIF exists, it is an easier definition to comply with than the original 1988 definition.

VI. HOW IS THE LEGISLATION STRUCTURED?

The new measures are 32 pages long consisting of 14 new sections and a number of consequential and transitional sections. The brevity of the legislation lies in the formulation of the structure of the FIF measures. New Zealand's approach to FIFs has been to continue with the jurisdictional approach[10] adopted under its CFC regime.[11]

Although this approach in the New Zealand context reduces the volume of legislation required to implement the new measures, it is contrary to the worldwide approach,[12] preferred by most countries with FIF regimes. The traditional advantages inherent in a "worldwide approach" are simplicity (resulting from avoiding the complexities of a jurisdictional approach with designated concessions) and reduction in compliance costs (resulting from the elimination of the administrative costs of maintaining the list to prevent the avoidance opportunities that a jurisdictional approach can afford). However, these traditional advantages are negated under New Zealand's jurisdictional approach as the New Zealand scheme contains a very short list of excluded countries.

VII. EXEMPTIONS FROM THE MEASURES

Given the inevitable nature of the Government's broad policy direction, much of the policy discussion and development was centred on the exemptions to the measures. From the industry's view, if you are able to get your investment exempted, then the measures have no impact, save record keeping. Thus, as the wide scope of these measures is narrowed by the exemptions, a detailed understanding of them

4. *International Tax Guide* (1989) Internal Revenue NZ, 46.
5. See *supra* note 1, at 85.
6. See *supra* note 1, at 84.
7. Sec. 245RL.
8. Sec. 245RM and 245RA.
9. The 16th Schedule currently does not list any foreign entities or classes of foreign entities rights which are deemed to be interests in FIFs. The Government intends to list concessions and special tax treatments available in grey list countries which permit significant tax deferral (*supra* note 1 at 80).
10. A "jurisdictional approach" is based on the application of measures on whether the investments are in comparable tax or low tax countries (including tax havens).
11. Part IVA.
12. Sometimes subject to certain exclusions (for example, for comparably taxed investments).

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and the underlying policy becomes crucial in defining the scope of the measures.

A. *Residency*

The measures are limited to residents holding interests in FIFs.[13] Thus, the effect is to exclude most non-residents from the measures. The non-residents which are caught are those persons who possess dual residency of New Zealand and another country. This arises even when a dual resident is deemed to be a resident of another country under a comprehensive double tax agreement. Such dual residents will be subject to the measures as at domestic level as they are still residents of New Zealand. This is contrary to the purpose of such bilateral agreements under which the parties agree to give up certain rights to tax in order to prevent double taxation. Any attempt to then claw back those rights could amount to treaty override. A minor amendment could resolve this problem.

B. *Jurisdiction exemption*

Interests in entities resident in a 15th Schedule jurisdiction (the "grey list") which are liable to income tax in that jurisdiction (country) by reason of domicile, residence or place of incorporation or management, are exempt from FIF taxation, unless the 16th Schedule applies to those interests.[14] The "grey list" is a list of countries which generally have a tax base similar to that of New Zealand. This means that their income and expense recognition rules are no more favourable than that of New Zealand, they have few or no tax incentives, they subject companies resident there to an effective tax rate that is not less than 85 percent of that imposed under New Zealand tax law, they have strong anti-avoidance rules such as their own CFC regime, and they have a tax treaty with New Zealand.[15]

Countries currently listed under the 15th Schedule are Australia (excluding Norfolk Island), Canada, Federal Republic of Germany, Japan, the United Kingdom and the United States (excluding its possessions and territories).[16]

Interests in superannuation funds (other than employment-related superannuation funds) and life insurance policies in grey list countries are not exempt from these measures.

C. *Small investor exclusion (de minimis rule)*

Small investors, being natural persons, with total FIF interests costing less than $ 20,000, are excluded from the measures.[17] This exclusion is extremely narrow when compared with the level of exclusion offered under the Australian FIF regime ($ 50,000) and given the fact that the exclusion level does not take into account indirect investments. The narrowness of the exemptions further confirms the investment control nature of such measures.

D. *Foreign employer-sponsored superannuation exemption*

An exemption is also provided for employment-related superannuation funds. It was recognized that some immigrants to New Zealand may have worked in countries which provided compulsory or voluntary superannuation funds. Even though some of the funds are not tied, or are subject to a low rate of tax, many are non-alienable (i.e. employees cannot dispose of an interest in the fund even if they so desire). Therefore, it would be inequitable to tax those individuals on their interests in such funds, as the funds cannot be used for general investment (i.e. cannot be abused). Further, it would subject individuals to the FIF regime, even though such persons would not have the option of disposing of the interest, due to the alienation restrictions.[18]

To ensure investment funds are not indirectly excluded, only employment-related superannuation funds qualify for the exemption. A superannuation fund is defined[19] to be an employment-related superannuation fund if:

- the taxpayer (an individual) had acquired the interest in the fund as a result of employment in the country of residence of the fund, and any benefits that accrued, accrued before the taxpayer first became a New Zealand resident. Also, the taxpayer must be subjected to either substantial legal penalties under the deed or substantial tax penalties for pre-retirement withdrawals from the fund; and
- the fund is required to be funded by the individual and/or the individual's employer, contributions being based upon a percentage of the individual's employment income. The fund should also prohibit assignment of the benefits.

E. *Attributable taxpayer exemption*

Also excluded from the measures are income interests in CFCs of 10 percent or greater.[20] This ensures integrity of the two systems and reduces the scope for double taxation.

F. *Life assurance policies*

Another exemption is to "grandfather" pre-announcement life policies. This is done by providing a limited exemption for persons who receive a death benefit under a policy of life assurance. The binding contract must have been entered into before 2 July 1992 or before the taxpayer became a resident, and the benefit must not increase by any voluntary action taken after this date.[21]

G. *Trading stock*

To limit manipulative use of trading stock, the new measures prohibit FIF interests being treated as trading stock if, either the comparative value method or the deemed rate of return methods of calculation are used.[22]

13. Sec. 245RB(4).
14. Sec. 245RA(2)(b).
15. See *supra* note 1, at 79.
16. France was removed from the "grey list" by Income Tax Amendment Act (No. 2) of 1993, with general effect from 1 April 1993.
17. Sec. 245RA(2)(d).
18. See *supra* note 1, at 83.
19. Sec. 245R.
20. Sec. 245RA(2)(a).
21. Sec. 245RB(7).
22. Sec. 245RB(6)(e).

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H. *Conclusion*

The effect of the exemptions is to exclude small investors and to provide relief where the full application of the measures would be inequitable. The absence of active business exemptions or some form of distribution exemption means that there is no scope for rearranging offshore investment portfolios to lessen or even avoid the impact of the measures. The measures remain extremely wide and punish investments even where no avoidance lies. Thus, the measures have retained a strong investment/exchange control profile.

The effect of the measures can only be to act as a practical impediment to offshore investment by New Zealand residents. This practical prohibition can only have negative consequences for New Zealand, particularly in terms of the general development of an internationally competitive economy that is integrated with global markets. The absence of exemptions for investments in emerging nations, for example, may hinder New Zealand's access to these markets and the future financial rewards that will flow from these fast growing economies.

If the levels of capital flowing out for investment in other countries was a major concern to the New Zealand Government then direct controls, rather than the bastardization of tax anti- avoidance measures, may have been a better way to overcome this. If return of profits stored offshore was a concern, then to encourage the return of capital, an amnesty period should have been used to allow for certain capital and profits to be repatriated tax free, or at very low rates of tax. It would be a more positive approach than the current Foreign Dividend Withholding Payment (FDWP) scheme.

VIII. HOW IS ATTRIBUTED INCOME OF THE FIF CALCULATED?

As the interests in FIF are non-controlling, the availability of financial information to investors will usually be limited. In other circumstances, however, the interest, although small in terms of control, maybe financially significant. In these circumstances financial information will be readily available. To balance this diversity between available information and the associated needs for simplicity, the regime provides four alternative methods whereby the FIF interest is taxed according to information available to the investors.

As the schemes enable movement between the various measures and have extensive anti-avoidance provisions to deal with such changes, the calculation methods are highly technical. Therefore, I propose to give an overview of each method rather than examine each of them in detail. This will be done in descending information requirement order.

A. *Branch-equivalent method*

The branch-equivalent method is only available to holders of FIF interests in foreign companies. The branch-equivalent method is the same method used to attribute income to a taxpayer under the CFC regime[23] (i.e. the income or loss is calculated as if the FIF is a resident of New Zealand, subject to a number of modifications). The actual calculation is as follows. The FIF income or loss is calculated by multiplying the holder's interest in the FIF (as calculated under the CFC rules) by the branch equivalent income or loss. The branch equivalent income or loss is calculated according to the CFC rules; however, some modifications apply. It is calculated in the currency in which the FIF prepares its financial accounts, unless the New Zealand resident elects to prepare them in New Zealand currency. This amount is then to be converted into New Zealand currency at the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the accounting period of the FIF.[24]

The modifications to the CFC rules include modified rules for calculating the opening book value of any premises, plant, machinery, equipment and trading stock,[25] the acquisition price of any financial arrangement in relation to any accounting period[26] and special provisions to allow a deduction for foreign Goods and Services Taxes.[27]

Other sections of the Act are deemed to apply,[28] whilst some sections are excluded from the calculation of the branch equivalent income or loss. Among the excluded sections are: [29]

- which exempt from income tax interest payments made by the Government or by a local or public authority to non-residents,[30] or that exempt from income tax income derived by any organization established for the purpose of tourism or general public amenity development in any city, borough or other district;[31]
- that exclude from the accruals regime non-residents and non- resident withholding income,[32] or those which include attributed foreign income (in respect of an interest in a CFC) and all FIF income as assessable income directly;[33]
- that allow a deduction for first year depreciation on certain plant and machinery and on certain buildings,[34] or for certain development expenditure by a taxpayer engaged in any farming or agricultural business, a forestry business or aquaculture;[35] or
- that allow for income equalization.[36]

To accommodate FIFs under the method specific sections have been added that determine a taxpayer's share of the income calculated[37] and prescribe jurisdictional quarantining, similar to that prescribed under the CFC regime.[38]

23. Part XIIC is extended to apply by Sec. 245RH.
24. Sec. 245J(3).
25. Sec. 245J(4).
26. Sec. 245J(5).
27. Sec. 245J(16).
28. Sec. 245J(7) deems a business to be carried on in New Zealand if Sec. 74 (income derived from use or occupation of land), or Sec. 113A (supplementary depreciation allowance for plant and machinery used in two and three shift industries) or Sec. 128A to 128C (expenditure on land improvements used for farming, agriculture, forestry and in relation to aquaculture) apply to the business conducted by the CFC.
29. Sec. 245J(6).
30. Sec. 61(18).
31. Sec. 61(33).
32. Sec. 64M(e).
33. Sec. 65(2)(ea) and (eb).
34. Sec. 112.
35. Secs. 127A, 127 and 128, respectively.
36. Secs. 175 to 186.
37. Sec. 245RG.
38. Sec. 245RJ(3).

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This method is the fairest and most accurate as it only taxes the income as calculated in accordance with New Zealand tax law. However, on the down side, in order for interest holders to elect to use the method, they must have access to a large amount of financial information in respect of the FIF. Therefore, as the information requirements are onerous, it is likely that only a minority of taxpayers would use this method.

B. *Accounting profits method*

Under the accounting profits method[39] the net after-tax accounting profits or losses of a FIF for the relevant accounting period are multiplied by the income interest of the holder calculated in accordance with the CFC provisions of the Act.[40]

Although the amount of information required to use the method and the actual income calculation are greatly reduced when compared with the branch-equivalent method, its use is the subject of strict qualifying requirements. These include restricting its operation to interests in foreign companies[41] listed on a recognized exchange or which have their shares widely available. Also, in order to qualify, the accepted accounting principles must be used in the calculation of the foreign company's income and the audited net after-tax profits must be detailed in financial accounts sent to shareholders or made available to the public. Finally, the net after-tax profits must not be declared by the Commissioner as not representing the net profits of the company.[42]

Although this method does not reflect the income calculated in accordance with New Zealand law, it still provides a reasonable estimate of a taxpayer's income. Also, taxpayers will not be required to have access to large quantities of financial records in order to use the method. However, the number of persons able to use this method is again limited by the harsh qualification standards.

C. *Comparative value method*

The comparative value (CV) method[43] assesses the taxpayer on the change in the market value of an interest in a FIF over a financial period. It is the same method as prescribed in the former Section 245R(3). Although there are no requirements under the New Zealand proposals to use any particular calculation method, the CV method is deemed to apply when the accounting profits method is impractical to use. The precise formula for calculating the income attributable is as follows,

(a + b) - (c + d)

where:

a is the market value of the interest in the FIF held on the last day of the person's income year;

b is the aggregate of all distributions received or receivable in relation to the interest in the FIF during the income year (including any tax paid or payable by or on behalf of the person which is allowable as a credit to that person.[44] Item b also includes the proceeds received or receivable from the sale of all or part of the FIF interest during the year;

c is the beginning-of-year market value, i.e. the market value of the interest in the FIF held on the last day of the person's preceding income year;

d is the total market value of all amounts paid or payable in relation to the interest in the FIF during the income year. Item d will include all amounts paid or payable to purchase all or part of the interest.

If the result is positive, the amount represents the gross FIF income. If the result is negative a FIF loss has occurred. This FIF loss may be offset against other income according to a prescribed order.[45]

The taxpayer must first offset the FIF loss against FIF income derived by that taxpayer in the same income year from any FIF (regardless of the country or territory in which the FIF was resident). Any balance remaining then can be offset against other assessable income, derived in that income year. However, the amount offset is limited to the amount of FIF income that the person has derived in previous years, which has not been offset against other FIF losses.

Finally, where the total FIF loss cannot be offset using the above rules, the balance of the loss is carried forward[46] to the next income year. As FIF losses are to be offset in the same order as that in which they were incurred it is worth noting that losses carried forward are deemed to have been incurred on the last day of the income year in which they were incurred.

There are also group loss provisions which allow (subject to certain conditions) a FIF loss which is unable to be offset by a company, to be offset within the specified group to which the company belongs.[47]

This method has been the subject of many criticisms. The first criticism relates to accuracy. The taxpayer's income, which is estimated as being equal to the increase in market value of the FIF, will often bear no relationship to the taxpayer's actual share of income earned by the FIF.

Other criticisms are based upon equity concerns. Realized gains will also be assessed even though such gains would not be assessed if earned domestically. Should this criticism be dismissed by the fact that the realized gains, which are otherwise exempt in New Zealand, were in fact a stated target of the regime, the fact that unrealized gains can be taxed cannot be. This will occur where a fully distributing fund may experience an increase in market value due to increase in the value of its assets. The application of the market value in these circumstances will result in the taxation of these unrealized capital gains.

These outcomes are easily illustrated in the following example:

> Assume that an interest in a fund was acquired for $ 245,000 on 30 June 1994. For the year ended 30 June 1995 there are no distributions, but the market value has increased to $ 275,000 due to the

39. Sec. 245RF.
40. *Id.*
41. Sec. 245RC(4).
42. Sec. 245RC(5).
43. Sec. 245RD.
44. By virtue of Sec. 293.
45. Sec. 245RJ.
46. Subject to Sec. 188.
47. Sec. 245RK.

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increase in the value of land the fund owned. The interest is sold on 1 July 1996 for $ 275,000.

Thus, in 1995, applying the above formulas, the market value increase is $ 30,000. The taxpayer would be assessed $ 30,000 in respect of an unrealized capital gain for the year ended 30 June 1995. However, had the asset been a domestic one the $ 30,000 gain would not have been assessable (unless sold in the ordinary course of carrying on a business or deemed to be income under Section 65).

D. *Deemed rate-of-return method*

Under the deemed rate-of-return method the interest holder's income is calculated by multiplying "the adjusted cost" (book value) of the interest by a specified rate of return.[48] The rate was recently announced to be 11.6%. This method must be used where the comparative value or accounting profits methods are not available, or the taxpayer is a natural person with FIF funds not greater than $ 100,000 during the year.[49] Thus, it will be used mainly in respect of interests in private companies and interests in superannuation funds and life insurance policies.

The formula is adjusted to deal with variations[50] in the amount of the interest and in part year holdings.[51] Where the proceeds on disposal are greater than the book value, the method provides that the difference be assessed as it represents accrued income. Similarly, where the proceeds on disposal are less than the book value an equivalent deduction is available.

The major criticism of the method is that as the income calculation is based on an arbitrary figure it bears no relationship to the actual income earned. Further, if a penal rate is set by the Government, the effect of the method will be to deem the taxpayer's interest in the FIF to have an earnings rate far in excess of market returns. When faced with the stark reality of being taxed upon returns in excess of the market rates, taxpayers have no other option other than to dispose of such interests, regardless, in some cases, of the potential high realization costs.

IX. TAXATION OF FOREIGN LIFE ASSURANCE POLICIES

Although interests in life policies are deemed to be interests in FIFs, the regime does not prescribe any special calculation rules. Given the valuation problems, it is likely that the life policies will be assessed under the deemed rate-of-return method. The problem with this from an equity viewpoint is that the interest holder will be assessed not only on the investment component of the policy but also on the risk component of the premium. This problem will be compounded if the Government specifies a penal rate for the deemed rate-of-return method.

Further, as there are no exemptions, the effect of these measures is to remove any incentive for offshore life assurance policies and to destroy the market for single premium bonds ("wrap-around bonds"). This in turn will have a major impact upon expatriate investment decisions. Further, the high monetary cost of surrendering the policies may effect some migration decisions.

X. AVOIDANCE OF DOUBLE TAXATION

Income taxed under the branch-equivalent method may be taxed again upon distribution under the dividend withholding payment regime. To avoid this double taxation a branch-equivalent tax account may be maintained to relieve the tax imposed under dividend withholding to the extent that a credit for tax paid upon attribution on foreign income is recorded on that account.

XI. PENALTIES

The penalty and offence provisions were originally amended in 1988 to introduce new provisions to deal with CFC regime offences.[52] These provisions continue to apply to these new measures, prescribing offences for:

- knowingly failing to disclose any information required in relation to a FIF;
- knowingly making a false declaration or giving false information to the Commissioner; and
- aiding, abetting or inciting one of the above.

A taxpayer if convicted on any one of these offences a term of imprisonment of up to two years and/or a fine of up to $ 50,000 may be imposed. Officers and employees of a company may also be charged with an offence, where they are responsible for making disclosures for that entity.

XII. CONCLUSION

In summary, the scope of these anti-avoidance measures is such that it renders them akin to "applying a sledgehammer to crack a nut".[53] This is more so given their investment control objective. The result of combining the two policies has been to severely limit the range of offshore investments available to investors in New Zealand. Investor involvement has not only been removed in the passive income investments (pooled investment funds, short-term life policies and like investments), but also in active businesses, particularly in the emerging Asian markets. In their current form they can only have negative consequences for New Zealand, particularly in terms of the general development of an internationally competitive economy that is integrated with global markets.

Further, as a result of the introduction of these measures, every resident taxpayer with foreign investments would be wise to dispose of any investments not held in the 15th Schedule countries. To retain such investments would be foolhardy and costly leaving the investor after the fall of the hammer without the kernel, merely the dust.

48. Sec. 245RE(1).
49. Sec. 245RC(5).
50. Sec. 245RE(5).
51. Sec. 245RE(4).
52. Secs. 416(1)(ba), (bb), 416A(3) and 416B(2A) apply penalties for offences under the FIF regime.
53. "Taking the sledgehammer to Foreign Investment Funds", *Australian Financial Review* (28 April 1992), at 10.

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AUSTRALIA:

NEW FIF REGIME: AN INTERNATIONAL COMPARISON

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Contents

I. Introduction
II. To Whom Do the Measures Apply?
A. Which entities are caught
B. Which income is caught
C. To whom can attribution be made
III. Payment of Tax
A. Calculation and payment of tax
B. Distribution of profits
C. Relief from foreign taxes
IV. Example
V. Conclusion

I. INTRODUCTION

The Australian government recently introduced new measures[1] aimed at preventing the deferral of Australian tax through investment in non-Australian controlled offshore funds which do not pursue a full distribution policy. These funds formerly enabled the deferral of Australian tax through the accumulation of low-taxed income offshore, which on disposal of the interest in the fund was usually converted into concessionally-taxed capital gains. The new Australian measures are both similar and dissimilar to measures existing in the United States and in Germany. In broad terms, the new Australian measures provide that where an Australian taxpayer has an interest in an offshore fund which holds mainly passive income-earning assets, the income earned by that fund is to be attributed to the Australian taxpayer in proportion to that taxpayer's holding in the fund. The amount of income attributed is to be included in the taxpayer's assessable income for the year of income in which the accounting period of that fund ends.[2]

This article evaluates Australia's new measures by focusing on a number of the key elements to the applicability of those measures and compares the breadth of those elements with the corresponding elements under the US and German measures. Part II examines which persons are affected by the measures. Part III considers the payment of tax under the measures, including when tax on the attributed amount is to be paid and how it is calculated. Finally, Part IV provides a short factual example of the application of the measures in order to illustrate the differences between the measures imposed by each of the three countries under consideration.

Each of the headings addressed will first discuss the relevant provisions under the Australian measures. The relevant provisions under US measures are then compared, pointing out similarities and differences where relevant. Finally, the relevant German provisions are compared to the corresponding provisions under both the Australian and US measures.

II. TO WHOM DO THE MEASURES APPLY?

This section compares the persons caught by the measures.

The discussion will first focus on which foreign entities are caught, i.e. which are the foreign entities whose income may be attributed to resident taxpayers? Secondly, the types of income which may be attributed under the measures will be considered, and finally the discussion will shift to whom attribution of the foreign entities' income can be made, i.e. at whom the measures are aimed.

A. *Which entities are caught*

1. Australia

The Australian measures potentially apply to any non-resident corporation or trust[3] as well as certain foreign life assurance policies[4] that have an investment component. However, the measures go on to provide an exemption for a direct investment in a foreign corporation which is carrying on an active business by principally engaging in "eligible activities".[5] All activities other than those listed are considered to be eligible activities, i.e. a blacklist approach of activities is used. Business activities which are not "eligible activities" are banking and the provision of finance, financial intermediation services, life insurance business, general insur-

1. Which applies from 1 January 1993 and is known as the Foreign Investment Fund regime.
2. Sec. 529 Income Tax Assessment Act (ITAA). Unless otherwise indicated, all references are to the ITAA.
3. Sec. 481.
4. Sec. 498.
5. Sec. 497. Because both the US and German measures only apply to foreign corporations, the discussion of the Australian measures will be limited to their application to foreign corporations unless otherwise relevant. However, it is worth noting that the active business exemption is not available to a taxpayer with an interest in a non-resident trust even though the trust's underlying investments are principally active.

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ance business, management of funds, certain activities connected with real property and investment in certain tainted assets.[6]

There are two methods by which a corporation may show that it is not principally engaged in one of the blacklisted activities. The first method uses stock exchange categorization or international sectoral classifications[7] to establish a corporation's principal activity at the end of the accounting period of the foreign corporation.[8] This method can only be used if the interest held by the taxpayer in the foreign corporation is listed either on one of the stock exchanges approved by the Australian legislation or an approved international sectoral classification system.[9]

The second method of showing a foreign corporation is engaged principally in active business is the balance sheet method. Where at least 50 percent of the gross value of a foreign corporation's assets are held for use in active business, the corporation will pass the active business test. This test is satisfied by reference to the foreign corporation's balance sheet which must be prepared in accordance with commercially accepted accounting principles. For the purposes of this 50 percent test, where an asset is not used solely in active business its value must be apportioned, the asset's active business value being reduced to the extent that the asset is used for non-active purposes.[10]

For the purposes of this second method, there is also a look-through rule which applies to direct or indirect holdings of 50 percent or more in other corporations.[11] Where this rule applies, the foreign corporation is treated as owning its proportionate share of the subsidiary's assets. Further, the foreign corporation's holding in the subsidiary is ignored as an asset for the purpose of establishing whether the foreign corporation is engaged principally whether active business under the balance sheet method. The effect of the look-through rule is that a foreign holding corporation with active subsidiaries will not fail the balance sheet method of determining if its principal activity is active and therefore will not be subject to the Australian measures.[12]

Where a foreign corporation is engaged in two or more active business activities but the corporation is not principally engaged in one of those activities, the corporation will be subject to the Australian measures. However, an exemption is provided[13] where two or more activities of the foreign corporation, which are eligible activities for the purposes of the active business exemption or for one of the industry specific exemptions (see below), when taken together are the activities in which the corporation is principally engaged. For this exemption to apply, the corporation's shares must be listed on an approved stock exchange and widely held.

While banking, insurance and activities of certain real property corporations are expressly excluded from eligible activities and these activities are therefore prima facie subject to the Australian measures, specific exemptions are provided for these activities. To fall within these exemptions,[14] shares in the foreign corporation must be widely held and listed on an approved stock exchange. The exemptions are only available to shareholders who hold such shares.

The conduct of life assurance business is also provided with a specific exemption[15] where the foreign corporation's assets are principally used in carrying on that business.[16]

2. United States

The US measures only apply to "Passive Foreign Investment Companies" (PFICs), as defined.[17] The definition has two prongs: a PFIC is a foreign corporation which in any given year has at least 75 percent of its gross income represented by passive income;[18] and a foreign corporation is a PFIC if in any given year at least 50 percent of its assets were used in earning passive income.

When comparing the definition of a PFIC under the US measures with a foreign corporation which meets the active business test under the Australian measures, two points are worthy of note. Firstly, both measures have a 50 percent passive assets test; however, the second test under the Australian measures looks to stock exchange categorization while the US second measure tests the age of passive income earned. The Australian test is to be preferred, as it promotes certainty and is simple to apply. Secondly, the US measures concentrate on the type of income earned, i.e. passive income, while the Australian measures focus on the type of business conducted, i.e. active business. This second difference does not appear to be significant unless it can be argued that under the Australian measures there may be circumstances where an asset may be classified as an active business asset despite the fact that it produces passive income, i.e. an argument similar to the German functional approach (see below).[19]

Under the US measures, "passive income" is defined to include dividends, interest and its equivalents, passive rents and royalties, annuities, gains from the sale of shares, bonds and certain other assets, gains from commodity trading and certain foreign exchange gains. There are two exclusions from this definition. Firstly, certain income derived in the active conduct of a banking or insurance business. The second exclusion from the definition of passive income is inter-

6. These activities are listed in Schedule 4.
7. Such as Bloomberg's Information Systems or Morgan Stanley Capital International Index.
8. Sec. 499.
9. Sec. 500.
10. Sec. 500(11).
11. Sec. 501.
12. There is no limit to the number of tiers of subsidiaries that can be looked through, provided the first tier foreign holding corporation has an effective interest of at least 50% in the lower tier corporation (see Sec. 501).
13. Sec. 523.
14. See Secs. 503, 508 and 511.
15. Secs. 506-507.
16. It should be noted that despite this exemption, the holder of a life assurance policy with an investment component will still be subject to attribution.
17. The US measures were introduced in 1986 by Internal Revenue Code (IRC) Sec. 1296(a).
18. A tax bill has been introduced into the US Congress which, if passed, will lower this level to a 60% passive income test.
19. It is submitted that the requirement under the Australian active business test that an asset be used `solely' in active business (and an apportionment of its value where the asset is not) would negate any argument that the functional approach could apply.

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est, dividends, rents or royalties received from a related person[20] which is paid from income which is not itself passive.

In determining whether a foreign corporation is a PFIC, look-through rules apply. If the foreign corporation has an interest of 25 percent or more in another corporation (a 25 percent subsidiary), that corporation is treated as earning a portion of the subsidiary's income based on its level of shareholding. These rules attribute a proportionate share of both the passive and the active income of the 25 percent subsidiary for the purpose of the 75 percent passive income test in determining whether a foreign corporation is a PFIC. Similarly, these look-through rules treat the foreign corporation as the owner of its proportionate share of the assets of the subsidiary in determining the 50 percent assets producing passive income test. When these look-through rules apply, any dividends or interest received from the subsidiary are ignored for the purpose of the 75 percent test and the foreign corporation's holding in the subsidiary is ignored for the purpose of the 50 percent test. These look-through rules also extend to lower tier subsidiaries owned indirectly by the foreign corporation. The effect of these look-through rules is that a foreign holding corporation with active subsidiaries will not be caught by the US measures. This US rule, which only requires a 25 percent subsidiary, can be contrasted with the corresponding Australian provision where a 50 percent subsidiary is required.

Finally, under the US measures there are exceptions to the definition of a PFIC for the first year of operation of the foreign corporation if it thereafter engages in active business, and a grace year for a foreign corporation that disposes of an active business and is in the process of acquiring another active business. The Australian measures have no equivalent; this may be due to the fact that the Australian measures also have no equivalent to the US 75 percent passive income test, but only an active assets test. It is probable that when an active business starts up or is in the process of acquiring a new active business the assets it holds will be classified as active assets even though they may not earn active income at the relevant time. As previously mentioned, the Australian measures are not concerned with active income but rather active business.

3. Germany

The German measures[21] include two limits on the applicability of the attribution regime to foreign corporations. Firstly, the German measures were enacted as an extension of their controlled foreign corporation (CFC) measures.[22] One effect of this extension is that the German measures only apply to a foreign corporation which is subject to low-level taxation in the country where that foreign corporation resides. Thus the foreign corporation has to be subject to effective foreign tax of less than 30 percent before the German measures can apply to such a corporation. Contrast this position with both the Australian and US measures which may apply to foreign corporations resident in countries which have an effective tax rate which is higher than the respective tax rates in those countries.

The second limit on the applicability of the German measures to foreign corporations is that only foreign corporations which generate predominantly "income with investment character" as defined (i.e. passive type income) may be subjected to the measures. "Predominantly" is accepted to mean that the foreign corporation's income must consist of more than 50 percent passive income before the measures can apply. This German test is much the same as the 75 percent passive income test for the definition of a PFIC under the US measures but with the threshold reduced to 50 percent. However, unlike either the Australian or the US measures, there is no alternative test for determining "passive corporation" status under the German measures. Further, the German measures are similar to the US measures in that they appear to concentrate on the type of income earned and not, as the Australian measures do, the type of business carried on by the foreign corporation. But this apparent similarity with the US measures and difference with the Australian measures may be deceptive because of the application of the German functional approach which results in a consideration of the underlying business in determining whether or not income is to be classified as passive. The German approach requires that items of income which would qualify as passive income if viewed separately be regarded as part of the income generated from an active business if it is viewed from a functional point of view as associated with an active business. For example, interest received on the interim deposit of funds set aside for the purchase or manufacture of machinery to be used in a manufacturing industry is, under the functional approach, not passive income.

"Income with investment character" (i.e. passive type income) is defined[23] as including the following types of income: income derived from holding, administering, value-maintenance or value-appreciation of monetary funds, claims, securities, participations or similar assets. While the Australian blacklist defines what is not active business (i.e. non-eligible activities), the German blacklist defines what is passive income although this difference appears to be of little significance.

The German measures provide four exceptions to this definition of passive income. Income to which these exceptions apply is not "income with investment character" and will not be counted towards meeting the 50 percent passive income test, but rather will reduce the proportion of passive income and therefore reduce the possibility that the German measures apply. The exceptions from the definition of "income with investment character" are as follows.

(a) *Active business exception*

Income generated by an active business conducted by a foreign corporation is not considered passive income. The German measures use the definition of "active" activities contained in the German CFC measures. These activities include agriculture and forestry, manufacturing and extractive industries, trading activities, international financing transactions,

20. Persons are "related" if one of them controls the other by 50% voting or ownership, or if they are under common control.
21. Adopted on 14 February 1992.
22. Unlike both the Australian and the US measures which were adopted separately from their CFC measures.
23. Sec. 10(6) Foreign Transactions Tax Act.

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certain banking and insurance activities and the receipt of certain dividends.

Banking and insurance activities may be considered to be active in similar circumstances as the Australian measures, i.e. they must be widely held and listed on an approved stock exchange. Life assurance is treated differently under the Australian measures.

Dividends received by a foreign corporation are principally treated as passive income. But where those dividends are received from a corporation of which the foreign corporation holds at least 25 percent, those dividends may be treated as active if two conditions are met. Firstly, the foreign corporation and the subsidiary must reside in the same jurisdiction, and secondly, the gross income of the subsidiary must be almost exclusively derived from active business. This provision is somewhat similar to the second exception to the US definition of passive income which treats dividends received from an active related corporation as active income. The Australian measures require no equivalent provision because those measures are not concerned with income.

(b) *Intercompany participations*

The second exception to the definition of "income with investment character" is similar in effect to the Australian and US look-through rules. This exception provides for attribution to the foreign corporation of a portion of the income of another corporation in which the foreign corporation holds at least a 10 percent interest. This threshold of 10 percent is much lower than the Australian 50 percent or the US 25 percent threshold. This exception attributes a portion of both the active income and the passive income of the 10 percent subsidiary. This exception can be contrasted with the classification of dividends received from a 25 percent subsidiary as active income discussed above. The look-through rules apportion undistributed income whereas the 25 percent rule deals with distributed dividends.

(c) *Intercompany financing*

The third exception to the definition of passive income applies to income derived from the financing of a foreign permanent establishment or a related corporation within the same group. This means a foreign company may be funded by equity and earn interest income from financing active group members or branches without being caught by the German measures. This may also be the case under the US measures due to the second exception to its definition of passive income.[24] By contrast, the Australian measures are not concerned with income types but rather with the type of business being conducted by the foreign corporation. In such a financing situation, under the Australian measures the assets of the subsidiaries concerned would be attributed to the foreign financing corporation and that corporation's holdings in the subsidiaries ignored under the look-through rules. The result may ultimately be the same, but not necessarily. Where assets bear different rates of return on their value a foreign corporation may be caught by the measures under a passive income test but not under a passive assets test or vice versa.[25]

(d) *Arm's length services*

The fourth exception to the definition of passive income under the German measures is for income derived from arm's length fees for services rendered by the foreign corporation. These services must be rendered to third parties, but the third party may be related to the servicing foreign corporation.

B. *Which income is caught*

This section considers what type of income earned by a foreign corporation may be attributed to a resident shareholder.

1. Australia and the United States

Under both the Australian and US measures, *all* income of a corporation subject to the measures may be apportioned and attributed to resident shareholders and not just the passive income which subjected the corporation to those measures. Attribution under both the Australian and US measures is not limited to passive income; once a foreign corporation has failed the active business test under the Australian measures or is deemed a PFIC under the US measures, even a proportionate share of the active income of such a foreign corporation is attributed to a resident shareholder.

2. Germany

In stark contrast to the Australian and US measures, the application of the German measures may only attribute the passive income of a foreign corporation to resident shareholders. Only "income with investment character" may be attributed to German shareholders.[26] Therefore the German measures are narrower in application than the Australian or US measures. The Australian and US measures are restricted in their application to certain types of foreign corporations but will attribute all income of such a corporation to resident shareholders. The German measures also restrict their application to certain types of foreign corporations but in addition restrict the type of income which may be attributed to German shareholders, i.e. only passive income.

C. *To whom can attribution be made*

This section looks at which residents may have their taxable income increased by the attribution of income earned by a foreign corporation which is subject to the measures.

1. Australia

The Australian measures apply to Australian taxpayers who have an interest in a FIF to which the measures apply. "Interest" is defined[27] to mean a share in a corporation[28] or an

24. This US exclusion appears to cover similar ground to the combined effect of the German measures which treat dividends received from active subsidiaries as active income and the intercompany financing exception from passive income being discussed. This is because the US measure covers the payment of not just dividends but also interest, rents and royalties.
25. Of course the threshold required is also important, the Australian threshold at 50% is much higher than the other two countries.
26. Sec. 7(6) International Tax Act.
27. Sec. 483.
28. Or an interest in the corpus or income of a trust.

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instrument to acquire such a share, e.g. an option or a convertible note. The Australian measures apply regardless of the level of the taxpayer's interest in the FIF. However, these measures do not apply to an interest in a FIF where that interest is sold before the end of the year of income in which it was purchased. Such a disposal is subject to ordinary taxation measures, i.e. the gain is taxed but there is no attribution of income. Some Australian taxpayers are exempt from the new measures despite their holding an interest in a FIF. Those exemptions are as follows.

(a) *Temporary residents*

An exemption from the Australian measures is available for taxpayers who are resident in Australia on a temporary entry permit.[29] This exemption is available for a maximum of four years.

(b) *Attributable taxpayers*

Where the new measures overlap with the existing Australian CFC or transferor trust measures, the CFC or transferor trust measures only apply, relieving any double taxation.[30]

(c) *Small investor*

The third, and most important exemption, for Australian interest holders in a FIF is the exemption available for small investors.[31] Where an Australian taxpayer's interests in FIFs[32] do not exceed A$ 50,000 aggregate in value at the end of the year of income, that taxpayer will not be subjected to attribution under the Australian measures. In determining the A$ 50,000 level, the taxpayer must aggregate his interests with those of his associates. "Associates" is defined to include relatives, controlled corporations and trusts, and partnerships in which the taxpayer is a partner.[33]

The small investor exemption is only available to a taxpayer who is a natural person. In valuing the taxpayer's interests, the higher of cost or market value at the end of the year of income is used. Where the aggregate of these values does not exceed A$ 50,000, the Australian measures will not apply to the directly held interests of the taxpayer.

However, an Australian taxpayer meeting this test who also holds an interest in a resident public unit trust may still be indirectly subjected to attribution in respect of his share of the trust's income where that trust holds interests in FIFs. This is because the trust is subject to attribution. In this case there is a second test which, if satisfied, excludes the effect of the Australian measures when calculating the taxpayer's share of income from the trust.[34] To obtain this extended exemption the taxpayer must show that the aggregate value of his interests in FIFs *and* resident public unit trusts does not exceed the A$ 50,000 limit.

(d) *Foreign employer-sponsored superannuation*

Natural persons who hold an interest in a foreign employer-sponsored superannuation fund which is a FIF are not subject to attribution with respect to that interest.[35] This exemption is only available if the taxpayer is or was an employee of the sponsoring employer.

(e) *5 percent of interests in FIFs only are caught*

Where 5 percent or less of the aggregate of a taxpayer's interests in FIFs are subject to attribution under the Australian measures, this 5 percent will be exempt from the measures together with the other 95 percent that is exempt under other exemption provisions.[36]

(f) *Trading stock*

An exemption is also available for an interest in a FIF that is trading stock, provided the taxpayer values that stock at the end of each year at market value.[37]

2. United States

Similar to the Australian measures, the US measures apply to all US taxpayers regardless of their level of participation in a PFIC.

The US measures apply to US taxpayers which own shares in a PFIC. Ownership of shares will include the holding of options to the extent provided by regulations. Contrast the Australian measures which expressly apply to the holders of options or convertible notes. The US measures also contain broad attribution rules which determine whether a US taxpayer is to be treated as the shareholder of a PFIC. US taxpayers may be taxable under the US measures if they hold shares in a PFIC indirectly through a foreign corporation (which may itself be a PFIC), partnership, trust or estate. These attribution rules are only applied to the extent that their ultimate effect is to treat shares of a PFIC as held by a US taxpayer. While the Australian measures have no equivalent, they may classify the offshore entity through which the Australian taxpayer indirectly holds interests in FIFs as being subject to the Australian measures. This is because all non-resident trusts are considered FIFs and partnerships are not taxable entities in Australia so they will be looked through in determining FIF status.

3. Germany

Once again, the German measures are the narrowest of the three countries under consideration. The German measures only apply to German taxpayers who have a shareholding of at least 10 percent in the foreign corporation. It appears that this 10 percent level was chosen because an investment of less than 10 percent does not benefit from the intercompany dividends-received exemption found in most German tax treaties. Therefore distributions received by a corporation from a foreign holding of less than 10 percent or by an individual from a foreign holding of any level, are subject to Ger-

29. Sec. 517.
30. Sec. 494.
31. Sec. 515.
32. Including interests in foreign life assurance policies which are caught by the Australian measures.
33. Sec. 470.
34. Sec. 96A.
35. Sec. 519.
36. Sec. 525.
37. Sec. 521.

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man tax.[38] This limitation on the applicability of the German measures shows that the policy behind the German measures was not just aimed at the deferral of German tax through investment in foreign corporations, but was also aimed at the perceived abuse of the intercompany dividends-received exemption in tax treaties. Neither the Australian nor the US measures have a shareholding limit before which attribution can be made, although the Australian small investor exemption may provide much the same relief for individuals.

It appears that unlike the Australian measures, the German measures do not apply to the holding of options or convertible notes. Further, the German measures do not apply to the use of a non-resident related person to hold shares in a PFIC for a German resident; they have no equivalent to the US attribution rules discussed above.

III. PAYMENT OF TAX

This section examines the payment of tax. Firstly, the calculation of the taxable amount and the time for payment of tax imposed will be discussed. Secondly, the effect of a distribution of profits by the foreign corporation from income which has been previously attributed to shareholders will be explored, and finally the relief available for foreign taxes imposed on income which has been subject to attribution and that available when a subsequent distribution is made will be considered.

A. *Calculation and payment of tax*

1. Australia

Where the Australian measures apply, an amount of the FIF's income will be attributed to and included in the Australian taxpayer's assessable income for the income year in which the statutory accounting period of the FIF ends. The amount to be included in the taxpayer's assessable income will be determined under one of three taxing methods. Under each of these methods the income to be attributed is measured in relation to a notional accounting period. This period is generally the taxpayer's income year but the taxpayer may elect to use the period for which the annual accounts of the FIF are made.[39] The legislation intends that the calculation of the attributable amount under each of these three methods approximates the portion of the FIF's net income for the notional accounting period that the taxpayer's shareholding in the FIF bears to the FIF's entire share capital. This amount, as calculated by any of the three methods is then reduced by any distributions made to the taxpayer by the FIF in the notional accounting period and the resultant amount is the sum that is included in the taxpayer's assessable income for the relevant year of income. The three methods of calculating the taxable amount are as follows.

(a) *Market value method*

The amount attributable to the taxpayer under the market value method is the increase in the market value of the taxpayer's interest in the FIF over the notional accounting period.[40] This method applies if it is practicable to do so and the taxpayer has not chosen to apply the calculation method. It is only practicable to use this method where it is possible at the end of the year of income to ascertain the market value for the class of interest in a FIF held by the taxpayer. Market value is determined by reference to quotations on approved stock exchanges or the officially quoted buy-back or redemption price is used.

In calculating the attributable amount, distributions made to the taxpayer during the year are added to the end of year market value of the stock. From this amount is deducted the opening market value for the year; the result is known as the attributable amount which will be included in the taxpayer's assessable income subject to the deduction for current year distributions mentioned earlier. Where this calculation results in a loss, the loss can be set off against other assessable income up to a limit of the amount previously subjected to the Australian measures for which loss relief has not been claimed. Any excess loss which cannot be set off against other assessable income may be carried forward to set off against any future assessable income, subject to the same limitation.

(b) *Deemed rate-of-return method*

The deemed rate-of-return method[41] applies where it is impracticable to apply the market value method and the taxpayer has not chosen to use the calculation method.[42] This method is applied separately to each group of interests held by the taxpayer. A group of interests is constituted by interests of the same class in the same FIF. The amount to be included in assessable income is the increase in value of the group of interests over the year subject to reduction for distributions made in the current year. This increase is determined by taking a pre-determined percentage of the opening value for the year in question. This percentage is currently set at 4 percent above the long-term bond rate. The opening value for the year is the closing value for the previous year plus the calculated increase for that year, i.e. the cost of the investment is compounded. The initial opening value is the consideration paid for the interest. Where the interest exists at the commencement of the FIF measures, a quotation value on an approved stock exchange, an independent valuation or the initial consideration indexed to the date of the commencement of the FIF regime will be used as the initial opening amount.

(c) *Calculation method*

The calculation method will only be used if the taxpayer elects to apply it.[43] Under this method, a notional income for the FIF is calculated and apportioned between holders of interests in that FIF. The first step is to calculate the FIF's notional income[44] which will include any gross income and

38. This tax is likely to be reduced by foreign tax credits for direct foreign taxes paid on the distribution, e.g. dividend withholding tax.
39. Sec. 486.
40. Secs. 537-542.
41. Where the Australian measures apply to an interest in a foreign life insurance policy, the deemed rate of return method must be used.
42. Secs. 543-557.
43. Secs. 558-583.
44. The rules used to calculate this income are a modified version of the general rules applicable under the ITAA.

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profits and gains of a capital or revenue nature derived during the notional accounting period. Secondly, deductions from this amount are generally allowed as they are incurred.[45]

Where the FIF itself has an interest[46] in another FIF, generally an amount of the income of the second tier FIF will be included in the notional income of the first tier FIF. This amount is calculated as though the first tier FIF was an Australian taxpayer. Notional income will not include any dividend or distribution paid to a first tier FIF by another FIF. Further, any amount to be included in the notional income of a FIF is a pre-tax amount.

A notional deduction is also allowed from the notional income of a FIF for Australian tax and foreign taxes paid by that FIF or any other FIF provided the tax relates to income included in the calculation of the notional income of that FIF.

Loss relief is granted in similar circumstances to that granted under the market value method.

While the market value method is likely to tax the unrealized capital gains of a FIF,[47] by contrast, the calculation method would not tax the unrealized capital gains of the FIF because capital gains will not be included in a FIF's notional income until realized. It can therefore be assumed that the attributable amount calculated under the calculation method will generally be less than that calculated under the market value method in years where capital gains are not realized.[48]

2. United States

The US measures, unlike the Australian measures, allow taxpayers to defer paying US taxes on otherwise attributable income until such time as they have actually received funds from the PFIC. A deferral charge is imposed for any such deferral in addition to regular tax. The US government felt that a taxpayer should not be forced to pay taxes on income that the taxpayer had not received provided the taxpayer and not the US government pays the cost of deferral. Contrast the Australian measures where no such option is available and the taxpayer must pay the tax imposed on the attributable amount despite the taxpayer not having received the income which has been subjected to taxation.

Under the US measures, the benefits received by the deferral of US tax through the use of a PFIC are removed in two ways. The first method imposes no current taxation but does impose a deferral charge on the shareholders that receive actual distributions from a PFIC or dispose of their shares in the PFIC. The second method imposes current taxation on the portion of income of a PFIC attributable to a US taxpayer's shareholding in that PFIC. This method is broadly similar to the calculation method under the Australian measures. However, even under this second method the taxpayer may choose to defer any tax currently payable, subject again to a deferral charge.

The first method is used when the taxpayer does not make an election to use the second method. Under this first method a taxpayer who disposes of his shares in or receives an "excess distribution" from a PFIC will be subjected to tax on any gain as well as a deferral charge to compensate the government for the delay in receiving payment of the deferred taxes. An excess distribution is a distribution received by a taxpayer from a PFIC that exceeds 125 percent of the average amount of annual distributions received by that shareholder during the preceding three years. Previous excess distributions subject to a deferral charge are not taken into account when computing this average. The excess distribution as calculated is allocated rateably to each day in the period that the shareholder has held the shares in the PFIC. The amounts attributed to each day are subjected to tax at the highest marginal rate for the year in question. A deferral charge is then imposed by way of accrued interest. There is no deferral charge for amounts allocated to the current year. Taxpayers that dispose of their shares in a PFIC are taxable on any gain recognized on the disposal as if that gain were an excess distribution, regardless of whether there has been a high level of distribution during the period of the shareholder's ownership.

The taxation of a gain on disposal of shares in a PFIC as an excess distribution may include the taxation of unrealized gains at the foreign corporation level, something which would not occur even if the PFIC was subjected to full current taxation. Upon such a sale, increases in value of the assets of a PFIC are allocated rateably to the entire holding period of the shares even if realization of the gains by the PFIC itself came later or not at all. Earlier, under the Australian measures it was suggested that the market value method may also tax these types of unrealized gains.

The second method is to currently tax the income of a PFIC attributable to a PFIC's shareholders as a deemed dividend. This method allows capital gains of the PFIC to flow through to the shareholder on disposal and be taxed at slightly concessional rates. The PFIC is required to be treated as a "qualified elective fund" (QEF). This status is granted to the PFIC for each shareholder individually, depending on whether that shareholder so elects and the PFIC complies with certain reporting requirements. Every taxpayer that makes such an election must include its pro rata share of the profits of the PFIC in its gross income. This amount is subject to current taxation.

As mentioned earlier, this method broadly corresponds with the calculation method under the Australian measures. One major difference between the application of these methods is the treatment of income from second tier FIFs or PFICs. Under the US measures there are broad attribution rules (see above) which will attribute shares held by a first tier PFIC in a second tier PFIC to US taxpayers for the purposes of current taxation. In this case, the US taxpayers will be subjected to two separate levels of attribution, one for the first tier PFIC and another for the second tier PFIC. Contrast the position under the Australian measures (discussed above) where a portion of the second tier FIF's income is attributed to the first tier FIF, so the taxpayer suffers indirect attribution from

45. However, a deduction is generally not allowed for expenditure on capital assets, but depreciation may be allowed.
46. There is no limitation on the level of this interest.
47. Assuming that these gains are reflected progressively in the value of quoted interests in the FIF from year to year.
48. Unless the FIF has incurred unrealized capital losses which current depreciation has not compensated for.

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the second tier FIF. Under the US measures, the US taxpayer is subjected to direct attribution from the second tier PFIC.

Under the US measures payment of tax on the attributable amount may also be deferred by a further election of the taxpayer, this time on a yearly basis. This deferred tax is subjected to an interest charge generally applicable to late payment of taxes. This deferral expires upon a subsequent distribution or transfer of the shareholding giving rise to the taxation.

Another point of contrast between the Australian and the US measures is that while the Australian measures have no election to defer the amount of current taxation, the US measures have no equivalent to the deemed rate-of-return method or the market value method of calculating the taxable amount. In particular, the latter method seems appropriate when a shareholder may have difficulty in obtaining the information necessary to use a calculation type method from an uncontrolled foreign corporation. It is therefore not surprising that the market value method would be introduced into the US measures if the bill to amend the US measures mentioned earlier is passed.[49] Under that bill, each US taxpayer owning less than 25 percent of a PFIC will be taxed under one of three methods: a calculation type method; current taxation on an annual increase in the value of the PFIC's shares, determined by a "mark to market" valuation, i.e. a market value method; or an interest charge on the disposal of PFIC shares similar to the present measures. Where a US shareholder owns 25 percent or more the calculation method must be used.

3. Germany

At the end of the German taxing year, undistributed passive income of a foreign corporation is attributed to and taxed in the hands of shareholders caught by the German measures as if it had been distributed in the form of a dividend. The quantum of passive income is computed in accordance with the valuation and accounting rules of German law. The attributable amount taxable in the hands of the German taxpayer is a portion of the total attributable income of the foreign corporation depending on the taxpayer's shareholding. This method of calculating the attributable amount is broadly similar to Australia's calculation method or the computation of the current taxable amount under the US measures. However, the German measures are only concerned with calculating the amount of passive income. This is also the only method of calculating the taxable amount under the German measures, unlike the Australian and US measures which provide options.

B. *Distribution of profits*

This section discusses the distribution of profits by the foreign corporation from income which has been previously attributed to a shareholder and the effect that such a distribution has on the shareholder's taxable income.

1. Australia

A distribution from income which has been attributed to a taxpayer under the FIF measures is exempt from tax when paid to that taxpayer.[50] This is done in order to prevent the double taxation of those attributable profits. The exemption is only available where the distribution comes to the particular taxpayer who was subject to attribution. Additionally, when an interest in a FIF is disposed of the money received from the sale is reduced by previously attributed income that has not been distributed to the taxpayer, thereby reducing any capital gain.[51]

To claim the exemption on distribution or the reduction on disposal, the taxpayer must keep records of the income attributed under the FIF measures and any distribution from the FIF for which an exemption or part thereof has been granted. These records are known as attribution accounts.[52] These attribution accounts are credited by amounts attributed to the taxpayer from the FIF. The accounts are debited by the amount distributed to the taxpayer by the FIF. Any distribution from the FIF to the taxpayer will be exempt unless the payment exceeds the surplus of the account. In such a case only an amount equal to that surplus will be exempt. These attribution accounts are specific to a particular taxpayer, so that when income is attributed to an Australian partnership or trust, the credit does not attach to the partnership or the trust but the person paying the tax, i.e. the partner or beneficiary.

2. United States

Where a shareholder has not elected for current taxation and receives a distribution which is an excess distribution (see discussion above), the distribution gives rise to the imposition of tax at the highest marginal rates and a deferral charge. Undistributed income included in the gross income of a shareholder under the current taxation election is not taxable again when an actual distribution is made. However, any taxes deferred under the current taxation election and accrued interest thereon must be paid at the time of distribution. Such a distribution from previously attributed earnings of the PFIC is treated as a distribution which is not a dividend and therefore not taxable as such.

Under the current taxation election, the cost base of the holding in the foreign corporation is altered from year to year. That cost base is increased for undistributed attributable amounts and decreased for distributions from profits which have already been attributed. Under the Australian measures, it is not the cost base that is altered but the consideration received from the sale of the shares.

3. Germany

The amount of income which will be attributable to a German taxpayer in any given year is reduced by dividends received in that year. Similar to the Australian and US measures, dividends actually distributed by the foreign corporation from previously attributed income are exempt up to the amount of previously attributed income. The German measures also reduce the tax payable on gains received on the sale of shares in a PFIC by the tax paid on attributed amounts that have not been distributed.

49. See *supra* note 18.
50. Sec. 23AK.
51. Sec. 613.
52. The rules in relation to these accounts appear in Secs. 601-607.

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C. *Relief from foreign taxes*

This section considers what relief is available for foreign taxes imposed on both income that has been subject to attribution and distributions which have been made from such income.

1. Australia

Under the foreign tax credit system, foreign-source income derived by Australian residents is generally subjected to Australian income tax. A credit for foreign tax paid, up to a limit of the Australian income tax payable on the relevant amount, is allowed against the Australian tax payable. Further, an Australian resident corporation that receives a dividend from a related foreign corporation is allowed not only the direct credit for foreign taxes imposed on the dividend but also an indirect credit for any foreign taxes imposed on the portion of profits from which the dividend is paid, i.e. the underlying foreign tax. A foreign corporation is a related corporation if the Australian corporation has a direct voting interest of at least 10 percent in the foreign corporation. This relationship can extend through any number of tiers of foreign corporations provided each member in the chain has a 10 percent interest in the corporation in the tier below and the Australian corporation has a direct or indirect voting interest of at least 5 percent in the foreign corporation. The credit allowable for foreign tax paid on foreign income is also subject to quarantining provisions whereby the allowable credit is calculated separately for various types of income. Further, excess foreign tax credits can be carried forward for five years and applied against foreign income of the same class. Non-portfolio dividends paid to a resident corporation by a related corporation which is resident in one of certain listed countries[53] are exempt from Australian tax.

The availability of relief for foreign taxes when income of a FIF is attributed to an Australian taxpayer will now be considered. Firstly, where the market value method is used to determine attributable income, no credit is allowed for foreign tax paid by the FIF. This is because the closing market value of the interest in the FIF implicitly takes into account any liability for taxes. No credit for this underlying tax is available where the deemed rate-of-return method is used to calculate FIF income.

Where the calculation method is used, a foreign tax credit may be allowed for the foreign tax paid by the FIF on the income which has been attributed. However, this will only be allowed where the Australian taxpayer and the FIF are related.[54] The credit allowed is equal to the resident corporation's share of the taxes paid by the FIF that were allowed as a notional deduction in the calculation of the FIF's notional income. However, where the credit is claimed, the foreign attributable income in the hands of the Australian related corporation must be grossed up to include the foreign tax, i.e. the deemed underlying tax credit.[55]

Relief from foreign taxes when a distribution is made in whole or in part from income which has been previously attributed will now be considered. Firstly, the part of the dividend which is taxable[56] may qualify for a foreign tax credit under the general provisions mentioned earlier. In addition, the taxpayer is allowed a credit for the foreign tax paid on that portion of the dividend that is exempt because of previous attribution.[57] The difficulty with these credits is that when attribution is made, Australian tax is paid on the foreign income. When a distribution from that income occurs some time later, foreign withholding tax will be paid on the distribution and a foreign tax credit will arise in Australia despite the dividend being exempt. However, this credit can only be set off against foreign income of the same class, but the foreign income it relates to may have been attributed and taxed some years before and the taxpayer is only allowed to carry excess credits forward for five years. Shareholders who have amounts attributed to them and taxed, and receive a final large distribution from a FIF[58] may find that they have large foreign tax credits and after the disposal of their interest in a FIF, no foreign income to set them against.

As mentioned earlier, where the Australian shareholder and the FIF are related corporations, the shareholder is entitled to claim a foreign tax credit at the attribution stage for the underlying foreign tax on the income attributed, but only if the calculation method is used. A shareholder who claims such a credit must keep "attributed tax accounts" in addition to the attribution accounts mentioned above.[59] The foreign tax credit which is normally allowed on the distribution of profits from previously attributed income, including the credit for underlying foreign tax, will be reduced by the tax credit which the shareholder has already claimed at the attribution stage.

2. United States

The US measures with respect to relief for foreign taxes are broadly the same as the Australian measures, i.e. there is both a direct foreign tax credit for foreign taxes paid on distributions to US shareholders and an indirect credit for the foreign tax paid on the income from which the distribution is made where the US shareholder is a corporation with at least a 10 percent interest in the foreign corporation paying the distribution.

Where such a 10 percent corporate shareholder has elected for current taxation it can claim an immediate tax credit for the underlying foreign tax paid by the PFIC on the income which has been attributed to it. This also requires the grossing up of the attributable amount to include the indirect foreign taxes. When a distribution is made, any creditable direct or indirect foreign taxes will be reduced by the credit previously granted. These provisions are much the same as the Australian measures.

Where the US shareholder does not elect for current taxation, when a distribution is made the shareholder may still claim

53. Countries whose tax system is comparable to that in Australia.
54. For the meaning of "related", see *supra* note 20.
55. See generally Secs. 6AB, 6AC and 160AFCE.
56. Having not been distributed from previously attributed income.
57. Sec. 160AFCG.
58. E.g. upon its liquidation.
59. Secs. 602-612.

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both a direct and indirect (where the shareholder is a corporation) credit for the foreign tax paid. These taxes are first allocated between that part of the distribution which is an excess distribution and that part which is not. The taxes attributable to the excess distribution are further allocated rateably to each day the taxpayer has held the shares in the PFIC. The portion of taxes so allocated reduces the tax payable with respect to each year that the excess distribution is allocated, thereby reducing the overall deferral charge. While this is not technically a foreign tax credit, it operates in much the same way.

US shareholders who elect current taxation may also claim a direct credit for foreign taxes imposed on distributions from a PFIC, but these taxes are not allocated to each year of their holding. A corporate shareholder may also claim an indirect credit where one was not claimed at the attribution stage. Income derived from a PFIC will be included in the passive income basket for the purposes of computing the limitation on the foreign tax credit under the US quarantining measures.

3. Germany

Germany also has implemented a foreign tax credit system. Both a direct foreign tax credit and an indirect credit (where the German corporation directly holds at least 10 percent of the foreign corporation for a full 12 months) may be available to the extent of the German tax imposed.

Under most German tax treaties, dividends received by a German corporation from a corporation resident in the other country are tax exempt.[60] This treaty exemption has been removed for income which is attributable as a deemed dividend under the new German measures. A direct credit is available for taxes imposed on distributions from previously attributed amounts when that income is distributed. An indirect tax credit may be available for German corporate shareholders[61] for the underlying tax on income which has been previously attributed to the shareholder; this credit reduces the German tax payable on the attributed dividend. The German measures apply in much the same way as the Australian and US measures.

IV. EXAMPLE

Offshore Co. is a foreign corporation which earns predominantly passive income and is therefore subject to the Australian, US and German measures. Offshore has issued 100 shares of which A owns 5, B owns 15 and C Ltd owns 25. The shares in Offshore have been held for three years during which Offshore has paid no dividends. Offshore has assets of $ 400,000. In years 4 and 5, Offshore's books reveal:

	Year 4	*Year 5*
Gross Active Income	10 000	10 000
Gross Passive Income	30 000	30 000
Total	40 000	40 000
Tax	10 000	10 000
Net available for distribution	30 000	30 000
Distributions from Net Income	Nil	50 000

For the purpose of this example, it is assumed that the foreign corporate tax rate is 25 percent and the foreign withholding tax rate is 15 percent. Further, it is assumed the domestic corporate tax rate is 30 percent and the individual tax rate is 35 percent. The taxation of the shareholders in years 4 and 5 is as follows:

Year 4

Shareholder A

Australia
A is a small investor as his interest is worth approximately 5 percent of $ 400,000 or $ 20,000. A is exempt from attribution under the Australian measures.

United States
A is subject to the US measures but for the purpose of the example it is assumed he does not elect current taxation and therefore has no liability in year 4.

Germany
A is exempt from the German measures because he holds less than a 10 percent interest.

Shareholder B

Australia
B uses the calculation method to determine the attributable amount. Offshore's notional income is $ 40,000 less foreign corporate tax of $ 10,000, i.e. $ 30,000. B's share of this income is 15 percent or $ 4,500. This amount is included in B's taxable income for year 4 giving rise to tax of $ 1,575.

United States
B elects current taxation, the tax payable in year 4 is $ 1,575, calculated in a similar manner as under the Australian measures. B elects to defer payment of this tax and so has no liability in year 4.

Germany
B is attributed only a portion of Offshore's passive income. This amount is $ 30,000 less foreign corporate tax of $ 7,500, leaving $ 22,500 of which B's share is 15 percent or $ 3,375. This amount is included in B's taxable income giving rise to tax of $ 1,181.

Shareholder C Ltd

Australia
C Ltd also uses the calculation method. Notional income is again $ 30,000 (net of foreign corporate tax) of which C Ltd's share is 25 percent or $ 7,500. C Ltd must gross this amount up with foreign corporate tax in order to claim an indirect foreign tax credit. $ 10,000 is included in C Ltd's taxable income giving rise to $ 3,000 tax. This tax is reduced by the indirect foreign tax credit of $ 2,500, leaving $ 500 of tax payable in year 4.

United States
C Ltd elects current taxation. This tax is calculated in a similar manner as under the Australian measures giving rise to a current liability of $ 500.

60. Conditions are generally placed on this exemption, e.g. a 10% holding in the other corporation.
61. Subject to certain conditions.

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Germany

C Ltd is attributed its portion of Offshore's passive income gross of foreign corporate tax assuming it can claim an indirect foreign tax credit. C Ltd's share of the passive income is 25 percent of $ 30,000 or $ 7,500. This amount gives rise to tax of $ 2,250 which is offset by a foreign tax credit equal to C Ltd's share of the foreign corporate tax paid, being 25 percent of $ 30,000 is $ 7,500 foreign corporate tax of which C Ltd's share is 25 percent or $ 1,875. C Ltd must pay $ 375 in year 4.

Year 5

Shareholder A

Australia

A receives 5 percent of the distribution, i.e. $ 2,500. This amount is included in A's taxable income, giving rise to tax of $ 875. A is granted a tax credit for foreign withholding tax of 15 percent of the dividend or $ 375. A must pay $ 500 in tax in year 5.

United States

A receives a dividend of $ 2,500, all of which constitutes an excess distribution because no distributions have been received in the last three years. This amount is allocated rateably to each day in A's five years of holding shares in Offshore and tax is imposed on the yearly totals at the highest marginal rates, i.e. $ 500 is allocated to each year, the tax on this amount is $ 175 per year. A may still claim the direct foreign tax credit of $ 375. This amount is also allocated rateably to each day in A's holding and reduces the tax payable in each year, i.e. $ 75 credit is allocated to each year reducing the tax payable in each year to $ 100. The deferral charge is then imposed and compounded on the tax outstanding for years other than the current year. Suppose the deferral rate is 10 percent simple interest per year, the deferral charge for year 1 in year 5 is $ 46, for year 2 is $ 33, for year 3 is $ 21 and for year 4 is $ 10. A is liable to pay the total of the outstanding taxes and the compounded deferral charges i.e. 500 + 46 + 33 + 21 + 10 = $ 610.

Germany

A's tax is calculated in a similar method as the Australian measures giving rise to tax of $ 500.

Shareholder B

Australia

The notional income of Offshore is the same as for year 4, i.e. $ 30,000, of which $ 4,500 is B's share. B also receives 15 percent of the dividend or $ 7,500. $ 4,500 of this amount eliminates the notional income attributable to B, but this amount of the dividend is not paid from previously attributable income so it must be included in B's taxable income. The remaining $ 3,000 is paid out of previously attributed income and is therefore exempt. The tax imposed on $ 4,500 is $ 1,575. B may offset against this tax a credit for the foreign withholding tax payable on the entire dividend, i.e. 15 percent or $ 1,125. B must pay $ 450 tax in year 5.

United States

Of the $ 7,500 dividend received by B, $ 4,500 is attributable to income earned by Offshore in the current year. This amount is subject to tax of $ 1,575. The other $ 3,000 is paid out of previously attributed income which is exempt. However, the payment of this amount makes a portion of the tax deferred from year 4 payable. $ 3,000 is two-thirds of the income attributed in year 4 and so two-thirds of the tax deferred is payable, i.e. $ 1,050 is now payable. B can claim a credit for the foreign withholding tax of $ 1,125. $ 675 of this credit relates to current tax on the sum of $ 4,500, reducing tax thereon to $ 900. The remaining $ 450 reduces the deferred tax that is payable to $ 600. The deferral charge on this amount is $ 60. In year 5 B must pay $ 1,560 (900 + 600 + 60).

Germany

As all Offshore's passive income for year 5 has been distributed, B is not subject to attribution. Of the $ 7,500 dividend, $ 4,500 relates to income from year 5 and $ 3,000 to income from year 4. In year 4, three-quarters of Offshore's income was passive, therefore three-quarters of the $ 3,000 is attributable to passive income of year 4 or $ 2,250. This amount is exempt from tax because it is paid from previously attributable income. The remaining $ 5,250 is subject to tax of $ 1,837.50. This tax is reduced by a credit for the foreign withholding tax of $ 1,125. B must pay tax of $ 712.50 in year 5.

Shareholder C Ltd

Australia

C Ltd's share of Offshore's income ($ 7,500 the same as year 4) is paid as part of the $ 12,500 dividend received, attribution taxation will not apply to this sum of $ 7,500. This $ 7,500 has not been paid out of previously attributed income; it is grossed up with foreign tax because C Ltd wishes to claim an indirect credit for the underlying foreign corporate tax. The grossed up amount is $ 10,000 which is included in C Ltd's taxable income, giving rise to tax of $ 3,000.

C Ltd can claim a credit for the foreign withholding tax on the $ 12,500 dividend, being $ 1,875. There is also an indirect credit for the part of the dividend not paid out of previously attributed income, i.e. $ 10,000 giving rise to a tax credit of $ 2,500. The indirect foreign tax credit for the rest of the dividend was claimed in year 4. The total of these credits ($ 4,375) is limited to the amount of Australian tax payable on similar income. The Australian tax payable on the $ 7,500 part of the dividend is $ 3,000 (as calculated in the last paragraph). The $ 5,000 part of the dividend is first grossed up by foreign corporate tax to $ 6,666.66, the Australian tax on this sum is $ 2,000. Therefore, the foreign tax credit limit is $ 5,000, of which, indirect credit for the $ 5,000 part of the dividend was granted in year 4 in an amount of $ 1,666.66 (i.e. $ 5,000 is two-thirds of the amount attributed in year 4, so two-thirds of the $ 2,500 tax credit is $ 1,666.66). Thus the foreign tax credit available in year 5 is $ 3,333.34 ($ 5,000 – $ 1,666.66). This amount offsets the Australian tax payable giving rise to an excess foreign tax credit of $ 333.34.

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United States
C Ltd's tax is calculated in a similar way to that under the Australian measures. C Ltd has an excess foreign tax credit of $ 333.34.

Germany
All passive income for year 5 has been distributed. The $ 12,500 dividend relates $ 7,500 to income of year 5 and $ 5,000 to income of year 4. Three-quarters of this $ 5,000 amount is attributable to passive income of year 4, i.e. $ 3,750. This amount is exempt because it is paid from previously attributed income. The remaining amount of the dividend, i.e. $ 8,750, is grossed up with foreign corporate tax assuming C Ltd can claim an indirect tax credit, i.e. $ 11,666.66. The tax on this sum is $ 3,500.

C Ltd claims a credit for the foreign withholding tax on the distribution in the sum of $ 1,875. There is also an indirect foreign tax credit for foreign corporate tax paid on that part of the dividend which was paid out of income which was not previously attributed, i.e. $ 8,750 grossed up to $ 11,666.66, giving rise to a credit of $ 2,916.66. The potential foreign tax credit is $ 4,791.66 but this sum is limited to the amount of German tax payable on a similar sum, i.e. $ 11,666.66 + $ 5,000 ($ 3,750 grossed up with foreign tax) = $ 16,666.66. The German tax would be $ 5,000 and this is the foreign tax credit limit. This limit is reduced by the portion of the credit granted in year 4 which relates to the exempt part of the dividend, i.e. grossed up dividend of $ 5,000 is two-thirds of the amount attributed in year 4 ($ 7,500); two-thirds of the foreign tax credit granted in year 4 ($ 1,875) is $ 1,250. Therefore the limit is reduced to $ 3,750 ($ 5,000 – $ 1,250). This credit eliminates the tax due in year 5 and C Ltd has an excess foreign tax credit of $ 250.

V. CONCLUSION

The most significant difference between the measures is that the German measures only attribute income of corporations resident in low-taxed countries and only seek to attribute passive income. In contrast, the Australian and US measures apply regardless of the foreign tax rate and seek to attribute all the income of the foreign corporation. Therefore the German measures are the narrowest in scope. Another major difference is the option under the US measures to defer payment of the tax imposed on the attributable amount; this option is not available under the Australian or German measures. This option is desirable as it temporarily relieves a tax burden imposed on a taxpayer who has not received the income subject to taxation.

The example illustrates how the most simple factual situation can give rise to complex issues in determining the tax payable, particularly the foreign tax credits available. While the Australian model appears fair in light of the US and German models, it suffers the same flaw in that it creates a high level of compliance costs. While this factor is unlikely to upset lawyers and accountants, the taxpayers who have to meet not only the compliance costs but the tax liability may decide to keep their passive investments onshore. No doubt, this is one of the motives behind the implementation of such measures.

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GERMANY:
RECENT LEGISLATIVE DEVELOPMENTS

Friedhelm Jacob

Mr Jacob is an associate tax partner at Hengeler Mueller Weitzel Wirtz, Frankfurt. He was the Associate International Tax Counsel for the German Federal Finance Ministry from 1980–1986, and from 1986–1991 he was the Fiscal Counsellor of the German Embassy in Washington, D.C. He has authored numerous publications on international tax law, and is a co-author of the Debatin-Walter Handbook on the US–German Tax Treaty. He contributes regularly to Internationale Wirtschaftsbriefe.

In the July/August 1993 issue of the *Bulletin* a tax package was presented that was still in draft form at that time. We can now provide an update on the key features of this package which was promulgated on 17 September 1993.[1]

I. REVENUE LOSERS

Corporate income tax rates are lowered
- on retained profits from currently 50 percent to 45 percent;
- on distributed profits from currently 36 percent to 30 percent;
- on the profits of a German branch of a foreign corporation from currently 46 percent to 42 percent.

The current "recapture" of corporate income tax on the distribution of foreign treaty-exempt income is eliminated if such income is distributed to a corporate shareholder. The dividend received by the German shareholder corporation remains tax-exempt to the extent the dividend is distributed out of foreign treaty-exempt income. However, the further distribution of such income to the ultimate individual shareholder, while not subject to a recapture tax on the level of the distributing corporation, will remain taxable to the recipient. The individual shareholder is not entitled to the corporate imputation credit (because no German corporate income tax was collected with respect to the treaty-exempt income). There is also no relief for any foreign tax paid on the relevant income underlying the distribution. The new rules will enhance the tax situation of German holding companies and their German corporate shareholders.

The dividend participation exemption under tax treaties is extended to capital gains from the disposition of shares in a foreign subsidiary or affiliate. A capital loss remains deductible from taxable income.

The German permanent establishment of a non-resident corporation enjoys the same exemptions with respect to treaty-exempt income as a German resident corporation entitled to the benefits of the relevant tax treaty.

The top personal income tax rate on income from industrial or commercial activities is lowered from currently 53 percent to 47 percent in order to compensate for trade tax on income without eliminating this tax altogether (requiring an entirely new system of revenue sharing) and without an across-the-board lowering of the top personal income tax rate on all categories of income.

II. REVENUE RAISERS

These tax benefits are partly offset by base-broadening measures. In the international context these base-broadening measures involve the introduction of thin capitalization and anti-dividend stripping rules.

A. *New thin capitalization rules (Section 8a Corporate Income Tax Act)*

The new provisions would recharacterize as constructive dividend distributions any consideration payable by a German resident corporation to a shareholder not entitled to the corporate imputation credit holding more than a 25 percent interest in the stated capital of the corporation,[2] where such consideration pertains to
- any debt instrument providing for consideration in terms other than a fixed percentage of the loan principal (such as profit participating rights or loans or other

1. See Bundesgesetzblatt 1993 part I, at 1569.
2. Specific anti-avoidance rules provide that the thin capitalization legislation also applies to shares held through a partnership and to 25% or lower shareholdings where the shareholder, either alone or in cooperation with other shareholders, exercises "controlling influence" over the corporation.

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"hybrid instruments") where the loan capital extended by the shareholder exceeds 50 percent of that portion of the corporation's equity that corresponds to the shareholder's interest in the corporation's stated capital (1:2 debt/equity ratio);
- any other indebtedness, where the loan exceeds a debt/equity ratio of 3:1, unless an unrelated party would have extended such loan capital at the same terms and conditions or the loan serves to finance transactions usual in the banking sector.

The same rules apply if a person related to the shareholder extends the loan and such person is not entitled to the corporate imputation credit or if a third party provides the loan financing, where such third party has recourse to the shareholder or to a person related to the shareholder.

A special safe haven debt/equity ratio of 9:1 applies to German holding companies with respect to non-hybrid debt instruments. However, the German entities controlled by the holding company are not covered by a special safe haven. As a consequence a holding company structure cannot be used to increase the volume of acceptable shareholder loan financing of share acquisitions beyond the 9:1 ratio.

B. *New anti-dividend stripping rules (Section 36(2) No. 3(g); Section 50c(7) and (10) EStG)*

Due to the German corporate tax regime (imputation credit) and the unwillingness of the German legislature to permit a corporate tax refund to non-resident shareholders by treaty, stock of a German corporation is worth more in the hands of a resident taxable entity on dividend day than in the hands of a non-resident or a domestic tax-exempt entity. The imputation credit mechanism has led to a substantial volume of trade into Germany with respect to stock in German corporations around ex-dividend day designed to make the imputation credit available, at least economically, to non-resident shareholders. Surprisingly little administrative guidance exists on the acceptability of such "dividend strategies". A 1978 ruling denies the tax credit to the interim holder of stock that purchased stock from a non-resident shortly before ex-dividend day, collected the dividend, claimed the withholding and imputation credits, and agreed to sell the stock back at the quoted price soon thereafter. The ruling relies on abuse of legal form considerations.

A tax court decision of 1982 indicates that even a repurchase arrangement is acceptable and results in the attribution of the income derived from a security to its interim holder as the beneficial owner of the income. The decision dealt with debt instrument generating tax-exempt interest, not dividends.

The use by non-residents of the imputation credit runs counter to a core element of the German corporate tax imputation system. This is why the legislators saw a need for new rules designed to make certain dividend arrangements between persons not entitled to the German corporate tax imputation credit (i.e. persons not resident in Germany and German-resident tax-exempts) and persons entitled to such credit less attractive.[3]

The new legislation seeks to tackle the issue on two separate fronts, i.e. by
- denying the corporate imputation credit in full or in part to the resident dividend recipient;
- limiting the ability of the resident to claim a tax deduction for the trading loss that arises when he sells the share after the ex-dividend day.

1. Limitations on the resident's ability to claim the imputation credit

Under the new legislation (see Section 36(2) No. 3(g) Income Tax Act) the dividend recipient is not entitled to the corporate imputation credit to the extent that

> "the corporate income tax is attributable to investment income derived by the payee where such investment income does not result in an assessment of the payee to tax due to the fact that the payee, in connection with such investment income, has itself made deductible payments (other than for financing costs usual in the market) which are outside German taxability in the hands of their recipient."

This language is obviously designed to apply to any arrangement pursuant to which the resident and the non-resident somehow share the imputation credit benefit. If a non-resident makes available over ex-dividend day shares issued by a German resident corporation to a German resident entity, the German resident is entitled to the dividend income and would normally also be entitled to the corporate imputation credit. If the German resident transports the dividend plus all or part of the corporate imputation credit to the non-resident, for instance by way of a stock lending fee or an "in lieu" payment, such payment constitutes a deductible business expense to the German resident and offsets the taxable income from the dividend receipt, grossed-up by the amount of the corporate imputation credit. The non-resident is not subject to German tax with respect to the "in lieu" payment received. Section 50c Income Tax Act (see below at 2) is generally inapplicable to this type of arrangement as the shares are either not transferred back to the non-resident or are transferred back at a predetermined price that does not result in a loss to the German resident.

2. Limitations on the recognition of loss after ex-dividend day

Pursuant to Section 50c Income Tax Act a German resident acquiring from a non-resident stock issued by a German resident corporation cannot recognize a tax loss where the loss reflects a reduction in the stock's value due to the distribution of the dividend. A tax deduction for such loss is barred for ten years beginning in the year of the acquisition and extends to losses from the disposition of the stock and to extraordinary write-offs under a mark-to-market approach. By way of an exception to this general rule, Section 50c is currently inapplicable to stock acquired on the exchange through a financial institution.

3. For ease of presentation a person not entitled to the corporate imputation credit is referred to here as the "non-resident" and a person entitled to such credit as the "resident".

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The new legislation modifies and limits the exchange-trading exception. The exception now applies to any acquisition of shares on the exchange regardless of whether the trade was executed through a financial institution. Where shares are acquired on the exchange the exchange-trading exception will be unavailable in any one of the following three situations:

- the time period between the acquisition of the shares and the disposition of the same shares or shares of the same kind does not comprise at least 30 days, and the dividend was declared during such time period;
- the shares or shares of the same kind are sold back to the seller, directly or indirectly, pursuant to terms and conditions that result in a "limitation of the price risk", whether these terms and conditions are taken alone or in conjunction with other arrangements;
- all or part of the consideration for the acquisition of the shares is represented by an obligation to transfer shares that do not or do not fully entitle their owner to receive dividends.

If the German resident purchaser of the shares can demonstrate that the shares were acquired from a resident then the foregoing limitations to the exchange-trading exception do not apply.

Under the new rules the limitations to the exchange-trading exception do not apply to the extent the imputation credit is denied under Section 36(2) No. 3(g) Income Tax Act.

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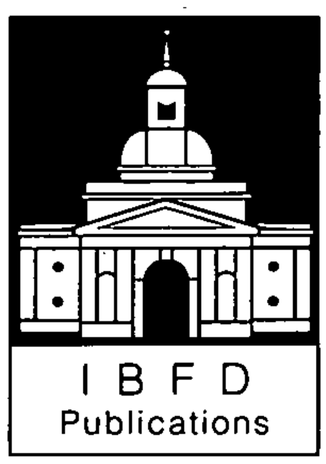
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IFA NEWS

SOME HIGHLIGHTS FROM THE SECRETARY GENERAL'S 1992/93 GENERAL REPORT

J. Frans Spierdijk

INTRODUCTION

In this year between Cancún and Florence the General Secretariat has been involved particularly in the deliberations and preparations concerning the new discussion procedures for the main Subjects which we are going to try out in the forthcoming Congress. There have been frequent contacts and meetings with Prof. Fantozzi, with the Discussion Leaders, the General Reporters and others and we all look forward with great interest now to what the discussions are going to bring us in actual practice. It is a gratifying experience to assist in the work that a number of highly qualified people are willing to do for IFA on a voluntary basis. This is true not just for this specific project. Generally speaking, there is no doubt that our sizeable worldwide Association could not be seconded by a small General Secretariat like we have without the invaluable contributions of time, effort and resources made by many of our members and by the National Branch organizations. There is every reason for me and the staff at the General Secretariat to express our appreciation to all of you who make our work feasible and light.

CANCÚN CONGRESS

The second IFA Congress held in Mexico – the first one convened in Mexico City in 1974 – definitely was a great success. First of all, the topics of both the main Subjects and Seminars were of great interest. Secondly, the tropical time schedule met with the approval of many attendants to the sessions. The working sessions were remarkably well attended. Upon recommendation of the Permanent Scientific Committee (PSC), in consultation with our Italian IFA friends, it was decided to follow the same time schedule during the 1993 Florence Congress. Let us see whether it works as well in a non-tropical climate.

We owe great thanks to the Mexican IFA Branch for having done such a good job. In particular, Mr Carlos Sellerier, President of the Congress, and Mr Enrique Ramírez Villegas, were the ones who made it all work and who invested much time, enthusiasm and effort during the long period of preparation. Mrs Mercedes Sellerier and Mrs Yolanda Ramírez, I know, were more than supportive to their husbands and I gladly include them in our feelings of appreciation and gratitude.

For main Subject I, "Transfer pricing in the absence of comparable market prices", the General Reporter was Avv. G. Maisto (Italy). Twenty-six National Reports were included in the 1992 Cahiers. Discussion Leader was Mr N. Boidman (Canada). Panellists were Messrs J.P. Le Gall (France), Y. Gomi (Japan), H.M.A.L. Hamaekers (Netherlands), D. Lüthi (Switzerland) and R. Watson (USA), whereas Mr A. Navarro (Mexico) was Chairman of the Working Session and Mr R. Caraza Escobedo (Mexico) and Mr A. Manganelli (Italy) acted as Secretaries. The Résumé Committee was chaired by Mr M. Ellis (Netherlands), with Messrs P. Anderson (Australia), J.A.K. Clark (United Kingdom), R. Moreyra (Mexico), H. Torrione (Switzerland) and A. Weber (Germany) as members.

Mr W.B. Taylor (USA) covered main Subject II, "Tax consequences of international acquisitions and business combinations", in his General Report. This Cahier contains 27 National Reports. Mr R. Koch-Nielsen (Denmark) acted as Discussion Leader, and Dr J. Sáinz Alarcón (Mexico) and Mr G. Preciado (Mexico) as Chairman and Secretary of the Working Session. Members of the Panel were Messrs M. Gammie (United kingdom), H. de Groot (Netherlands), J.S. Hausman (Canada), Y. Kergall (France) and Dr J. Killius (Germany). Chairman and members of the Résumé Committee were Dr A. Burckhardt (Switzerland), and Messrs A.C. de Abreu e Silva (Brazil), C. D'Andria (Italy), Dr H. Becker (Germany), M. Castro (France) and H. Ortiz (Mexico).

The Report of Proceedings on Subjects I and II were written by Dr J.B. Bracewell-Milnes (United Kingdom) and published in the IFA Yearbook 1992. There one also finds the Resolutions on the two Subjects and their reviews by the Chairmen and of the Résumé Committees. The IFA membership is again indebted to all those people who have helped to develop two most interesting Subjects of international taxation. The General Reporters, the National Reporters, the Discussion Leaders, the Panellists and Secretaries, the Chairmen and Members of the Résumé Committees and also the other participants in the discussions deserve our sincere thanks.

The Seminars were the following: Seminar A treated the topic of "Advance ruling: practice and legality". Prof. J.M. Rivier (Switzerland) acted as Chairman, Mr P.A. Harris (Australia) as Secretary, and Messrs R. Baconnier (France, W. Dann (Germany), S. Lainoff (USA), A. Timmermans (Netherlands) and N. Virin (Sweden) as members of the Panel. "Branch Tax" was the topic of Seminar B. The Panel, consisting of Messrs E. Bunders (Netherlands), J.C. Contrim (Brazil), F.L. Jacob (Germany) and Guillouet (France) was chaired by Mr C.L. Estes (USA). Dr R. Asorey (Argentina) chaired Seminar C, "Tax treatment of international loans". The Panel consisted of Messrs A. Elvinger (Luxemburg), E. Henbrey (United Kingdom), A. Joseph (USA), M Otsuka (Japan) and A. de Souza Correa Meyer (Brazil). "Consequences under tax treaties of operating through a dependent or independent agent", Seminar D, was chaired by Prof. K. van Raad (Netherlands). Panellists were Messrs R. Doernberg (USA), W.T. Kim (Korea, Republic of), Prof. J.M. Mössner (Germany) and A. Skaar (Norway), while Mr R. Sommerhalder (Netherlands) acted as Secretary. Chairman of Seminar E, "Mexican tax treaties", was Dr R. Aguirre (Mexico), with Messrs J.M. Déry (Canada), F. Ruiz (Mexico), M.

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Stucker (USA), and M. Tron (Mexico) as members of the Panel.

Expectedly, Seminars A and D will result in a publication in the "IFA Congress Seminar Series".

Finally, I take pleasure to report that Mr Jacques Sasseville from the OECD made an interesting and lively presentation of the new loose-leaf OECD Model Tax Convention at a special session of the Cancún IFA Congress. We took good note of his speech and in particular of the fact that the OECD would welcome suggestions from IFA on various matters. The PSC and Executive Committee (EC) are considering how to best structure IFA's involvement in this process.

PERMANENT SCIENTIFIC COMMITTEE

In February the PSC enjoyed the superb hospitality of the Italian Branch at their meeting in Rome. Part of the deliberations dealt with the new discussion procedure at the working sessions of the Main Subjects, which is going to be introduced in Florence on a trial basis. Application of this so-called "Fantozzi Model" is going to be an interesting experiment for all of us. The new procedure is explained in a letter by the PSC Chairman, Prof. Avv. Augusto Fantozzi, sent with the Florence invitation programme. Like last year, this programme was printed in and mailed from the Netherlands, in April. Since the new procedure needs careful evaluation afterwards, I urge all participants to the Florence Congress to please fill out the questionnaire to be distributed.

Another new feature to be introduced at the Florence Congress on a trial basis is what was called "Poster Sessions". It means that in the Exhibition Area some students are given the opportunity to present to the Congress participants the doctoral thesis they are working on in the field of international or comparative taxation. They are invited to do so by way of showing a sort of Poster outlining the structure of their thesis. It is expected that the students and, hopefully, a great number of Congress participants will find it interesting and beneficial to meet and exchange views.

The preparations for Florence are proceeding satisfactorily. Twenty-six National Reports were submitted for both Subject I, Interpretation of double taxation conventions, and Subject II, "Non-discrimination rules in international taxation". General Reporters are Prof. Dr K. Vogel and Dr R. Prokisch (Germany) for Subject I; and Prof. Avv. P. Adonnino (Italy) for Subject II.

The following Seminars will be held:

A: Harmonization of corporate taxes in the EC.
Chairman: Prof. H.M.A.L. Hamaekers (Netherlands)

B: Taxation of employee fringe benefits
Chairman: Prof. R. Krever (Australia)

C: Environmental taxes and charges
Chairman: Prof. S.O. Lodin (Sweden)

D: Corporate tax on distributions (equalization tax)
Chairman: Dr M. Pagani (Italy)

E: Resolution of tax treaty conflicts by arbitration
Chairman: Prof. G. Lindencrona (Sweden)

F: Italian tax treatment of new financial instruments
Chairman: Prof. Avv. G. Tremonti (Italy).

For the 1994 Toronto Congress the two main Subjects will be "Deductibility of interest and other financing charges in computing income", General Reporter: Prof. B.J. Arnold (Canada); and Subject II, "National and international tax consequences of demergers", General Reporter: Prof. A.J. Rädler (Germany). The Seminars will deal with Harmonization of tax under the North American Free Trade Agreement; How domestic anti-avoidance legislation affects double taxation conventions; OECD Model Treaty; Recent transactions; and possibly "Secondary aspects of transfer pricing adjustments".

The main Subjects for Cannes 1995 were definitely fixed. They are: Subject I, "International tax problems of partnerships", with Mr J.P. le Gall (France) as General Reporter; and Subject II, on "Tax aspects of recently developed financial instruments", with Messrs H.D. Rosenbloom and C.T. Plambeck (USA) as General Reporters, and Ms D.M. Ring (USA) as Assistant General Reporter.

Promising topics came up for the 1996 Congress in Geneva. With the help of the IFA researchers some of them will be developed further.

Implementing IFA's policy of a more frequent rotation and rejuvenation of Committee membership it was decided to recommend a number of changes to the Executive Committee for subsequent proposal to the General Council during the Florence Congress. The proposed changes are as follows:

- Prof. I. Claeys Bouuaert to be replaced by Mr J. Malherbe (Belgium)
- Prof. Dr E.J. Reig by Dr A. Atchabahian (Argentina)
- Dr J.B. Bracewell-Milnes by Mr I. Spence (United Kingdom)
- Mr J. Basxanta de la Peña by Mr M. Marin Arias (Spain).

The selection of topics by the PSC is made considerably easier by the thorough preparatory work done by the Research Subcommittee. Under the Chairmanship of Prof. Hugh Ault the Subcommittee develops balanced recommendations for the scientific programmes of our Congresses. In making its recommendations, the Subcommittee liaises with the hosting IFA Branches of future Congresses and also has an open eye for what is going on in OECD circles. In close cooperation with the IBFD, the IFA researcher is instructed to work on certain subjects and to prepare outlines and bibliographies. Mr Peter Harris (Australia) did an excellent job in this respect. He has now been replaced by Ms Lynette Eastmond (Barbados), from whom we also have great expectations.

EXECUTIVE COMMITTEE

On 2 May 1993, the Executive Committee convened at the Como Lake, Italy, in the beautiful Villa Serbelloni in Bellagio, where our Italian IFA friends spoiled us with their generous hospitality. Mr R.J. Dart (Canada) was welcomed as a new member and we were glad to see Mr A. Piera (Spain) in our midst as member-elect. It was decided to try and involve

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the IFA branches in Japan and Australia more actively in the Central IFA organization and to that end a membership of the EC would be appropriate. Our new Articles of Association allow for a maximum of 14 members. In the meantime discussions with these Branches are underway.

As regards the further composition of the EC, the following will be submitted to the General Council for approval. To re-elect Messrs G. Dominjon (France), S.H. Goldberg (USA), I.W. Harris (United Kingdom, previously Hong Kong) and L. Hinnekens (Belgium) for another term of two years; and to nominate Prof. F. Zimmer (Norway) and a candidate from Germany in the vacancies created by the resignations of Mr P. Sundgren (Sweden) and Mr K. Beusch (Germany), respectively.

To issue a press release after each IFA Congress aimed at the major financial newspapers is an idea to be further developed. The distribution of IFA Resolutions/Précis by the National Branches to their governments and other institutions is, generally speaking, taking place on a large scale, so the EC noted with satisfaction.

THINK TANK COMMITTEE

As a result of the discussions held during the Cancún Congress, the TT Committee drafted a questionnaire, which was sent to the National Branches. It is hoped to receive representative answers by 1 September 1993. The purpose of this questionnaire is to ask whether the National Branches of IFA can assist the TT Committee in achieving one of its tasks: to try and establish the desires and objectives of National Branches regarding IFA activities and come up with recommendations or suggested discussion points for EC and PSC.

The outcome of this questionnaire will be carefully reviewed by the TT Committee during their Florence, October 1993, meeting.

MEMBERSHIP FEES

The General Treasurer will propose to maintain the membership fees for 1994 at the level of the previous year:

NLG 105 for individual members of National Branches
NLG 115 for direct individual members
NLG 250 for corporate members, both direct and of National Branches.

NATIONAL BRANCHES AND MEMBERSHIP

During the Cancún Congress we recognized our 41st Branch, in the Republic of China (Taiwan). I am glad to report that the Branch is active and alive as I was able to observe when visiting Taiwan last March, where I was invited to attend a meeting of CESTO, the Council of Executive Secretaries of Tax Organizations.

The Congress in Cancún gave me an opportunity to pay a visit to Panama where I assisted at the inauguration of the association which will expectedly be recognized as IFA Branch at the Florence Congress. With the help of Ms Grace Hernandez and some other IFA members a visit to Costa Rica resulted in a number of interesting contacts which might lead to further developments at a later stage. In Chile, where I attended the Annual Meeting of CIAT last April, I found a number of people interested in establishing an IFA Branch and I look forward to further discussions with participants from Chile at the Florence Congress.

Preparations for the formation of a Branch in Poland are in an advanced stage. In Russia the process is likely to take some more time.

Mr Charlie Dowling has been instrumental in the creation of a Branch in Ireland which will expectedly be recognized as such during the Florence Congress. It is a pleasure working with him.

During a visit to Greece I met with Messrs D. Tsingris, G. Stathopoulos and G. Samothrakis to discuss future activities. Our congratulations to Mr Tsingris, an old-time and devoted IFA member, whom many of us have often met at Congresses, who recently informed us of his Honourary Chairmanship of the Branch.

The annual meeting of the US Branch in Boston on 4-5 March 1993, made it again clear that this is one of the most interesting and comprehensive conferences on international taxation taking place in the US. Contacts between Central IFA and the very active US Branch are excellent from my perception and it is a pleasure to be in touch from time to time with President Mr Richard Goldman and many others.

The Netherlands/UK bilateral IFA meeting in Amsterdam last June provided a good occasion to take part in high-level, off the record discussions in an amicable atmosphere. A most enjoyable experience.

In conclusion, let me refer to the Newsletter which we send quarterly to all National Branches. More and more Branches are informing us of their activities to the benefit of other Branches. Bravo and thanks.

REGIONAL CONFERENCES

It was unfortunate that the 3rd Regional Conference which was scheduled to be held in Singapore in May 1993 had to be cancelled due to a regrettably low number of registrants. All the time and effort spent by the members of the Singapore and US Branches were lost in this way and we can only express our gratitude to them for their thorough preparatory work.

The EC evaluated the situation in their meeting in May of this year and concluded that IFA should for the time being consider the organization of Regional Conferences with some degree of reservation. It was decided that the expansion and strengthening of IFA in certain countries in Asia and Eastern Europe, which continues to be one of our priorities, should be pursued primarily on a country by country basis. To that end a plan of specific action is being developed. The (greater) involvement of government authorities in a number of countries forms part of that plan.

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MITCHELL B. CARROL PRIZE 1992

Out of four candidates, Ms Irene Burgers (Netherlands) received the 1992 MBC award for her thesis entitled "Taxation and supervision of branches of international banks". The Prize was awarded during the Cancún Opening Ceremony by Prof. Avv. P. Adonnino, acting Chairman of the Jury. The work of Dr M. Lang (Austria) "Doppelbesteuerungsabkommen und innerstaatliches Recht" received an "honourable mention". We have great admiration for Dr Lang who also in 1991 received a similar award for his work on hybrid financing.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

As can be concluded from what is mentioned under the heading PSC, the cooperation with the IBFD continues to be very useful for our organizations. At this place I would like to express my appreciation for the good and pleasant working and personal relationships we are experiencing at the General Secretariat in our frequent contacts with IBFD representatives.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

Our contacts with CIAT and with the ICC Tax Committee are being carefully maintained. This year IFA was made a corporate member of the International Institute of Public Finance (IIFP), a prestigious organization with which we have a strong historical relationship (*vide* the IFA Jubilee Book). I attended their 49th Congress in Berlin this year, where Tax Evasion was one of the topics.

The ties with the UN Economic and Social Council have been strengthened. In December of this year IFA will participate as an observer to the 7th meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters in Geneva.

THE 47TH CONGRESS IN FLORENCE

The number of registrants to date confirms our expectations of a great attendance. We are looking forward to the Congress with anticipation and confidence. A number of novelties will be introduced, not only on a trial basis in the scientific programme, as described under the heading of the PSC, but also in the social events. A gala dinner split up into four locations with a choice of ambience going from gala to jeans. Our very best wishes for a successful Congress to all the people actively involved in its preparation, in particular to the enthusiastic Organizing Committee chaired by Prof. Avv. Piera Filippi, and to our busy President-elect, Prof. Avv. P. Adonnino, who is also President of the Congress and General Reporter for Subject II.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

NOVEMBER 1993

The Asian Corporate Finance Conference 1993, Singapore, 22-23 November 1993 (English):

IIR PTE Ltd., Suite 08-03 Golden Wall Centre, 89 Short Street, Singapore 0718, Tel.: 65-338 3521, Fax: 65-336 4017.

Internationale Holdinggesellschaften im deutschen Steuerrecht, Bonn, 23 November 1993 (German):

Gesellschaft für Unternehmerinformation, Postfach 26 01 46, 43153 Bonn, Germany, Tel.: 49-228-379 355, Fax: 49-228-373 162.

The Legitimate Use of European Tax Havens, Malta, 29-30 November 1993 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

DECEMBER 1993

Internationale Steuersparmodelle auf dem Prüfstand, Bonn, 7 December 1993 (German):

Gesellschaft für Unternehmerinformation, Postfach 26 01 46, 43153 Bonn, Germany, Tel.: 49-228-379 355, Fax: 49-228-373 162.

Tax Treaties: The Latest Developments and Strategic Planning Opportunities, London, 7 December 1993 (English):

Kate Roberts or Vicki Goffin, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

Tax-efficient insurance-based products for use in Financial Planning, London, 9 December 1993 (English):

Katie Gwyn-Williams, IBC Financial Focus Ltd, 57-61 Mortimer Street, London W1N 7TD, England, Tel.: 44-71-637 4383, Fax: 44-71-323 4298.

International Tax Aspects of Cross-border Financing, Amsterdam, 13-14 December 1993 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JANUARY 1994

Principles of International Taxation, Amsterdam, 31 January-4 February 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 53-56 of the January 1993 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

South Africa

DIVARIS, Costa; SILKE, Jonathan.
Tax Yearbook 1992-93.
Kenwyn, Juta & Co Ltd., P.O. Box 14373, Kenwyn 7790, South Africa. 1993, pp. 900.
This edition is the successor to the annual "Silke on South African Income Tax Yearbook". The book contains detailed and technical commentary on the 1992 tax changes. It also includes consolidated and annotated texts of the Income Tax Act 1962 and the Estate Duty Act 1955.
(B. 13.475)

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22nd Edition.
Kenwyn, Juta & Company Ltd., P.O. Box 14373,Kenwyn 7790, South Africa. 1992, pp. 271. 39.80 R.
Quick reference guide illustrating the workings of income tax, undistributed profits tax, donations tax and estate duty in South Africa. The book is based on the law as at 1 October 1992 and on the 1992 income tax returns and information brochures. In relation to individuals, it covers the years of assessment ending 28 February and 30 June 1993, and in relation to companies, years of assessment ending during the twelve-month period ending on 31 March 1993.
(B. 13.471)

ASIA & THE PACIFIC

Hong Kong

DOING BUSINESS IN HONG KONG.
New York, Price Waterhouse. 1992, pp. 224.
Updated edition of information guide on doing business in Hong Kong. The material includes information on investment climate, audit and accounting, taxation of individuals and corporations, banking and finance, indirect taxes and tax treaties.
(B. 57.884)

India

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Investment and tax profile.
New Delhi, Vaish Associates, 10 Hailey Road, Flat No. 7, New Delhi 110001, India. 1993, pp. 51.
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Madras, Company Law Institute of India Private Lts., 88, Thyagaraya Road, Thyagarayanagat, Madras-600 017, India. 1993, pp. 1500.
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New York, Price Waterhouse. 1993, pp. 226.
Information guide on doing business, investment climate, audit and accounting, taxation aspects of individuals and corporations in India.
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Indonesia

DOING BUSINESS IN INDONESIA
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Japan

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New York, Price Waterhouse. 1993, pp. 255.
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RELATIO DE EXECUCAO DO PIDDA – Plano de Investismentos e de Despesas de Desenvolvimento da Administracao 1990/1991.
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Taiwan

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Taipei, Taxation and Tariff Commission, 6F. 547, Section 4, Chung Hsiao E. Road, Taipei,

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New York, Price Waterhouse. 1993, pp. 68.
Information guide considering matters for those who want to do business in the Cayman Islands. Subjects include: business environment, foreign investment and trade opportunities, investment incentives, banking and finance, restrictions on foreign investment and investors, business entities, accounting and auditing, offshore companies, tax system, labour relations and social security.
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New York, Price Waterhouse. 1993, pp. 202.
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Edited by Coopers & Lybrand.
Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 330. 85.- Dfl.
This pocket sized book explains how each EC country has implemented Council Directives 91/680/EEC and 92/111/EEC. It is divided into three parts: an overview of the new VAT system; the key points and rules of each country including whether or not a party is liable to VAT and if so the obligations of a taxable person; and an appendix which includes the integrated text of the Sixth VAT Directive. An index is also included. The book contains information which is based on the laws and regulations in force on 1 March 1993.
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(B. 112.639)

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The legal reasoning of the European Court of Justice. Towards a European jurisprudence.
Oxford, Oxford University Press, Walton Street, Oxford OX2 6DP, England. 1993, pp. 294. £ 35.-.
This study examines and assesses the justificatory practice of the European Court of Justice by analysing EC law and the decision-making process of the Court from a legal theoretical or jurisprudential perspective.
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(B. 113.029)

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Praxis des Handels- und Wirtschaftsrechts, Heft 2. pp. 198. 32.- DM.
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pp. 233. 63.55 DM.
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(B. 112.325)

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Basic principles of taxation of enterprises. Every individual may be regarded as entrepreneur with regard to his working capacity and his net wealth. Under this point of view the author designs this textbook dealing with the taxation of enterprises.
(B. 110.574)

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Immobilieninvestitionen in den neuen Bundesländern.
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(B. 112.356)

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(B. 112.923)

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Stand: 1 Januar 1992.
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Collection of 46 complete texts of German tax- and corporation laws as of 1 January 1992.
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New York, Price Waterhouse. 1992, pp. 226.
Information guide on doing business in Germany. The material includes information on business environment, foreign investment and trade opportunities, investment incentives, restrictions on foreign investment and investors, banking and finance, exporting to Germany, labour relations and social security, auditing and accounting, tax system, taxation of corporations and individuals, partnerships and joint ventures, shareholders, value added tax and other indirect taxes, tax treaties.
(B. 112.844)

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Darstellung und Ratschläge zur Besteuerung.
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(B. 112.849)

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(B. 112.951)

SCHÖLLHORN, Peter.
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Analyse und Vergleich der Besteuerung von Kapitalgesellschaften nach deutschem und amerikanischem Steuerrecht. Eine EDV-gestützte Modelluntersuchung zum internationalen Steuerbelastungsvergleich.
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pp. 341. 80.- Sfrs.
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(B. 112.801)

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Die Besteuerung internationaler Geschäftsbeziehungen.
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(B. 112.646)

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(B. 112.531)

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(B. 112.491)

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(B. 112.995)

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(B. 112.763)

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(B. 113.035)

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  releases 158, 159
- Loonbelasting
  releases 551-555
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CUMULATIVE INDEX – 1993 Nos. 1-10

I. ARTICLES

Canada:
Nathan Boidman:
Tax Developments of Interest to US Tax Advisers 389

Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Research Incentives 255

Bangladesh:
K.A. Gofran:
Salient Features of the 1993/94 Budget 601

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Michael Riegels:
Financial Services in the British Virgin Islands 143

Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Denmark:
Bente Møll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

Finland:
Kari S. Tikka:
Fundamental Tax Reform: 25 Percent Rate on Capital Income and Corporate Income 348

France:
Olivier Delattre and Clothilde Fournier:
French Income Tax Developments of Interest to US Tax Advisers 367

Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Germany:
Friedhelm Jacob:
Administrative and Legislative Developments of Interest to US Tax Advisers 383

Dr Klaus Sieker and Adrian Yeeles:
New Thin Capitalization Rules 594

Hong Kong:
Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283

Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37

G.K. Kawatra:
1993/94 Budget 294

International:
John Azzi:
Policy Considerations in the Taxation of Foreign Source Income 547

Vicki L. Beyer:
Issues raised by International Cooperation in Revenue Enforcement: Directions for the Future 436

Sijbren Cnossen:
What Kind of Corporation Tax? 3

John Hasseldine:
How do Revenue Audits Affect Taxpayer Compliance 424

Ken Messere:
Recent Tax Revenue Developments in OECD Countries and Some Policy Implications 323

John Prebble:
100 Years of Income Tax 59

Stanley C. Ruchelman:
US Tax Considerations in International Derivative Products 235

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Italy:
Simona Belletini:
Tax Treatment of Financial Instruments in Italy 502

Karl Beusch:
1993 IFA Congress in Florence 471

Augusto Fantozzi:
Italy Welcomes Further EC Harmonization

Bruno Gangemi:
Tax Avoidance: The Italian Experience 522

Paolo Ludovici:
The Tax on the Net Worth of Enterprises 496

Guglielmo Maisto:
Implementation of the EC Merger Directive 480

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Andrea Manganelli:
Tax Treaty Developments 529

Andrea Manzitti:
Tax Incentives in Italy 516

Guiseppe Marino:
Taxation of Italian-Based Flows of Interest and Royalties in an International Context 510

Siegfried Mayr:
Implementation of the Parent-Subsidiary Directive 493

Japan:
Alum Bati:
Taxation of Dividends and Interest 202

Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Kazakhstan:
Charles E. McLure, Jr.:
Tax Foundation Signs Agreement with Kazakhstan and Russia 444

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Mexico:
Juan Pablo de la Calle Pardo:
Tax Developments of Interest to US Tax Advisers 407

New Zealand:
Andrew M.C. Smith:
Comprehensive Dividend Imputation, Neutrality and Double Taxation of Corporate Profits 568

Netherlands:
Ebel Magnin:
Proposed Tax Haven Legislation 589

Paul Sleurink:
Income Tax Developments of Interest to US Tax Advisers 371

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
Charles E. McLure, Jr.:
Tax Foundation Signs Agreement with Kazakhstan and Russia 444

James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Singapore:
Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

United Kingdom:
Eric Tomsett:
Holding Company Regimes 599

Guy Brannan:
Tax Developments in the United Kingdom of Interest to US Tax Advisers 363

United States:
Melvin S. Adess and Barbara M. Angus:
Knowledge and Technology Transfers to and from the United States – Characterization of Transfers of Computer Software 414

Stephen A. Mihaly:
How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the Best Method Rule of the New Section 482 Regulations 307

John G. Rienstra:
Revenue Reconciliation Act of 1993 581

Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187

Leif Weizman:
New Income Tax Treaty – An Analysis and Prognosis 450

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

Bruce Zagaris:
The US–Netherlands Income Tax Treaty:
Tax Collection Assistance and Evidence-Gathering 342

Wim Wijnen:
The New US/Netherlands Double Tax Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Report by the Committee on Fiscal Affairs on the Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with Tax Aspects of Transfer Pricing within Multinational Enterprises 21

III. IFA NEWS 44, 96, 219, 254, 473

IV. CONFERENCE DIARY 39, 149, 285, 347, 413, 492, 614

V. BIBLIOGRAPHY

- Books 49, 100, 150, 226, 297, 354, 462, 535, 602
- Loose-leaf services 51, 103, 154, 231, 302, 465, 540, 611
  - List of addresses of the major publishing houses appearing in the Bibliography 53

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CONTENTS

VOL. 48 NO. 12 **DECEMBER 1993**

AUSTRALIA:
THE LAST CHAPTER? A REVIEW OF AUSTRALIA'S NEW FOREIGN INVESTMENT FUND MEASURES — 687 — *Michael Dirkis*
The Australian Government has been engaged for several years in a drive to comprehensively reform the system for taxing foreign source income. While a number of measures were enacted avenues for tax avoidance remained via the holding of substantial passive investments (foreign investment funds) in non-resident entities, that are not Australian controlled and therefore fall outside the scope of the foreign source income rules. To overcome the revenue deferral and avoidance advantages of investments in these FIFs the Government FIF measures in 1992. This article illustrates the effect of the new legislation on offshore investment by Australians, first by examining the scope of the measures in light of the various exemptions, and then examining the income calculation methods.

UNITED STATES:
"TRIANGULAR PROBLEM" SETTLED IN US/NETHERLANDS TREATY PROTOCOL — 698 — *Philip H. Spector*
The United States and the Netherlands recently signed a protocol to their proposed new income tax treaty, which settles the so-called "triangular problem" involving interest and royalty payments from the United States to branches of Netherlands companies located in tax havens.

SOUTH AFRICA:
NEW DUAL TAX SYSTEM — 701 — *Marius Cloete van Blerck*
With a view to encouraging reinvestment, South Africa recently introduced a dual tax system, comprised of a single uniform lower income tax rate on corporate income and a 15 percent secondary tax on companies levied on the declaration of dividends. Mr van Blerck takes a look at how the new STC will operate in practice.

INTERNATIONAL:
ENVIRONMENT AND TAXATION:
MUTUALLY REINFORCING POLICIES — 708 — *Jeffrey Owens*
The potential for using taxes as part of an integrated environmental policy is currently the subject of considerable interest in OECD countries. However, the increased use of eco-taxes raises questions such as how can non-environmental taxes that may adversely affect environmentally sensitive sectors be adapted, and how can such taxes be best properly integrated into existing tax structures and policies.

DENMARK:
TAX REFORM — 711 — *Bente Møll Pedersen*
A number of changes have been made to the tax system in Denmark, most notably the taxation of all capital gains and the abolition of the inconsistent treatment of different types of income and capital gains.

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LIECHTENSTEIN: PREFERENTIAL TAX TREATMENT OF HOLDING AND DOMICILIARY COMPANIES	716	*Dr Norbert Seeger* Dr Seeger takes a look at the historical basis of holding and domiciliary companies, and outlines the preferential tax treatment accorded to these entities under Liechtenstein tax law.
INTERNATIONAL: POSTSCRIPT TO JUNE 1993 ARTICLE ON DEVELOPMENTS IN TAX REVENUES AND FISCAL DEFICITS OF OECD COUNTRIES	720	*Ken Messere* Since Mr Messere's article was published in June more recent estimates have become available on tax revenue developments and fiscal deficits in OECD member countries. He makes a few corrections in this note.
ASIA: DEVELOPMENTS IN ECONOMIC INTEGRATION AND FISCAL HARMONIZATION	724	*Angel Q. Yoingco* The significance of economic integration and fiscal harmonization was recognized by countries in Asia as early as 1956, and has been the subject of various discussions, cooperative efforts and initiatives since that date. Mr Yoingco examines the efforts to achieve a common economic direction for Asia, focusing primarily on the ASEAN initiatives, and the common tax reforms which have taken place in the last several years.
IFA NEWS	700	
BIBLIOGRAPHY		
– Books	728	
– Loose-leaf services	734	
CONFERENCE DIARY	707	
CUMULATIVE INDEX	736	

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AUSTRALIA:

THE LAST CHAPTER?

A REVIEW OF AUSTRALIA'S NEW FOREIGN INVESTMENT FUND MEASURES

Michael Dirkis

Contents

I. Introduction
II. Implementation History
III. Scope of the Measures
IV. Were the Measures Necessary?
V. Complexity of the Legislation
VI. Commencement Date
VII. Exemptions
  A. Short-term holding exemptions
  B. Residency
  C. Active business exemption
  D. Balanced investment exemption
  E. Exclusions for certain "black-listed" businesses
  F. Small investor exclusion (de minimis rule)
  G. Foreign employer-sponsored superannuation exemption
  H. Attributable taxpayer exemption
  I. Exclusions of certain country funds
  J. Exclusion of certain visitors to Australia
  K. Life assurance policies
  L. Trading stock, bare trusts and Lloyds
  M. Effectiveness of the exemptions
VIII. Calculation of the FIF Income (Excluding Life Policies)
  A. Market value method
  B. Calculation method
  C. Deemed rate-of-return method
IX. Taxation of Foreign Life Assurance Policies
X. The Assessment Calculation
XI. New Measures for Taxing Offshore Trusts
XII. Evaluation of Trust Changes
XIII. The Effect on Double Tax Agreements
XIV. Anti-Avoidance Provisions
XV. Record Keeping Requirements
XVI. Prosecution Provisions
XVII. Valuation of Trading Stock
XVIII. Conclusion

I. INTRODUCTION

The Australian Government's programme of comprehensively reforming the system for taxing foreign source income started with the introduction, for the 1987-88 income year, of a foreign tax credit system. The programme continued with the introduction, for the 1990-91 income year, of the foreign source income ("FSI") measures (which taxed Australian residents on an accrual basis on income earned by controlled foreign companies ("CFCs") and transferor trusts).

Although these measures were comprehensive, avenues remained for offshore tax avoidance via the holding of substantial passive investments in non-resident entities, that are not Australian controlled and thereby fall outside the scope of the FSI measures.[1] These passive holdings are commonly known as foreign investment funds ("FIFs") or foreign income funds. They remained the last, untackled chapter in the Government's reform project.

Specifically, the Government sought to overcome the tax deferral advantage enjoyed by investments in these funds. The deferral arises from the fund income escaping Australian tax on a current basis, and in some cases, the non-remittance of the income to Australia. They also sought to negate the advantages arising from the conversion of lowly taxed (or untaxed) income of the funds into tax-exempt forms (e.g. loans) or more favourably taxed receipts like capital gains.[2]

With large amounts invested offshore (estimated to be A$ 25 billion) by fund managers on behalf of superannuation funds, life companies, banks and private investors, the FIF measures will have a marked effect on the manner and form of current and future offshore investment. Early estimates of the cost of the measures was A$ 2 billion annually, rising to A$ 10 billion annually.[3] Although these early estimates were on the high side, industry sources have recently estimated that up to 30 June 1993 the measures have induced precautionary sales of offshore investments by fund managers in excess of A$ 500 million.[4] It is also claimed that the

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The author wishes to thank Mr Carmine Di Cesare for his thoughtful comments and editorial suggestions during the preparation of this article.

1. "Taxation of Interests in Foreign Investment Funds", Information Paper (1992), at 6.
2. Capital gains are taxed on a more favourable basis than other types of Australian income, with only the gain realized above inflation being taxed.
3. Estimates by investment research house, IPAC Securities, reported in "Foreign investment tax will hit hard", *The Weekend Australian* (30-31 May 1992), at 57.
4. "FIF rules cause bout of selling by funds", *Australian Financial Review* (21 July 1993), at 19.

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measures are already having a profound effect on some markets in which the funds are placed, and on individual enterprises within those markets.[5]

Therefore, in order to illustrate the effect of these reforms on offshore investment by Australians I propose initially to identify the scope of the measures in light of the various exemptions, before looking at income calculation methods. Unfortunately, the complexity of the measures necessitates the adoption of technical based descriptions in some areas. These technical descriptions combined with policy comment are required to accurately convey the impact of the measures and the subtleties of the policy decisions underlying certain aspects of the measures.

II. IMPLEMENTATION HISTORY

To overcome the revenue deferral and avoidance advantages of investments in these FIFs, the Government announced its FIF measures in April 1992.[6] Legislation encoding the measures was introduced in Parliament on 25 June 1992. However, in an unprecedented move the Government announced, after the introduction of the legislation, that it would consult further with industry before passing the measures.[7]

The Government appointed Canadian Professor Brian Arnold to oversee the consultation process. In response to Professor Arnold's report (the "Arnold Report")[8] released on 9 October 1992, the Government announced a number of changes.[9] The initial Bill was withdrawn and a consolidated bill was introduced on 3 November 1992, becoming law on 18 December 1992 (the Income Tax Assessment Amendment (Foreign Investment) Act 1992). Subsequently, minor procedural amendments were made in the Taxation Laws Amendment Act (No. 2) 1993, which became law on 9 June 1993. As both these Acts amend the Income Tax Assessment Act 1936 (ITAA), in this paper all section references will be in terms of the ITAA.

III. SCOPE OF THE MEASURES

The measures have been designed to have a broad scope. They apply to any proprietary interest or right to acquire such an interest in

- a foreign trust or company (FIF),[10] or
- a life assurance policy issued by a foreign entity (FLP).[11]

Despite general criticisms from fund managers that the scope of the definition is too wide, the Government has resisted the temptation to narrow the scope of the legislation to deal only with known offshore avoidance schemes. As the "...methods of tax avoidance are many, varied and subject to continuous change..." the Government believed that focused legislation would only lead to a "...wasteful and extensive game of seeking new tax avoidance methods".[12] The failure of the measures to address prescibed avoidance schemes does not mean that the legislation is unfocused. As will be discussed later, the extensive list of exemptions adopted means that in fact the measures are focused on areas of tax avoidance.

IV. WERE THE MEASURES NECESSARY?

Fund managers have argued that "...the legislation is aimed at stopping tax avoidance that does not virtually exist."[13] This is clearly not the case given Hong Kong newspaper reports in May 1992 that stated that "...the tax avoidance industry here in Hong Kong that specializes in Australian tax is burning the midnight oil to find a way around the new measures".[14] The need for such measures in the Australian context was in fact acknowledged in the Arnold Report.[15] The report did not even question the fundamental underlying policy and structure of the measures; rather, it concentrated on changes to the minor policy issues associated with the structure of the measures.

V. COMPLEXITY OF THE LEGISLATION

The Australian legislation "is excessively long and complicated",[16] consisting of 113 pages, made up of 168 new sections and three new schedules. That it adopted a worldwide, activity-based approach in structuring the FIF measures is in part the reason for its length.

Had Australia continued with the jurisdictional approach adopted under its FSI measures,[17] the scheme enacted would have been shorter in length. However, the long list of excluded countries under Australia's FSI measures would have resulted in greater complexity. The complexity arises from the provision of designated concessions. Also a jurisdictional-based scheme would have imposed greater compliance costs on the Australian Taxation Office due to the greater administrative costs of maintaining the lists to prevent avoidance opportunities that a jurisdictional approach embodies.

VI. COMMENCEMENT DATE

The FIF measures took effect on 1 January 1993. Many of the changes contained in the Taxation Laws Amendment Act

5. *Id.* The article reports that the Hong Kong market has been hit with half the stocks traded being considered to be too risky for Australian investors to hold.
6. See *supra* note 1.
7. §Treasurer's Press Release No. 103/1992, 25 June 1992.
8. *Arnold Report on the Implementation Issues Arising from the Foreign Investment Fund Legislation* (1992).
9. Treasurer's Press Release No. 153/1992, 9 October 1992.
10. Sec. 481.
11. Sec. 482.
12. Explanatory Memorandum to the Bill.
13. "Striking a blow at tax cheats", *The Weekend Australian* (4-5 July 1992), at 46.
14. "Expats cry foul as Australia plugs tax loophole", *South China Post (HK)* (18 May 1992).
15. See *supra* note 8.
16. See *supra* note 9, at 60.
17. Australia's FSI (i.e. accruals/CFC measures) took effect from the 1990-91 income year.

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(No. 2) 1993 were also backdated to have effect from 1 January 1993, despite only becoming law (receiving the Royal Assent) on 9 June 1993.

The measures apply differently for interests in FIFs compared with those in FLPs. A FIF interest will only be subject to the measures if the resident's interest in a FIF is held at the end of the year of income[18] and the notional accounting period of the FIF also ends during that year.[19] Thus, where the taxpayer disposes of the interest in a FIF before the end of that year of income, there will be no FIF taxation for that income year, as the interest is not held.

In contrast, where the resident's interest in an FLP is held at any time during the notional accounting period of the FLP that ends during the taxpayer's year of income, the measures will apply.[20] An exception was provided for interests in an FLP where it was disposed of before 30 June 1993.[21]

VII. EXEMPTIONS

As it seems that the investors and Professor Arnold had accepted the inevitable nature of the Government's broad policy direction, much of the policy discussion and development in the later days of the consultative process was centred on the exemptions to the measures. From the industry's view, if you are able to get your investment exempted, then the measures have no impact, save record keeping. Thus, a detailed understanding of the exemptions and the underlying policy is crucial in grasping the actual scope of the measures.

A. *Short-term holding exemptions*

Taxpayers under the measures may elect for the notional accounting period of the FIF to coincide with the period for which the accounts of the FIF are prepared,[22] where a divergence between the accounting period of the FIF (the notional accounting period) and the taxpayer's year of income occurs. As a FIF interest will only be subject to the measures if the resident's interest in a FIF is held at the end of the year of income and the notional accounting period of the FIF also ends during that year, this divergence gives rise to a "short-term holding" exemption of up to 18 months.[23] This is best illustrated by the following example:

> In year 1 the interest is purchased 1 January 1998 in a FIF with a notional accounting period ending on 31 December 1998. At 30 June 1998, as the notional accounting period of the FIF did not end during that year, no income is brought into account. It is not brought into account under the operative provision until 31 December 1998.
>
> In year 2, if a taxpayer sells the interest on 29 June 1998 again no income will arise for the income year ended 30 June 1998 as it was not owned at the end of the taxpayers year of income. Thus, again the interest escapes the FIF measures in both years. The divergence has resulted in an exemption from the measures for interests held up to 18 months.

B. *Residency*

The legislation only taxes resident taxpayers with the requisite interest in offshore entities held at the end of the 1992-93 income year.[24] However, as the measures provide for apportionment of income based on the period of residency of the taxpayer,[25] a non-resident taxpayer could be assessed on a FIF interest under the measures. This could occur where a resident taxpayer becomes a non-resident and retains a FIF interest at the end of the period.[26]

Dual residents who hold FIF interests are expressly excluded from the measures, provided they are deemed to be residents of another country under a comprehensive double tax agreement.[27] This exemption is consistent with the purpose of entering such bilateral tax agreements, i.e. the avoidance of double tax by the parties agreeing to share the rights to tax. The taxpayer is only taxed in the country of most attachment.

C. *Active business exemption*

The Australian measures provide an exemption to exclude "active" businesses from its scope. A similar exemption is provided for in the United States under its passive foreign investment company rules. However, the Australian measures are radically different to the US exemption which determines an active business by the percentage of passive income in gross income of the fund.[28] The Australian "active business exemption" exempts all direct investment (or in respect of offshore holding companies, indirect investments) in foreign companies whose business does not principally derive passive income.

The exemption is provided by restricting the measures only to interests in companies which are engaged in business activities that are principally passive. The business activities that are considered to be principally passive (i.e. investment, financial services, and certain real estate, banking and insurance businesses) are prescribed on a "black list". The Government felt that by prescribing a short "black list", the exemption would be administratively easier to manage. Also, by reducing the number of categories, uncertainty in categorization of activities is reduced.[29]

Whether a foreign company is principally engaged in a "black list" business activity is determined by two methods.

18. Sec. 485(3).
19. Sec. 529.
20. Sec. 485(4).
21. Sec. 485(5).
22. Sec. 485(4).
23. Sec. 529, the operative provision, provides for the FIF income to be included in the taxpayer's assessable income for the taxpayer's year of income in which the notional accounting period of the FIF ends.
24. Sec. 485(3).
25. Sec. 529.
26. See further Pizzacalla, "Foreign Investment Fund Income: A Practical Perspective", *Australian Accountant* (May 1993), at 27.
27. Sec. 485(3)(4).
28. For details see Klein and Sofe, "Passive Foreign Corporation Proposal: Simplification or Complication", 20 *Tax Management International Journal* (1991), at 423.
29. See *supra* note 8.

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The first method uses stock exchange listings to determine what industry a company is principally engaged in. If the activities of the company are classified by the "approved stock exchanges" or the "approved international sectoral classification systems"[30] as belonging to a class of companies in the "black list" at the test time, the company is deemed not to be principally engaged in an "active business".

This exemption is widened to exclude interests in listed foreign companies whose principal activities are an aggregate of two or more of active businesses or business activities expressly exempted.[31] However, this is conditional on the company's shares being listed on an approved exchange, being widely held and actively traded on a regular basis.

The second method is the balance sheet method. The principal activity of a company is determined by reference to the company's balance sheet at test time.[32] Where at test time at least 50 percent of assets are for use or held for use[33] in a "black list" business activity the company will fail the active business test. If both of these methods are capable of being applied to a particular company, the company must choose the method to be used. If it is not possible to use either one of the methods the exemption will not be available.

Only companies can take advantage of the active business exemption. It will not apply to any interest in a non-resident trust, even though the trust's underlying investments may be principally active. A recommendation in the Arnold Report to extend the exemption to trusts was rejected by the Government[34] on the grounds that the inherent flexibility of trusts would result in tax planning advantages.[35] However, the exemption will apply when calculating the FIF income of interests held by foreign trusts, assessed under the trust provisions in Division 6.

D. *Balanced investment exemption*

A balanced investment exemption is provided to ensure that the measures do not lead to lack of diversity in foreign investment portfolios, thus exposing investors to greater risk.[36] Under this exemption a taxpayer with "black listed" FIF interests will be exempt if the "black listed" interests do not constitute 5 percent or more of the taxpayer's portfolio at the test time. It has been reported that many fund managers have taken advantage of this exemption.[37]

E. *Exclusions for certain "black listed" businesses*

Not all "black listed" investments are caught under the measures. The measures do prescribe restrictive exemptions in respect of certain "black listed" activities, in particular certain banking, real estate, life and general insurance businesses that are considered to be active businesses. For interests in a foreign bank (including a foreign holding company of a foreign bank),[38] general insurance[39] or real estate[40] company to be exempt, the shares must be listed on one of the approved stock exchanges, must be widely held and actively traded on a regular basis. Also, the companies must actually carry on their respective businesses of banking, general insurance and real estate development. In addition, banks and general insurance companies must meet a further requirement. They must be authorized to carry on their respective businesses of banking or general insurance in their country of residence.

An investment in a life insurance company will be exempt if the company's balance sheet at test time shows that at least 50 percent of the gross value of the company's assets was used in the carrying on of a life assurance business, as defined by Section 4 of the Life Insurance Act 1945.[41] It must also be authorized by law to carry on life insurance business in its country of residence. Unlike the other categories of black list exceptions, it does not matter whether the company's shares are publicly listed. This modification for life companies reflects the fact that many life companies are owned by policy holders, rather than share holders or via a combination of both.

F. *Small investor exclusion (de minimis rule)*

The measures also provide for two small investor exemptions for natural persons with A$ 50,000 or less invested offshore. Under the first exemption the FIF measures will not apply to individuals (other than trustees) where the total of the individual's interests together with the interests of associates, in foreign companies, trusts and life policies is not more than A$ 50,000.[42] The term "associates" is widely defined to include the immediate relatives, a company in which the taxpayer holds a majority of the voting shares, a trust controlled by the taxpayer and a partnership in which the taxpayer is a partner.[43]

The second exemption takes account of indirect offshore investments held through interests in resident public unit trusts. If the total of the taxpayer's interests (together with those of associates) in foreign companies, trusts, foreign life policies and interests in resident public unit trusts at the end of the year of income does not exceed A$ 50,000, the FIF

30. The following are approved international sectorial classification systems:
- Bloomberg's Information Systems;
- Financial times - Actuaries World Index;
- Morgan Stanley Capital International Index;
- Solomon Brothers Frank Russell Index; and
- Standard and Poor's Composite Index (S&P 500).

In July 1993 the Treasurer announced that two further approved international sectorial classification systems were to be included:
- Extel Financial Workstation Index; and
- International Finance Corporation Composite Index.

31. Sec. 523.
32. Sec. 500.
33. Taxation Determination TD 93/137.
34. See *supra* note 8, at 27.
35. See *supra* note 9, at Att C 2.
36. Sec. 525.
37. See *supra* note 4.
38. Secs. 503 and 504.
39. Sec 470 defines general insurance business to mean any insurance business other than a life assurance business as defined by Sec. 4 of the Life Insurance Act (Aust) 1945.
40. Sec. 511.
41. Secs. 506 and 507.
42. Under Sec. 515(1).
43. Associate is defined by Sec. 318, as modified by Sec. 491.

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measures will not apply to the taxpayer's direct interests, nor to the taxpayer's share of net income from the resident public unit trusts.[44]

G. *Foreign employer-sponsored superannuation exemption*

Where a natural person holds an interest in a foreign employer-sponsored superannuation fund, the interest is excluded from the operative provision[45] provided that the person is an employee (including a company director) or past employee of the employer and that the fund is managed by the employer or associate company on behalf of current or past employees. The exemption is very narrow and the Arnold Report[46] recommended that the exemption be widened. The Government's view on the matter is still under consideration.[47]

H. *Attributable taxpayer exemption*

The FIF measures will apply in calculating the income of a CFC or trust which holds interests in FIFs. However, in overlap situations (i.e. where they overlap with the FIF measures), the CFC measures or the transferor trust measures[48] will continue to have precedence.

I. *Exclusions of certain country funds*

A further exemption is provided in respect of interests in foreign trusts listed in Schedule 6.[49] These trusts are established in countries which prohibit or restrict direct investment on their stock exchanges (e.g. Chile, India, the Republic of Korea and Taiwan). The list has been extended recently to bring the total number of trusts listed in Schedule 6 to 28.[50]

However, the exemption has been criticized as outdated, as some of these countries have recently freed up their markets[51] and other developing markets with restrictions, such as Indonesia and Vietnam, should have been listed. There is, however, hope for change as the Government has indicated that this exemption will be modified and updated where necessary.[52] To date no major review has been undertaken.

Also, where the measures do not apply to the beneficiary's interest in that estate because of the country fund exemption, the legislation ensures that the measures will also not operate in the calculation of a beneficiary's income of a trust estate.[53] This avoids possible double taxation.

J. *Exclusion of certain visitors to Australia*

Natural persons who are visitors to Australia may also be exempt from the FIF measures.[54] This exemption is an extension of the exemption granted to such visitors in respect of the capital gains tax provisions. An exempt visitor is prescribed to be any person who resides in Australia under a temporary entry permit (with a maximum duration, including rights to extension, of four years).[55] However, they will not qualify for the exemption if they have applied for, or been given, permanent residency in Australia.

K. *Life assurance policies*

The measures also exclude three categories of life policies.[56] The exempt policies are those policies:

- which provide life cover, or life and permanent disability cover only; or
- were issued before 1 July 1992 and cannot, after this date, be cancelled, surrendered or redeemed and for which the terms have not, after this date, been altered in a material respect; or
- which are a contract of reinsurance of pure life cover between a resident insurer and a non-resident reinsurer.

L. *Trading stock, bare trusts and Lloyds*

Other minor exemptions provided are for interests that are trading stock,[57] interests that are held via bare trusts[58] and interests held by underwriting members of Lloyds.[59]

M. *Effectiveness of the exemptions*

The effect of the exemptions is to focus the measures "...more directly at tax avoidance..."[60] They achieve this by excluding small investors and directing offshore investment to specific areas. Investments in entities holding passive investments are on the whole excluded, as such entities can more easily shift profits to entities resident in low-tax countries.

However, the lack of a distribution exemption has been much criticized.[61] Under a distribution exemption a FIF interest would be excluded if the FIF distributed all or a prescribed percentage of its income. It is claimed that the effect of such

44. Sec. 96A(2).
45. By Sec. 519.
46. See *supra* note 8, at 46.
47. See *supra* note 9.
48. Secs. 493 and 494.
49. Sec. 513.
50. Treasurer's Press Release 29 April 1993.
51. For further discussion, see "FIF...FLP..."WHAT? – A review of Australia's proposed Foreign Income Fund measures", 4(5) *CCH Journal of Asian Pacific Taxation* (1992), at 11.
52. See *supra* note 9, at Attachment A 3.
53. Sec. 585A(3).
54. Sec. 517.
55. The permit must have been issued under the Migration Act 1958.
56. Sec. 482.
57. Sec. 521.
58. Sec. 484.
59. Sec. 527.
60. "FIF revisions a relief to small offshore investors", *Australian Financial Review* (29 June 1992), at 4.
61. Wachtel, Anderson and Diskin, "Foreign Investment Fund measures", *Butterworths Weekly Tax Bulletin* (1992), at 640; and Wachtel and Anderson, *Australian Tax Practice* (Butterworths, 1993), at 830,053.

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an exemption would force distributions, thus ensuring that the fund's income is subjected to Australian tax annually. Such exemptions exist in the UK FIF measures and formed part of the definition of a FIF under New Zealand's former measures.[62]

However, the Treasurer claimed that such exemptions do not work,[63] and the exemption would merely provide another avenue for continued avoidance. The Treasurer pointed to tests in other countries and how these tests are overcome by storing realized gains in lower tier entities. The higher tier entity merely has unrealized gains and therefore nothing to distribute.

Even from a practical viewpoint there are limitations in such exemptions. Given legitimate reinvestment requirements of businesses, the distribution requirement must be less than 100 percent. Otherwise, the operation of active businesses and investment therein would be disadvantaged. Thus, the setting of a distribution percentage to take account of entities' reinvestment requirements can only be arbitrary. Further, such a reduction in the distribution required provides a tax discount for the passive funds. It does this by prescribing that they only need to distribute a portion of their income, rather than all of it.

Thus, the exemptions do provide a means by which offshore investment portfolios can be rearranged to lessen or even avoid the impact of the measures. This can be achieved by investing directly or through a holding company in companies that are classified as primarily engaged in active businesses. Investments can also be channelled to approved banking, life assurance, general assurance and real property stocks, as well as approved country funds. Even interests in passive investments can be maintained, provided they form less than 5 percent of a portfolio.

However, care must be taken in choosing the investment vehicle. A direct interest in a company engaged in an active business should always be sought ahead of an indirect investment through a company which holds the interest. The direct interest will be exempt, while the indirect interest is not.

VIII. CALCULATION OF THE FIF INCOME (EXCLUDING LIFE POLICIES)

The availability of financial information to investors will usually be limited in respect of FIF interests as they are non-controlling interests. However, in a limited number of cases the interest, although small in terms of control, may be financially significant. In these circumstances financial information will be readily available. To balance this diversity in available information and the associated needs for simplicity, the measures provide three alternative methods for calculating the income attributable to the interest in the FIF. The method used by an investor will depend upon the information available.

The calculation methods are highly technical as the measures allow movement between the various calculation methods and have extensive anti-avoidance provisions to deal with these potential movements. Therefore, I propose to give an overview of each method rather than examine each of them in detail.

A. *Market value method*[64]

The principal method of determining the attributable income in respect of an interest in a FIF is the market value method. Under this method, the attributed income is the amount represented by the annual change in the value of an investor's interest in a FIF. As it is based on the value of interests, it is most likely to be used where financial information is scarce and/or where the scale of interests held is large (e.g. where fund is being managed).

A market value of an interest in a FIF is determined by reference to the quoted market values of interests from an approved stock exchange.[65] The officially quoted buy-back or redemption price of units will be used for unlisted funds.[66] Where there is more than one quoted price, or where the stock exchange used can no longer be used, or where a price is not quoted at the time the measures begin, special rules apply.[67] Generally, if the market value for an interest or class of interests in a FIF cannot be ascertained at the relevant measurement point, the method cannot be used. Also, a taxpayer can only use the method provided he has not elected to use the calculation method at the first or second tier.

The income accrued to the holder of a FIF interest is calculated in two steps. The first step is to calculate the movement in the market value between two annual reporting dates (i.e. the Foreign Income Fund Amount (FIFA)). The FIFA is calculated by:

deducting

- the sum of (a) the opening value of the interests (i.e. closing value of interests held at the end of the prior accounting period), determined either under the deemed rate-of-return method[68] (if applied), or if the method did not apply, determined under the market value method and (b) the cost of any interests in the FIF which the taxpayer acquired during the notional accounting period;

from

- the sum of the market value of the taxpayer's interests in the FIF on the last day of the notional accounting period, *and* the value of distributions by the FIF to the taxpayer during the notional accounting period in respect of the interests held on that day;

and adding

- the value of distributions by the FIF to the taxpayer during the notional accounting period in respect of interests which have been disposed of prior to that day.

62. Schedule 27 Income and Corporation Taxes (UK) Act 1988 and the former Sec. 245R(2)(d) of Income Tax Act (NZ) 1976.
63. See *supra* note 1, at 9.
64. Secs. 537-542.
65. Sec. 539(2).
66. Sec. 539(3).
67. Under Sec. 539.
68. Sec. 551.

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Generally the entire calculation is done in the currency in which the market value is recorded. However, rather than doing all the calculations in a foreign currency and only converting where a gain arises, a taxpayer can irrevocably elect for all FIF interests to do all the calculations in Australian currency.[69] This has the effect of dealing with all currency gains and losses annually.

If the FIFA is positive, the amount represents the gross FIF amount.[70] If the FIFA is negative a FIF loss has occurred.[71] This FIF loss may be used to offset assessable income of the taxpayer. However, the amount of offset is limited to the amount of foreign income taxation previously raised in respect of that FIF.[72] The undeducted balance of the loss (the 'undeducted amount of FIF losses')[73] is carried forward, in its foreign currency form, to be offset against future years' gross FIF income.

The second step[74] is to provide for recoupment of any 'unapplied previous FIF losses' (past year losses) against the gross FIFA in the current year. If the net FIFA after applying the losses is positive, then that amount is included in the assessable income of the taxpayer. Only where the calculation is done in a foreign currency is there a need to convert the net FIFA figure into Australian dollars.[75] If the calculation results in a loss, no conversion is required.

If the result is negative, the balance of the 'undeducted amount of FIF loss' will be carried forward to subsequent years. To stop manipulation of losses there are special rules to deal with determining the actual 'unapplied previous FIF loss', where one or more of the exclusion or exemption provisions apply.[76] If a notional FIFA would have been assessed except for an exemption, that amount is used to reduce the 'unapplied previous FIF loss'.

The market value method was the subject of the greatest criticism when enacted. First, the measures successfully remove indexation for capital gains purposes by taxing the whole of the market value increase. As well as taxing the realized gains as intended, the methods also tax unrealized gains. A fully distributing fund may experience an increase in market value due to an increase in the value of its assets. The application of the market value in these circumstances will result in the taxation of these unrealized capital gains. These outcomes are easily illustrated in the following example:

> Assume that an interest in a fund was acquired for $ 100,000 on 30 June 1993. For the year ended 30 June 1994 there are no distributions, but the market value has increased to $ 110,000 due to the increase in the value of land the owned by the fund. The interest is sold on 1 July 1995 for $ 110,000. Also assume that CPI increase is 10%.
>
> Thus, in 1994, applying the above formulas, the market value increase is $ 10,000. The taxpayer would be assessed $ 10,000 in respect of an unrealized capital gain for the year ended 30 June 1994. However, had the asset been a domestic one, the $ 10,000 gain would not have been assessable in either year because of indexation.

Despite the Arnold Report recommending the restoration of the indexation advantage,[77] the Government rejected the recommendation on the basis that the accruals taxing methods make no distinction between income and capital. To allow indexation it was argued, would in effect permit the indexation of income.[78]

B. *Calculation method*

Where a taxpayer has the financial information to calculate the income of the FIF, a taxpayer can elect to use this method in preference to the market value method.[79] Under this method the income related to the FIF interest is calculated in accordance with a series of modified rules based on the general scheme of Australia's legislation.

It would be safe to assume that this method will only be available to a few interest holders as the information requirements are so high. Further, the use of the method is restricted to calculating the income of the first and second tier FIFs. One of the other two methods must be used for calculating the income of the third tier FIF.[80] However, where the first tier is a CFC, the calculation method can be used for calculating the income of the second and third tier FIFs.

There are two steps in the calculation under this method. The first step requires a taxpayer to calculate the profit or loss for the FIF for a notional accounting period, by deducting the FIF's notional expenses from the FIF's notional income. This method uses a general income section and a general deductions section, similar to that used in the general scheme of Australia's legislation. However, it is different in a number of key aspects. For example, deductions that are of a capital or private nature (subject to specific non-allowable categories) will be deductible. This modification recognizes the fact that due to the scarcity of information most taxpayers could not distinguish private and capital expenditure. Thus, it allows more taxpayers to use this method.

The calculation is to be done in the currency in which the FIF keeps its accounts.[81] Amounts derived or incurred by a FIF that are expressed in another currency may be converted to the FIF's currency on a reasonable and appropriate basis. If there is a loss, it is carried forward in the foreign currency and taken into account for subsequent notional accounting periods. If there is a profit, the second step arises.

Under the second step the taxpayer's share of the profit must be determined (i.e. the attributable income). The attributable income is determined by multiplying the profit of the FIF (as determined above) by the taxpayer's percentage interest in the FIF at the end of that period (the "attribution percentage"). The resulting amount is included in the taxpayer's

69. Sec. 538(4).
70. Sec. 540.
71. Sec. 541.
72. Sec. 532.
73. Sec. 542.
74. *Id.*
75. Sec. 542(3).
76. See Div 2-15.
77. See *supra* note 8, at 51.
78. See *supra* note 9, at Attachment C 4.
79. Under Sec. 535.
80. Sec. 577.
81. Sec. 559.

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assessable income for the year of income in which the notional accounting period of the FIF ends.

There are two methods of calculating the attribution percentage; one where the interest is in a FIF company, the other where it is in a FIF trust. For an interest in a company, a taxpayer's FIF attribution percentage will be equal to the percentage that the taxpayer holds or is 'entitled to acquire' in

- the total paid-up share capital of the company;
- the total rights to vote, or to participate in decision making, in relation to distributions of profit or capital of the company, the constituent document of the company, or a variation to the share capital of the company; or
- the total rights to distributions of profits or capital on winding-up, or at any other time.

Where different rights exist, the attribution percentage for a FIF interest in a company is the greatest of the taxpayer's rights.[82]

The calculation of attribution percentage for an interest in a foreign trust is a two tier, alternative test. In order to use the first test, the trust must be fully distributing (i.e. the trustee distributes or allocates to the beneficiaries, all of the trust's accounting income, profits and gains, which are income, profits and gains to which the beneficiaries are presently entitled, or which are distributed to the beneficiaries within two months of the end of the income year).[83] The "income, profits or gains" referred to is not the "net income" calculated under Division 6 for income tax purposes. Instead, the terms refer to the accounting income, profits or gains of the trust.

If the above requirement is satisfied, the taxpayer's attribution percentage is calculated by reference to the present entitlement and/or the amount distributed to the taxpayer out of the income, profits or gains that arises during the trust's notional accounting period. If the income, profits or gains of the foreign trust are not fully distributed or allocated to beneficiaries, as described above, then the taxpayer's attribution percentage is determined under the second test.

Under the second test the taxpayer's attribution percentage is equal to the greater of the percentages of the taxpayer's interest in, and entitlement to acquire the income of the trust or the corpus of the trust.[84]

In general, it is assumed that the taxpayer's rights in relation to the foreign trust at the test time applied at all times throughout the applicable period. However, where a taxpayer holds an interest in the FIF during a notional accounting period and adds to or reduces that interest during the period, the amount included in assessable income will be altered to reflect the changing size of the attribution interest. If the taxpayer had an interest in a FIF for only a particular part of the notional accounting period, the above formula is modified by multiplying it by the proportion of the number of days throughout the period in which the taxpayer held the interest.

The resulting amounts calculated above under both tiers are included in the taxpayer's assessable income for the year of income in which the notional accounting period of the FIF ends.[85]

C. *Deemed rate-of-return method*

The calculation method of last resort is the deemed rate-of-return method. Under this method, the attributed income is calculated by multiplying the taxpayer's interests in the FIF by the "deemed rate-of-return" for the period the investment was held. It applies only if it is not practicable to apply the market value method and the taxpayer has not choosen to use the calculation method.[86]

The deemed rate-of-return method is applied separately to each group of interests held by the taxpayer.[87] If a taxpayer had only one interest in a FIF during the notional accounting period that interest is a group. If a taxpayer had two or more interests in a FIF that are not in the same group of interests, the deemed rate-of-return method is applied separately to each group.

The opening value of the interest is the actual cost increased by previous inclusions of income attributable to the interest and decreased by distributions received. Once the opening deemed value has been ascertained, the FIFA for the notional accounting period, is calculated by applying the specified formula:[88]

$$\text{FIFA} = \text{Opening value} \times \text{Deemed rate} \times \frac{\text{Number of days held}}{\text{Total number of days}}$$

Where:

The deemed rate-of-return is the rate of interest prescribed (currently 10 percent per annum) increased by 4 percent.[89]
Number of days held is the number of days in the notional accounting period in which the taxpayer had the interests in the group.
Total number of days is the total number of days in the notional accounting period (usually 365 days).

The final step in applying the deemed rate-of-return method is to determine the amount attributed to the taxpayer (the FIF income). To do this the FIF amount is first converted to the corresponding amount in Australian currency.[90] Losses cannot occur. Where the investment has been either under-taxed (its value increased at a rate greater than the deemed rate) or over-taxed (its value increased at a rate less than the deemed rate) the capital gains provisions are used as the adjustment mechanism.

IX. TAXATION OF FOREIGN LIFE ASSURANCE POLICIES

A foreign life assurance policy (FLP) is a life assurance[91] policy which has been issued by an entity that was a non-resi-

82. Sec. 555(1).
83. Sec. 582(1).
84. Sec. 582(6).
85. Secs. 580 and 582.
86. Sec. 535.
87. Under Sec. 518, interests in a FIF are considered as a group of interests if they are of the same class (for example, two parcels of A class shares held during the same period).
88. In Sec. 544.
89. By Sec. 10 of the Taxation (Interest on Overpayments) Act 1983.
90. Secs. 556 and 557.
91. A life assurance policy is defined by Sec. 482(2)(a)-(2)(d) to be a policy which provides for a payment of money upon death, other than death by accident or specified sickness, or the happening of a specified event which relates to the ending or continuing of a human life. A life assurance policy also includes an instrument which grants an annuity for a term dependent upon a human life.

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dent at any time in that year of income. Foreign companies authorized to carry on life assurance business in Australia are excluded from the definition.[92] This prevents policies, issued in Australia by foreign life companies operating through a branch, from being caught by the measures.[93] An interest is defined to be legal title to the FLP.[94] Assessing the legal owner of the interest ensures that employers who pay the premiums on behalf of an employee will not be assessed.

The measures impose on the holder of an interest in an FLP[95] a tax calculated either under the deemed rate-of-return method[96] or via election,[97] under the cash surrender value method. Under the deemed rate-of-return method (already described) an interest holder will be assessed on a deemed earnings rate (currently 14 percent per annum) on the value of the FLP. The cash surrender value method,[98] on the other hand, assesses the interest holder on the increase in the cash surrender value of the life policy by the use of a formula similar to that used in the market value method. The cash surrender value method overcomes the problem under the deemed rate-of-return method of assessing a taxpayer on the risk component of the policy.

However, despite the cash surrender value method alternative only assessing the holder on the investment component of a life policy, it would be safe to say that these measures have effectively ended the market in Australia for foreign life assurance policies. They have removed any incentive for offshore life assurance policies and destroyed the market for single premium bonds ("wrap-around bonds"). They may also have a major impact on expatriate Australian[99] investment decisions as the monetary cost of surrendering the policies will be high. This high cost of surrendering policies may also effect some migration decisions.[100]

X. THE ASSESSMENT CALCULATION

Once the income attributable to the FIF or FLP interest is calculated, taxpayers are required to include in their assessable income of a year of income that attributable income.[101] A combination of exemption provisions and attribution accounts has been provided in the measures to minimize the risk of double taxation.

The amount of attributable income to be included in a taxpayer's income is reduced by the amount of any income already included in assessable income or exempt under Section 23AJ.[102] Also excluded from the taxpayer's assessable income are amounts which are notionally exempt income of a CFC in which the taxpayer has an interest. These measures ensure that double taxation does not occur where a distribution is made during an accounting period from profits which are included in the taxpayer's attributable income of the FIF at the end of that period.

Also, to prevent double taxation attribution accounts are provided for under the measures. The accounts are designed to operate in a manner similar to the CFC attribution account system.[103] Attribution accounts work simply. If tax is raised on the assessment, that tax will give rise to an attribution credit.[104] Any subsequent distribution from the FIF will be exempt under Section 23AK to the extent there is an attribution surplus. Thus, the credit in the account is offset by these subsequent FIF distributions[105] (i.e. they give rise to an attribution debit). An attribution surplus can be used to reduce the consideration paid on disposal of the FIF interest, thus reducing the amount assessable under either Section 25(1) or under Part IIIA.[106]

The foreign tax credit regime also has limited application. Only taxpayers using the calculation method can take advantage of it, but only in respect of distributions that are not exempt under Section 23AK.

XI. NEW MEASURES FOR TAXING OFFSHORE TRUSTS

For the 1992-93 year of income the method of taxing non-resident trusts which escape the FIF net is dramatically changed. Interests in the non-resident trust will escape the FIF regime if they are either excluded from the FIF measures (i.e. where the interest is held by an attributable taxpayer in respect of a transferor trust[107] or an attributable taxpayer in respect of a controlled foreign trust[108]) or are exempt interests under the FIF regime.[109] The new scheme affects the quantum of income attributed to Australian beneficiaries of non-resident trust estates, as well as the method for calculating the income of non-resident trust estates.[110]

Again there are two steps in calculating the income of a beneficiary. The first step is to calculate the net income of the trust. The net income of a non-resident trust is calculated as it always has been under Division 6.[111] The assessable income of the trust is calculated as if the trustee were a resident taxpayer. It includes the assessable FIF income from interests which the trustee holds in a lower tier FIF.

The second step is to calculate the beneficiary's share of the net income of the trust. A two tier test, similar to that used in

92. Sec. 482(1).
93. See Mills, "Cross Examinations: Foreign Life Policies",
27 *Taxation in Australia* (1993), at 350.
94. Sec. 483(3).
95. A person has an interest in a FLP, under Sec. 483(3) if that person has legal title to the FLP.
96. Sec. 585.
97. Sec. 536.
98. Sec. 595.
99. See *supra* note 14.
100. "Offshore Funds: Life Investments Crippled?", 27 *Taxation in Australia* (1992), at 95.
101. Sec. 529 .
102. Sec. 530.
103. Secs. 558-566.
104. Sec. 605.
105. See Sec. 603.
106. Sec. 613.
107. Division 6AAA.
108. Part X.
109. That is, exempt under the foreign employer-sponsored superannuation fund exemption, the small investor exemptions, the country fund exclusion, exempt visitor exclusion, or is a deceased estate.
110. Sec. 99B.
111. Sec. 95(1).

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the calculation method,[112] is used.[113] In order to use the first test, the trust must be fully distributing (i.e. the trustee distributes or allocates to the beneficiaries, all of the trust's accounting income, profits and gains, which are income, profits and gains to which the beneficiaries are presently entitled, or which are distributed to the beneficiaries within two months of the end of the income year).[114]

If the above requirement is satisfied, the taxpayer's attribution percentage is calculated by reference to the present entitlement and/or the amount distributed to the taxpayer out of the income, profits or gains that arises during the trust's notional accounting period. If the income, profits or gains of the foreign trust are not fully distributed or allocated to beneficiaries, as described above, then the taxpayer's attribution percentage is determined under the second test.

Under the second test the beneficiary's share of the net income of the trust estate is determined by calculating the beneficiary's share of the net income referable to interests held in a trust estate for the whole year and adding it to the beneficiary's share of the net income referable to interests held in a trust estate for only part of the year.[115]

The method for calculating the beneficiary's share of the net income referable to interests held in a trust estate for the whole year is to multiply the net income by the attribution percentage. Where a part or parts of the beneficiary's share of the net income referable to interests held in a trust estate for only part of the year, the method of calculation is the same as above, but is apportioned by the number of days held over the number of days in income year. The attribution percentage is defined to be the greater of:[116]

- the percentage of the income of the trust estate represented by the share of income to which the taxpayer was entitled, or entitled to acquire, because of the beneficiary's interest in the trust estate and any interest in the trust estate that the beneficiary was entitled to acquire; or
- the percentage of the corpus of the trust estate to which the beneficiary was entitled, or was entitled to acquire, because of the taxpayer's interest in the trust estate and any interest in the trust estate that the taxpayer was entitled to acquire.

Untaxed income of non-resident trusts that is distributed or applied for the benefit of a resident taxpayer and is included in the assessable income of a taxpayer under Section 99B is subjected to an interest charge.[117] Section 99B does not apply to amounts which have previously been subject to tax in Australia either in the hands of the trustee or the beneficiary. The measures also exempt a taxpayer from an interest charge on distributions from deceased estates,[118] public unit trusts[119] and amounts which have been taxed at comparable rates.[120]

The purpose of the interest charge is to compensate the Government for the deferred taxation where a taxpayer receives distributions on an infrequent basis. The method is an estimate, as to attempt to calculate the tax that is actually deferred would add complexity to the measures. The major advantages of the interest charge approach is that it only taxes at points where there is an actual distribution of income and profit, thereby avoiding the taxation of unrealized gains. However, interest charges do not necessarily prevent deferral. Some taxpayers can be expected to hold out indefinitely from receiving a distribution, even though an interest charge will apply to accumulations. The charge can in some situations cause a lock-in effect. In addition, because deferral is still possible under the interest charge, the revenue collections on a year by year basis are likely to be erratic. The interest charge approach also fails to adequately deal with income accumulated in lower tier entities.

However, despite these disadvantages and given the discretionary nature of trusts, the interest charge is the only practical mechanism available to get some compensation for lost revenue.

XII. EVALUATION OF TRUST CHANGES

These changes to the taxation of interests in foreign trusts, in particularly the changes to "present entitlement", are radical and require close study. Their impact will be profound in respect of the structure and practices of all offshore trusts. What is of major concern, however, is that the exemptions have the effect of treating the holders of small exempt FIF trust interests more harshly than larger FIF trust interests caught under the measures. This arises as holders of exempt interests are required to compute their share of the net income of the foreign trust in accordance with normal Australian tax laws. The lack of information means that they can never comply.

Professor Arnold's call for the whole system of dealing with foreign trusts to be thoroughly re-examined with a view to rationalizing and simplifying those provisions should be heeded.[121] Although the Government has agreed to undertake a review at some time in the future,[122] there is an urgent need to provide in the short term a mechanism with which holders of small exempt FIF interests can comply. A suggestion is to allow small holders to elect to be caught by the FIF measures, which at least they can comply with.

XIII. THE EFFECT ON DOUBLE TAX AGREEMENTS

The effect of accrual taxation methods worldwide on bilateral tax agreements is an issue which has only received scant examination. This is odd, given the fact that in many situations the accruals methods appear to claw back the rights to tax given away under the tax agreement. Whether in fact they

112. Sec. 582.
113. Sec. 96C(1).
114. Sec. 582(1).
115. By Sec. 96C(2) to (5).
116. Sec. 95C(5).
117. Sec. 102AAM.
118. Sec. 102AAM(1B).
119. Sec. 102AAM(1C).
120. Sec. 102AAM(1A).
121. See *supra* note 8, at 53.
122. See *supra* note 9, Attachment B, 2.

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are a form of treaty override is unclear. Further research is required. Unfortunately, the issue is beyond the scope of this paper.

It is claimed that the FIF measures remove from investors any incentive granted by the foreign country and approved in bilateral tax agreements under tax sparing clauses.[123] This occurs where the FIF derives income subject to tax sparing (i.e. the income is subject to a tax holiday or to incentives via the reduction or waiver of tax). Under the bilateral tax agreements, these incentives are preserved by treating the income as being fully taxed in the country of derivation. Thus, when the income is remitted to Australia as dividends, these dividends are exempt.

However, under the FIF measures the income which would have been exempt is attributed in full to the Australian resident. Thus, the benefit of tax sparing is wasted and the subsequent dividend is granted exemption twice.[124]

However, in reality this is a theoretical rather than a practical problem as most tax sparing arrangements are restricted to active businesses. As active businesses are exempt under the measures, the tax sparing relief is still available.

XIV. ANTI-AVOIDANCE PROVISIONS

There are no specific anti-avoidance rules to prevent avoidance under the FIF measures. Instead, the general anti-avoidance rules of Part IVA apply.

XV. RECORD KEEPING REQUIREMENTS

A taxpayer who has an interest or interests in a FIF or an FLP must make and keep records in Australia. The extent of the records required for a particular taxpayer in relation to amounts of FIF income included in assessable income will depend on the method of assessment used,[125] the need to keep attribution accounts and whether the interest is exempt from FIF taxation.

To reflect the fact that access to information about offshore investments will be usually limited for resident investors with non-controlling interests, the record keeping requirements[126] are less onerous than the requirements for CFCs and controlled foreign trusts in Division 11 of Part X. Despite this, even taxpayers with exempt FIF interests are required to keep additional records or modify their existing accounting procedures.

The reasoning behind the imposition of these additional compliance requirements and their costs, even on taxpayers holding exempt interests, has been questioned, particularly given the Government's revenue estimates in respect of the measures. In fact, the Government's estimate of A$ 150 million in additional tax per annum has been criticized as being overstated. Some economists estimate the true revenue figure being closer to A$ 40 million.[127] If this is correct, then the measures may not be justified on economic grounds, particularly if the collection costs outweigh receipts.

XVI. PROSECUTION PROVISIONS

A prosecution can occur where there is a failure by a taxpayer to comply with the record keeping requirements prescribed.[128] The maximum penalty for a taxpayer who fails to keep records is a fine of A$ 3000.[129] Also, specific rules are enacted to ensure that partners cannot escape liability for the failure of another partner to keep partnership records.

XVII. VALUATION OF TRADING STOCK

As mentioned previously, where an interest in a FIF forms part of trading stock, an exemption is available provided the taxpayer elects to value all interests in FIFs, that are trading stock, at market value.[130] Another change was to prescribe for the 1991-92 income year and all subsequent years that where an interest in a FIF forms part of trading stock it is to be brought into closing value at cost.[131]

The purpose of this change is not concessionary. Its purpose is to stop taxpayers from electing to value the FIF interest at market value when the value of the FIF interest falls during the year (thus effectively allowing a deduction for the market value loss), but electing to value the trading stock at cost rather than market value where the value of the FIF interest is more than market value (thus deferring income).

Thus, in light of the general downward trend in stock market prices in recent times, this change will have a dramatic effect on current practices and tax planning in this area.

XVIII. CONCLUSION

Despite protests from the accounting and legal professions, investors and a review, the policy underlying the FIF measures remains. The measures have already had a dramatic effect on every Australian resident taxpayer with foreign investments. It is only with careful planning that portfolios can be arranged to best minimize the effect of the legislation. However, despite the best efforts there will still be increased record keeping requirements, resulting in higher compliance costs.

Despite the view that these measures represent the last chapter in the Government's reform process, like retiring football heroes, one gets the feeling that a comeback is around the corner, ready to provide a new chapter to the saga which is the taxation of income from foreign sources.

123. Petroulias, "FIF measures: The Elimination of Tax Sparing", 1 *Taxation in Australia* (Red Ed) (1993), at 215.
124. Once under Sec. 23AJ and again under Sec. 23AK.
125. The requirements for the market value method are dealt with under Sec. 616, for the deemed rate method, Sec 617 and the calculation method, Sec. 618.
126. Specified in Secs. 614-620 and Sec. 622.
127. "FIF: big compliance cost for little return", *Australian Financial Review* (13 July 92), at 19.
128. Under Secs. 621, 623 and 624.
129. Sec. 621.
130. Sec. 521.
131. Sec. 31(4).

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UNITED STATES:

"TRIANGULAR PROBLEM" SETTLED IN US–NETHERLANDS TREATY PROTOCOL

Philip H. Spector

The United States and the Netherlands recently signed a protocol to their proposed new income tax treaty (the "Treaty").[1] The protocol settles the so-called "triangular problem" involving interest and royalty payments from the United States to branches of Netherlands companies located in tax havens. The protocol paves the way for ratification of the Treaty, which is expected before year-end.

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I. THE "TRIANGULAR" PROBLEM

The "triangular problem" refers to a financing technique commonly used by foreign multinationals to finance US activities through a Netherlands corporation and its branch located in a tax haven. A combination of Netherlands tax rules and the availability of treaty benefits allows Netherlands companies to extract interest and royalties from the United States at a low overall tax rate. To illustrate, a Netherlands company could establish a branch in the Netherlands Antilles. The Netherlands company could transfer capital to the branch, or could transfer rights to use intangible property such as patents, copyrights or trademarks. The branch would then lend the capital, or license the intangible asset, to the Netherlands company's US subsidiary or affiliate. Interest and royalty income derived by the Netherlands company and attributable to the branch would be exempt from Netherlands tax under Netherlands law or the Netherlands–Netherlands Antilles tax treaty, the interest and royalty income would bear little Netherlands Antilles tax, and, absent a contrary provision, the interest and royalties would be subject to a zero rate of US withholding tax under the US–Netherlands tax treaty.

During the Treaty negotiations, the United States argued for a provision that would have denied treaty benefits in these branch financing scenarios. The issue was not resolved in the Treaty, but the Treaty required the issue to be addressed either in Netherlands domestic law or in a future protocol to the Treaty.[2] Although anti-tax haven legislation is now circulating in the Netherlands, the protocol route was chosen to resolve the issue in sufficient time to allow for ratification of the Treaty this year, and to ensure that all US concerns were addressed.

Subject to certain exceptions, the protocol permits the United States to impose withholding tax at the rate of 15 percent on US- source interest and royalties derived by a Netherlands enterprise and attributable to a permanent establishment in a third country if the overall profits of the permanent establishment are subject to a low rate of tax. For interest and royalties derived before 1 January 1998, the 15 percent withholding tax applies if the aggregate rate of tax on the profits imposed by the Netherlands and the third country is less than 50 percent of the general Netherlands corporate tax rate. For interest and royalties derived after 1 January 1998, the withholding tax applies if the aggregate tax rate is less than 60 percent of the general Netherlands corporate tax rate.[3]

The current Dutch corporate tax rate is 40 percent on the first NLG 250,000 of income and 35 percent on the remainder. It is understood that 35 percent is presently the regular corporate tax rate referred to in the protocol. Accordingly, for interest and royalty payments attributable to a third country permanent establishment that do not qualify for an exception for "active" income described below, the regular zero withholding tax rate will apply if the permanent establishment's overall profits

1. For prior coverage of the Treaty in this *Bulletin*, see Spector, "Limitations on Benefits under the New US–Netherlands Income tax Treaty", 47 *Bulletin for International Fiscal Documentation* (April 1993), at 159 (hereinafter cited as "Spector") and Kaplan, "Treaty Shopping under the New US–Netherlands Treaty," 47 *Bulletin for International Fiscal Documentation* (April 1993), at 175.
2. Treaty Art. 24(4).
3. Protocol Arts. 1 and 2, amending Treaty Arts. 12 and 13, respectively.

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are subject to combined Netherlands and third country tax of at least 17.5 percent. The 17.5 percent threshold will rise to 21 percent (60% of 35%) for payments made after 1 January 1998, assuming that the Dutch corporate tax rate remains the same.

An exception to the protocol's provisions applies to branches with active businesses. The Treaty's regular zero withholding tax rate continues to apply to interest derived in connection with or incidental to the active conduct of a trade or business in the third country, regardless of the aggregate rate of tax on the permanent establishment's profits. For this purpose, managing or holding investments (including group financing and portfolio investment) is not considered "active" unless carried on by a bank or insurance company. In addition, the zero withholding rate continues to apply to royalties received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself, in the third country.

II. LIMITATIONS ON BENEFITS

The protocol makes a couple of important changes to the Treaty's limitation on benefits provisions (Article 26), and ties up some loose ends.

A. *Indirect stock ownership*

The protocol modifies the test by which a subsidiary of one or more publicly-traded companies is made eligible for benefits. One of the categories[4] of Netherlands companies eligible for Treaty benefits is a company where (1) more than 50 percent of the aggregate vote and value of all of its shares is owned, directly *or indirectly*, by five or fewer companies ("parents") which are residents of either the United States or the Netherlands, (2) each parent satisfies the "publicly-traded" test,[5] and (3) the company is not a "conduit company".

Another category of Netherlands company eligible for all Treaty benefits is a company that satisfies the following requirements: (1) the company is resident in the Netherlands, (2) the company is not a conduit company, (3) at least 30 percent of the aggregate vote and value of all of its shares is owned, directly *or indirectly*, by five or fewer corporations that are residents of the Netherlands, each of which meets the publicly-traded test, and (4) at least 70 percent of the aggregate vote and value of all of its shares is owned, directly *or indirectly*, by five or fewer companies that are residents of the United States or residents of an EC member state, each of which companies satisfies the publicly-traded test (other than the listing requirement of that test).[6]

The protocol clarifies that for each of these tests, "indirect" ownership through a chain of companies can be taken into account in applying the 30% and 70% tests so long as each company in the chain is either a US or Netherlands resident or a resident of an EC member state.[7] Absent the protocol, the Treaty appeared to require each intermediary company to satisfy the requirements necessary to qualify for Treaty benefits under the relevant category, without regard to the intermediary's own country of residence.

B. *Active trade or business test*

Treaty benefits are available, in certain circumstances, for US source income that is derived "in connection with" or is "incidental to" an active trade or business carried on by a Dutch company in the Netherlands and/or in EC countries.[8] The provision generally contemplates that the Dutch company has an ownership interest in the US income-producing activity (e.g. stock of a US subsidiary or affiliate).[9]

The protocol makes treaty benefits available under the active business test in situations where the Dutch company is not engaged in a trade or business in the United States and does not own a significant ownership interest in the US income-producing activity. In such a case, the active business test is met so long as the US-source income is derived in connection with, or is incidental to the Netherlands/EC business. There is no requirement that the Netherlands/EC business be "substantial" in relation to the US income-producing activity. The protocol's provision might apply, for example, to interest received from a US customer that purchased goods from the Netherlands/EC business on credit.[10]

The protocol also clarifies that group financing and managing portfolio investments are not considered "active businesses" (unless conducted by a bank or insurance company). Thus, the active business test cannot be used to establish qualification for Treaty benefits for US-source interest income from those activities.[11]

C. *Headquarters companies*

A company resident in the Netherlands or the United States that functions as a headquarters company for a multinational corporate group can qualify for Treaty benefits if, among other requirements, the company provides a substantial portion of the overall supervision and administration of the corporate group and exercises independent discretionary authority to carry out those functions. The protocol clarifies that these functions must be performed in the company's country of residence.[12]

4. See Treaty Art. 26(1)(c)(ii). See also Spector at II.A.5.
5. For a description of the publicly-traded test, see Treaty Art. 26(1)(c)(i) and see also Spector at II.A.1.
6. See Treaty Art. 26(1)(c)(iii). See also Spector at II.A.6.
7. See Treaty Art. 26(8)(k) and Protocol Art. 5. See Spector at II.A.6: under the protocol, stock owned by NA in Example 3A would not be taken into account in applying the 30/70% test because NA, a Netherlands Antilles company, is not a resident of the Netherlands, the United States, or an EC member state.
8. See Treaty Art. 26(2)(a); see also Spector at II.B.
9. To be derived "in connection with" an active Netherlands trade or business, the business must be "substantial" in relation to the US income-producing activity. Substantiality is determined by reference to, among other things, the Netherlands resident's ownership interest in the US income-producing activity. Treaty Art. 26(2)(c).
10. Protocol, Agreed Minutes, Sec. II.
11. Protocol, Agreed Minutes, Sec. III.
12. Protocol, Agreed Minutes, Sec. V.

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D. *Publicly-traded companies*

The principal stock exchanges of Frankfurt, London, Paris, Brussels, Hamburg, Madrid, Milan, Tokyo, Sydney and Toronto now comprise the list of recognized stock exchanges on which a company's principal class of shares must be regularly and substantially traded to qualify for Treaty benefits as a publicly-traded company.[13]

E. *Resident of an EC member state*

Netherlands companies that are owned by a combination of residents of the Netherlands, the United States and EC members can qualify for treaty benefits in certain circumstances.[14] In addition, active business operations undertaken by affiliates that are members of EC member states can be taken into account in applying the active business test.[15] A person will qualify as a "resident of an EC member state" if it is entitled to treaty benefits under the income tax treaty between the company's home country and the United States, and would be entitled to benefits as a "qualified person" under a hypothetical tax treaty between its home country and the United States that contains a limitation on benefits provision identical to the Treaty Article 26. The protocol resolves issues that could arise from differences between the limitations on benefits provision the actual home country–US tax treaty and the Treaty Article 26. The protocol provides that the company must qualify as a qualified person under a hypothetical treaty between its home country and the United States that includes Article 26, and must also satisfy any additional provision of any limitation on benefits provision in the actual home country–US treaty if Article 26 does not contain the same or a similar provision.[16] If Article 26 does contain such a provision, the company must satisfy that provision of Article 26 (treating the company as though it were a resident of the Netherlands).

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III. NETHERLANDS PENSION TRUSTS

Under the Treaty, pension trusts that are exempt from tax in their country of residence generally are exempt from source country withholding taxes on dividends and interest. The exemption does not apply to interest and dividends from a "related person".[17] The protocol provides that a person is related to a pension trust if the trust owns more than 80 percent (by vote or value) of the payor.[18]

The protocol also subjects Netherlands pension trusts to 30 percent US withholding tax on dividends from a US real estate investment trust ("REIT"), to the extent that the dividends are attributable to US real property gains of the REIT.[19] Such pension trusts are otherwise exempt from US withholding tax on dividends and interest. As a result, it appears that Netherlands investment institutions (*beleggingsinstellingen*) may receive all REIT dividends subject to a reduced 15 percent US withholding tax.[20] For pension trusts, however, the capital gains portion of REIT dividends will be taxed at 30 percent, and the remaining portion will be exempt from US tax.

13. Protocol, Agreed Minutes, Sec. VI.
14. See Treaty Art. 26(1)(c)(iii).
15. See Treaty Art. 26(2)(h). See also Spector at II.B.4(e) and (f).
16. Protocol, Agreed Minutes, Sec. VII.
17. Treaty Art. 35(2).
18. Protocol, Agreed Minutes, Sec. VIII.
19. Protocol Art. 6, amending Treaty Art. 35(2).
20. Treaty Art. 10(2).

IFA NEWS

AUSTRALIAN BRANCH

In November, Mr Michael D'Ascenzo, Assistant Commissioner – Compliance Australian Taxation Office, spoke on "The Australian Taxation Office's Initiatives for Consultation on International Tax Matters".

HONG KONG BRANCH

Hong Kong/PRC double taxation is the scheduled topic for the January meeting.

NEW ZEALAND

The Annual General Meeting, to be held 24-26 February 1994, will focus on current New Zealand and international tax issues.

UK BRANCH

US tax developments under the Clinton administration were discussed at the December meeting. Topics scheduled for early 1994 include indirect tax issues in the EC, developments in Eastern Europe, tax implications of new financial instruments, the US–Netherlands tax treaty and Asian tax topics.

US BRANCH

At a meeting held in New York on 1 December the new excess passive asset rules and holding company structure in transnational investments were discussed. The 1994 Annual Meeting is scheduled for 3-4 March 1994 in Atlanta.

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SOUTH AFRICA:
NEW DUAL TAX SYSTEM

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I. INTRODUCTION

South Africa recently introduced a dual tax system, comprised of a single uniform lower income tax rate of 40 percent on corporate taxable income[1] and a 15 percent secondary tax on companies (STC) levied on the declaration of dividends. The new provisions are found primarily in Section 64B and C of the Income Tax Act (ITA).

The new corporate tax rate applies to all companies which were previously taxed at the rate of 48 percent, and it is not necessary that a company distribute dividends to be subject to the 40 percent rate. Thus, a company may elect to reduce or entirely pass its dividend in order to reduce or eliminate STC liability, but still be taxed at the new lower corporate tax rate.

In order for a company to be subject to STC it is not necessary that it be currently liable for income tax. Thus, where a company has current operating income but is not paying income tax because of current tax allowances or tax losses brought forward from prior years, it will nevertheless be subject to STC if it declares a dividend. In a sense STC is a conditional minimum tax on companies, triggered by a dividend declaration.

The 40 percent rate is effective for companies with years of assessment ending on or after 1 April 1993 while STC is effective (generally speaking) from 17 March 1993.[2]

The new dual tax system is designed to encourage corporate investment, or, more accurately, reinvestment. On the one hand, distributed earnings are taxed at effective rates of up to 49 percent, depending on the proportion of earnings distributed; on the other, retained earnings are taxed at an internationally acceptable rate. There is thus an incentive for a company's shareholders to approve the productive reinvestment of a greater proportion of earnings. Given the relatively low level of fixed investment in South Africa in the last decade, this is a positive step.

In a narrower context, the philosophy of STC is that it should not have a cascade effect, i.e. once distributed earnings have been subject to STC, they should be able to flow through the economy without further tax consequences. Thus, where an operating company declares a dividend to its holding company, that dividend should be subject to STC, and when the holding company passes that dividend on to its own shareholders by way of dividend, the latter dividend will effectively not be subjected to further STC.

II. EFFECTIVE COMBINED TAX RATE

A lower corporate tax rate of 40 percent together with a 15 percent STC on dividends distributed means that the effective total corporate tax rate on companies earning taxable income will range from 40 percent for companies paying no dividends to 47.83 percent (i.e. 40 percent plus 15/115 of the remaining 60 percent) for a company distributing all of its taxable income in a combination of dividends and STC. Furthermore, should a company distribute all of its taxable income as dividends, and fund the STC from other sources (e.g. retained earnings or non-taxable income) the combined tax rate on taxable income becomes 49 percent (i.e. 40 percent plus 15 percent of the remaining 60 percent).

Contents

I. Introduction
II. Effective Combined Tax Rate
III. STC Tax Base and the Dividend Cycle
IV. STC Trigger – Dividends Declared and Accrued
A. Declaration
B. Accrual
C. Exemptions
V. STC Credit – Dividend Income
VI. What is a Dividend?
A. Dividend definition
B. Deemed dividends
VII. Exemptions
A. Tax-exempt companies
B. Liquidation
C. Fixed property companies
D. Unit portfolios
E. Unbundling
VIII. International Aspects
A. South African branch operations
B. Foreign branch operations
C. Foreign holders of South African shares
D. South African holders of foreign shares
IX. Special Taxpayers
A. Tax-exempt entities
B. Long-term insurance business
C. Gold mining companies
D. Fixed property companies
X. Compliance Provisions
XI. Anti-Avoidance Provisions
XII. Conclusion

1. Previously the rates were 48% on ordinary companies and 49.44% on mining companies other than gold mining companies.
2. See *infra* note 3.

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Similarly, the effective rate on taxable income for a company distributing all of its current taxable income in a combination of dividends and STC in a period it is not currently taxable (e.g. because of current tax allowances or tax losses brought forward from prior years) is 13.04 percent (i.e. 15/115). Furthermore, should the company distribute all of its taxable income as dividends, and fund the STC from other sources (e.g. retained earnings or non-taxable income) the combined tax rate on taxable income becomes the full 15 percent.

It should be noted that South Africa does not subject resident recipients (corporate or individual) to any further tax on the receipt of dividend income. The above rates are the full effective rates on corporate earnings. However, in the case of non-resident shareholders, further tax is due as discussed under "International Aspects" below.

III. STC TAX BASE AND THE DIVIDEND CYCLE

The STC tax base is the difference between the dividends declared (as defined below) in a dividend cycle, and the dividend income (likewise, as defined below) in that cycle. To the extent that the dividends declared exceed dividend income, a tax base, known as the "net amount", is subject to STC. However, if the dividend income exceeds the dividends declared, there is an excess tax credit which can be carried forward to succeeding dividend cycles. There is no limit to the number of cycles such a credit may be carried forward to, but there is no provision for a carry back to previous cycles.

The first dividend cycle of a company commences on 1 September 1992 with one qualification: if there had been a declaration of an interim or final dividend by that company in respect of its ordinary shares (other than a dividend in specie) between that date and 17 March 1993, then the cycle commences on the date of such declaration. The first dividend cycle ends on the date on which the first dividend declared by a company in respect of any category of its shares (i.e. the initial limit to ordinary shares falls away) on or after 17 March 1993 accrues to the shareholders, with one controversial exception relating to certain dividends declared prior to 17 March 1993 but only paid thereafter.[3]

The second dividend cycle commences immediately after the end of the first, and ends on the date of accrual to shareholders of the next dividend declared by the company in respect of any category of shares; subsequent dividend cycles will be determined accordingly.

IV. STC TRIGGER – DIVIDENDS DECLARED AND ACCRUED

A. *Declaration*

As stated above, the potential STC liability of a company is triggered by the declaration of a dividend, at the time the dividend accrues to the shareholders. In this context, a "declaration" includes:

- in the case of an interim dividend of a company, the approval of the payment by the directors of the company or by another person under authority conferred by the company's memorandum and articles of association;
- in the case of a dividend distributed by a close corporation, the approval of the payment thereof by the "directors";[4] and
- in the case of a dividend in specie, the approval of the distribution thereof by the directors.

Where an unlisted company had declared a dividend prior to 17 March 1993 which had not been paid at that date, the dividend is deemed for STC purposes to have been declared on that date, and thus becomes subject to STC. There is only one exception to this, i.e. where prior to 17 March 1993 the company had taken reasonable steps to pay the dividend. Thus, for example, where exchange control procedures had delayed the remission of a dividend to a foreign shareholder, this exception will apply.

B. *Accrual*

Notwithstanding the declaration of a dividend, a dividend cycle only ends (and STC liability only becomes due) when the dividend accrues to the shareholders. In this context, where a dividend declaration specifies a last date of registration, accrual takes place only on that date. If the dividend declaration contains no such date, accrual takes place on the date of declaration.

C. *Exemptions*

For a dividend to be subject to STC, it must be a dividend for income tax purposes (see "What is a Dividend?" below). Nevertheless, a dividend will be exempt from STC if it falls within any of the following six exemptions:

- any dividend declared by a fixed property company, as defined in ITA Section 11(s), which qualifies for an income tax deduction under that provision;

3. Although the 40% corporate tax rate only applies to companies with tax years of assessment ending on or after 1 April 1993, STC commences with the close of the first dividend cycle on the earlier of the following two dates:
   - the date of accrual to the shareholders in respect of the first dividend declaration in respect of any category of shares, where such declaration is made on or after 17 March 1993; or
   - the date of accrual to the shareholders of any dividend declared by a company on or before 17 March 1993 which had not been paid on that date (with the exception of a dividend declaration which had publicly been announced by a listed company or its subsidiary), subject to the provisions below.

   Once the end of the first dividend cycle has been determined in this manner, the STC liability is determined on the basis of a calculation of a "net amount", taking into account the particular dividend which triggered the close of the cycle. In the case of the second category, somewhat controversially, the dividend is deemed to have been declared on 17 March 1993, with one exception, i.e. where the company had prior to this date taken reasonable steps to pay the dividend. As a concession of sorts the tax authorities have confirmed that where a company had credited shareholders' loan accounts prior to 17 March 1993, this will constitute payment.

4. Although close corporations do not have directors per se, for tax purposes this term includes anyone fulfilling a similar role for a close corporation.

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- the interest component of a dividend declared by a unit portfolio which is exempt from income tax under ITA Section 10(1)(iA);
- any dividend declared by a company which is exempt from income tax under ITA Section 10;
- any dividend declared in the course of the liquidation or winding up of a company, to the extent that it is shown by the company to be a distribution of profit (other than stock revaluation profits) derived in a year of assessment which ended on or prior to 31 March 1993;
- dividends in specie which are delivered to shareholders in the course of an approved unbundling exercise; and
- dividends declared by gold mining companies which have opted to retain the fiscal status quo (see "Special Taxpayers" below).

V. STC CREDIT – DIVIDEND INCOME

In order to ensure that the STC has no cascade effect, there is a deduction for dividend income in the calculation of the "net amount" subject to STC for any dividend cycle. For the dividend income to qualify for the deduction, it must have been declared in favour of, and have accrued to, the company in question.

All dividend income which accrues during the dividend cycle may be deducted, with only two exceptions, i.e. income relating to fixed property companies and income relating to unit portfolios (exempt dividends). Thus, both foreign-source dividends and dividends from gold mines which have opted to retain the fiscal status quo will be fully deductible.

For dividend income to be claimable as an STC deduction, it must specifically be classified as dividends for income tax purposes – it is not sufficient that the income be so classified for company law or accounting purposes.

VI. WHAT IS A DIVIDEND?

To be taken into account as a dividend declared or as dividend income for STC purposes, the amount in question must be a dividend as defined in ITA Section 1, or must be deemed to be a dividend under any other provision of the ITA.

A. *Dividend definition*

The ITA Section 1 dividend definition is regarded by many as the most complex in South Africa's fiscal legislation. Notwithstanding, the summary below should contain its essence.

A dividend means any amount distributed by a company to its shareholders, and includes:

- in relation to a company being wound up or liquidated, any profits distributed, whether in cash or otherwise, other than profits of a capital nature, earned before or during the winding up or liquidation;[5]
- in relation to a company not being wound up or liquidated, any profits distributed, whether in cash or otherwise, and whether or not of a capital nature;[6]
- in the event of a partial reduction or redemption of the capital of a company, so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the cash equivalent of the sum of the reduction in the nominal value of the shares in question and the reduction of the company's share premium, subject to the capitalization issue qualifications;[7] and
- in the event of the reconstruction of a company, so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the sum of the nominal value of the shares held and the company's share premium, prior to the reconstruction, subject to the capitalization issue qualifications.[8]

However, the definition expressly excludes:

- the nominal value of capitalization shares awarded on or after 1 July 1975 to shareholders as part of the equity share capital of a company; and
- a reduction in the share premium account of a company, represented by cash or assets given to shareholders, provided the share premium itself is what I will for convenience term a "primary" share premium, i.e. it was not created by means of a capitalization issue involving a transfer of reserves or undistributed profit to the share premium account. The latter form of premium could for convenience be termed a "secondary" share premium.

B. *Deemed dividends*

Limited measures have been introduced to deem certain loans and similar distributions to shareholders to be dividends purely for STC purposes (see below).

5. The use of the word "earned" has the effect that where a non-cash asset is distributed in specie to the shareholders, and its market value exceeds the cost to the company, the excess in question is not a dividend – in short, unrealized profits on liquidation dividends are not dividends.

6. The absence of the word "earned" means that both earned and unearned profits are dividends in the case of distributions by a going concern.

7. The capitalization issue qualifications are essentially simple:
- to the extent that an exempt capitalization issue which involved a transfer from reserves, a secondary share premium or unappropriated profits is followed by a partial reduction or redemption of capital;
- a reconstruction; or
- a reduction of share premium under which cash or any asset is given to shareholders, representing a return of share capital or share premium,

the amount so returned is automatically deemed to be a profit distributed (and thus, a dividend) to the extent of such previously capitalized reserves.
If any such reserves remain in existence when a company is ultimately wound up or liquidated, and the reserves originally capitalized were both of a capital and a revenue nature, apportionment rules apply to determine whether such reserves remaining on liquidation can still be so split. This is of significance because capital reserves distributed on liquidation are not dividends, even if capital reserves had previously been capitalized. By the same token, the distribution of capitalized revenue reserves on liquidation will be a dividend.

8. *Id.*

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VII. EXEMPTIONS

Only four categories of dividends are exempt from STC, while a fifth category is effectively exempt. These categories are listed below, and the STC consequence to the recipient is discussed in each case.

A. *Tax-exempt companies*

Where companies are completely or partially exempt from tax under ITA Section 10, the dividends declared by such companies are exempt from STC in their hands. However, companies receiving dividends from such exempt companies are able to claim STC credits for these dividends, ensuring that this income flows through the corporate system without attracting STC at any level.

B. *Liquidation*

Profits derived during any year of assessment which ended on or before 31 March 1993, other than stock revaluation profits, and which are subsequently distributed in the course of the liquidation or winding up of a company are exempt from STC. This special exemption effectively applies only to realized revenue profits, as capital profits (realized or unrealized) and unrealized revenue profits distributed on liquidation are in any event excluded from the dividend definition and are thus automatically outside the scope of STC.

C. *Fixed property companies*

Dividends declared by fixed property companies (as defined in Section 1 of the Unit Trusts Control Act) out of revenue profits, on shares included in a unit portfolio (comprised in any unit trust scheme in property shares authorized under the Act) are effectively treated as interest for income tax purposes. An income tax deduction is allowed to the fixed property company, and recipients are fully taxed on the income. As a result, such distributions are exempt from STC, and for the same reason, the STC credit is denied to corporate recipients.

D. *Unit portfolios*

Linked to fixed property companies, unit portfolios which constitute companies under ITA Section 1(e) are in a unique position for income tax purposes. Such unit portfolios are conduits for the special category of dividends dealt with under the previous heading, as well as for certain tax-exempt interest which is then distributed as a dividend. In both cases, the dividend distributed by the unit portfolio is fully taxable in the hands of recipients, and as a result, such distributions are exempt from STC and an STC credit is denied to corporate recipients.

E. *Unbundling*

Simultaneously to the introduction of the STC, a new provision was inserted in ITA Section 60, enabling "unbundling" to take place without tax hinderance. The concept of unbundling is beyond the scope of this article but suffice it to say that STC itself would, in the absence of special provisions, constitute the single most formidable obstacle to unbundling, because an essential component in any such arrangement is a dividend in specie. For this reason, it has been provided in these unbundling provisions that such a dividend in the context of an approved unbundling arrangement will be deemed not to constitute a dividend for the purposes of STC (as well as for the purposes of the Non-Resident Shareholders Tax (NRST)).

VIII. INTERNATIONAL ASPECTS

A. *South African branch operations*

Foreign companies earning profits (other than dividends) from a South African source through a branch in South Africa may potentially be subject to STC. In fact, provided that some of the company's profits are so sourced, there may be potential STC liability even if there is no formal branch operation. The potential liability arises when the company declares a dividend, and would be calculated by applying a ratio to the net amount. This ratio is the net annual profits from a South African source divided by net annual profits from all sources. Such net annual profits must exclude dividend income, and are to be determined in respect of the latest year of assessment prior to the dividend declaration in question. Where the Commissioner is satisfied that this ratio cannot reasonably be determined in relation to this latest year of assessment, he is empowered to authorize another method of determining the ratio. This provision has something of a parallel in the provisions which create a NRST liability in similar circumstances.

Where the foreign company is a resident of a country with a double tax agreement with South Africa which contains the classic Article 10(5) restriction found in the OECD model treaty, then South Africa will only be able to levy STC to the extent that the dividend is paid to a South African resident, or where the holding in respect of which the foreign company's dividend is paid is effectively connected with a permanent establishment or fixed base in South Africa; it is thus not sufficient that the foreign company earns profits from a South African source. No South African treaty exactly mirrors this provision, but some agreements contain elements of it.

In practice the NRST provision has not been rigorously enforced by the South African tax authorities and it is likely that the same position will prevail with regard to STC.

B. *Foreign branch operations*

South African companies earning profits (other than dividends) from foreign sources through foreign branches (or

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similar operations) will be exempt from STC if these are their only profits. However, they will be subject to the STC regime to the extent that they earn local profits. Potential STC liability thus arises when the company declares a dividend, and would be calculated by applying a ratio to the net amount. This ratio is the net annual profits from a South African source divided by net annual profits from all sources. Such net annual profits must exclude dividend income, and are to be determined in respect of the latest year of assessment prior to the dividend declaration in question, as described under the previous heading.

C. *Foreign holders of South African shares*

From a purely South African domestic point of view, foreign investors in South African equities should for the most part be positively affected by the new dual tax system, in much the same way as local investors have been affected. In the most extreme case, where the South African company is in a full taxpaying position, and distributes 100 percent of its after-tax earnings to a non-resident subject to the maximum NRST rate of 15 percent, the combined tax rate on the underlying earnings will drop marginally from 56 to 55.65 percent as illustrated below:

	Old	New
Corporate taxable earnings	100,000	100,000
Income tax (old 48%/new 40%)	48,000	40,000
Corporate earnings after tax	52,000	60,000
Distribution thereof		
Dividend	52,000	52,174
STC @ 15%	0	7,826
NRST on dividend @ 15%	7,800	7,826
Net receipt by foreign shareholder	44,000	44,348
Effective combined tax rate (%)	56.00	55.65

In the case of an investment in a mining company (other than a gold mining company) the reduction is a little more significant, from 57.02 to 55.65 percent, because of the previous higher income tax rate of 49.44 percent applicable to such companies. In the case of a gold mining investment, there should be no change at all, for reasons set out below.

To the extent that the company had a low effective tax rate, or was not paying income tax at all because of special allowances or tax losses, there will be a substantial increase in the overall tax levied on distributions to foreign shareholders, similarly to the case of distributions to local shareholders.

From a global tax perspective, the position of the foreign investor depends on the home country's classification of STC and method of taxation of foreign holdings, as well as the possible impact of DTAs.

D. *South African holders of foreign shares*

The STC system has no specific effect on such shareholders. In the case of individual shareholders, there is simply no STC liability, while, in the case of corporate shareholders, they will be allowed to claim a full deduction for all foreign dividend income in the dividend cycle, in determining the net amount subject to STC. This will ensure that such dividends can flow through the economy to ultimate shareholders without attracting an STC liability.

IX. SPECIAL TAXPAYERS

A. *Tax-exempt entities*

Dividends which are subject to STC under general principles remain so subject even if declared in favour of tax-exempt entities. On the other hand, as noted above, tax-exempt entities which pay dividends will not have to deduct STC on such dividends; such declarations are exempt from STC. However, non-exempt entities which receive such exempt dividends and which pass them on to their shareholders by way of dividend will have to deduct STC on their own dividend declarations but this will not involve any net cost as they will be able to obtain a deduction for such dividend income in determining their net amounts subject to STC.

B. *Long-term insurance business*

Dividends which are subject to STC under general principles remain so subject even if declared in favour of assurers, regardless of whether such dividends relate to the assurer's taxed business (i.e. long-term insurance) or exempt business (i.e. pension, provident and retirement annuity operations).

At present, pending the introduction of the "four fund" approach[9] where an incorporated assurer declares a dividend, such a dividend will fall fully within the STC net. In the determination of the "net amount" subject to STC, a deduction will be allowed for a portion of dividend income in the dividend cycle, determined according to the ratio of the assurer's free reserves (loosely, those reserves not dedicated to policyholder's funds) to total assets. Where an assurer is

9. The 1993 tax legislation introduced the "four fund" approach to the taxation of life assurers to replace the current system, to which all assurers must convert by 1996. This approach compartmentalizes the assets of assurers into four funds, as follows:
- the untaxed policyholder fund, comprising assets of pension, provident and retirement annuity funds, as well as of policyholders who are exempted from tax under ITA Sec. 10, the income of which will remain tax-exempt;
- the individual policyholder fund, the taxable income of which will be determined using general principles (i.e. excluding dividends) and subjected to a 30% tax rate, being an estimate of the average individual tax rate;
- the company policyholder fund, the taxable income of which will be determined using general principles (i.e. excluding dividends) and subjected to the applicable company tax rate, currently 40%; and
- the corporate fund, comprising all remaining assets, the taxable income of which will be determined using general corporate tax principles (i.e. excluding dividends) and subjected to the applicable company tax rate, currently 40%.

Once this new regime is in place, the calculation of STC on dividends paid by corporate assurers will continue in much the same manner as before, except that the calculation of the deduction of dividend income in the dividend cycle will be far easier, with the deduction being simply the dividend income attributable to the corporate fund.

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not incorporated (i.e. a mutual assurer) it cannot pay dividends, and the question of STC simply does not arise.

C. *Gold mining companies*

Gold mines are taxed on a formula basis rather than on a flat rate basis, the current formula being $y = 58 - (290/x)$, where y is the tax rate, and x is the ratio of mining taxable profit to mining total revenue (the profit to revenue ratio). The formula effectively provides for a sliding scale tax rate which increases as profitability increases. As a quid pro quo, the tax rate drops substantially as profitability declines, falling away altogether when a profit to revenue ratio of 5 percent or lower is reached. Under the dual tax system, the formula will fall to $y = 49 - (245/x)$, the tax rate on non-mining income will fall to 40 percent, and STC will apply to dividends declared, in the manner outlined above.

However, because of the complexities of the gold mining formula, gold mines have been given the option of remaining with the current tax formula, in which case their non-mining income will continue to be taxed at the old 48 percent rate.[10] Dividends declared by such "status quo" gold mines will not be subject to STC even where the company also earns non-mining income.[11] Furthermore, these dividends will be able to flow through the corporate system without attracting STC at corporate shareholder level, as the corporate recipients will be entitled to deduct such dividends in computing their own "net amounts" subject to STC.

Gold mines must exercise their options by 31 August 1993, and this option will be binding on all future years. New gold mining companies which may be formed in the future will be given the option of being taxed on the status quo basis, which option must be exercised within six months of commencing gold mining operations. In all cases the company will automatically revert to the dual tax system in the year following that in which it ceases to mine for gold.

D. *Fixed property companies*

Certain dividends distributed by fixed property companies on shares included in unit trust portfolios have long been deemed to be akin to interest, and have thus remained subject to income tax in the hands of the unit holders, and tax deductible in the hands of the property companies. As discussed above, the STC system will continue to recognize this deemed "non-dividend" status by exempting such declarations from STC, while denying the recipients a deduction for such income in their dividend cycle.

X. COMPLIANCE PROVISIONS

STC is payable at a rate of 15 percent on the "net amount" determined in accordance with the above rules, by the end of the month following the month of the declaration of each dividend which triggers the close of a dividend cycle. In this context, where a declaration refers to a LDR the date of declaration is the LDR specified.

As a transitional measure, in the case of the first dividend cycle or cycles in respect of dividends declared on or before 30 June 1993 (note that there may be more than one such declaration) the STC payment date is 31 July 1993. Similarly, in the case of dividend declarations before 17 March 1993 and which have been specifically drawn into the STC net under the provisions discussed above, the STC payment date is also 31 July 1993, even if the dividend is only paid subsequent to this date, as declaration is deemed to have taken place on 17 March 1993, thus triggering STC liability.

There is one exception to these transitional measures: if a company's year of assessment ended during the period from 1 December 1992 to 31 March 1993 (both dates inclusive) then the STC in respect of any dividend declared on or before 30 June 1993 only needs to be paid by 31 December 1993.

If the correct amount of STC is not paid (accompanied by a prescribed form) by the due date for each dividend cycle, interest at the prescribed rate (currently 18 percent) will become due. The deduction of such interest for income tax purposes is specifically disallowed.

XI. ANTI-AVOIDANCE PROVISIONS

For obvious reasons, it has been necessary to provide detailed anti-avoidance provisions governing loans to shareholders. These provisions, which deem certain loans (and related distributions) to be dividends for STC purposes, are necessitated by the fact that many unlisted companies would otherwise legitimately avoid STC by lending reserves to shareholders rather than declaring dividends.

Under these provisions any amount which is deemed to have been distributed (including a loan or credit) to a "recipient" is deemed to be a dividend. In this context, a "recipient" is any shareholder of a company or close corporation, any relative of such shareholder, or any trust of which such shareholder or relative is a beneficiary. Furthermore, these provisions apply where cash or any asset has been distributed by a company to or for the benefit of such recipient; or where such recipient is released from any obligation measurable in terms of money which he owes to the company; or where any debt owed by the recipient to any third party is paid or settled by the company; and finally, where any amount is used or applied by the company in any other manner for the benefit of the recipient.

However, there are a number of circumstances where these provisions will *not* apply. These are:

- loans at market-related interest rates;
- loans by a wholly-owned subsidiary to its holding company;

10. See *supra* note 1.
11. Calculations by the author indicate that a gold mine distributing its earnings in full would need to maintain a future profit to revenue ratio of at least 32.8% for the new dual system to be more favourable than the status quo. Since such profitability levels are currently rare in the industry, it is unlikely that many (or any) gold mines will opt for the new system.

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- loans between fellow wholly-owned subsidiaries;
- distributions which already constitute dividends under the dividend definition in ITA Section 1;
- distributions which expressly do *not* constitute dividends (under paragraphs (e) to (h) of the aforementioned definition), i.e. essentially capitalization shares and the reduction of "primary" share premium;
- remuneration of employees;
- settlement of the company's debts;
- loans to employees under a loan scheme generally available to employees who are not shareholders;
- distributions in excess of profits and reserves available for distribution;
- capital profits distributed pending or during a company's liquidation or winding-up; and
- loans to shareholders which are repaid by the end of the following year of assessment, provided the loans are not subsequently re-advanced, and provided this exemption only applies once to any particular company and cannot be repeated in any subsequent year.

A further qualification is that these deeming provisions only came into operation on 17 March 1993 and, as a consequence, they do not apply to distributions and loans made before this date, even if they remain outstanding afterwards.[12]

Where a loan by a company is deemed to be a dividend for STC purposes, and it is subsequently repaid, the repayment will be deemed to be dividend income in the company's hands for STC purposes. As a consequence, the company may then declare an equivalent amount as a dividend without attracting further STC, due to the credit it is entitled to for the deemed dividend income.

XII. CONCLUSION

The dual tax system adds a new dimension to the fiscal planning requirements of new investments as well as existing structures in South Africa. There is no doubt that, compared with the previous tax regime, the new system provides an incentive which should encourage the productive reinvestment of corporate earnings. It also provides an incentive for locally-sourced investment for new projects which once established are likely to grow through internal reinvestment. However, before the system could be said to be optimal, the STC rate and/or the basic corporate tax rate need to be lowered further to ensure that in combination they are closer to the international norm of 40 to 45 percent.

12. However, any increase in such a loan after this date will potentially fall within these provisions.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

JANUARY 1994

Tax Effective Exploitation of Intellectual Property, London, 18 January 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

Trusts and Tax Traps for Trustees, London, 20 January 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

Principles of International Taxation, Amsterdam, 31 January-4 February 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

FEBRUARY 1994

22nd International Company Lawyers' Conference, Barcelona, 9-11 February 1994 (English, Spanish and French):

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

Essential Tax Planning for Groups of Companies, London, 15-16 February 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

2nd Caribbean Tax Conference, Cancún, 17-18 February 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Death and Taxes in Europe, Amsterdam, 21-22 February 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

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INTERNATIONAL:

ENVIRONMENT AND TAXATION: MUTUALLY REINFORCING POLICIES

Jeffrey Owens

How do tax measures affect the environment? And what tax regime can best promote environmental protection without damaging production? The OECD has just published a report on taxation and the environment, prepared by a special task force which united both tax and environment experts.[1]

The potential for using taxes as part of an integrated environmental policy is now the subject of considerable interest in OECD countries. Environmental charges and taxes have multiplied over the last decade and, in energy policies and measures to combat greenhouse gases, several countries have introduced energy and/or carbon taxes.

The increased use of such "eco-taxes" raises two main issues. First, how should the (non-environmental) taxes that may have adverse effects on environmentally sensitive sectors – as in agriculture, transport and energy – be adapted? Second, how can such taxes be best properly integrated into existing tax structures and policies?

On the first count, a number of "government failures" have been identified. In transport, for instance, fiscal concessions have encouraged an excessive reliance on "company cars", and income tax deductions for commuting to work by car increase both accidents and air pollution. Energy taxes set at too low a rate will lead to pollution, such as emissions of carbon dioxide. Correcting this kind of fiscal failure reduces economic distortions and increases efficiency, and it also improves environmental protection – a "double dividend", which can even be increased if the introduction of new eco-taxes is compensated by the removal of existing tax distortions. Generally speaking, it may be preferable to replace taxes on labour and capital by taxes on pollutants – this is an issue which deserves much more attention. In Sweden, for example, a major fiscal reform was undertaken in 1990-91 in which income and corporate taxes were reduced (respectively, from 22.5 to 19.5 percent and from 2.8 to 1.9 percent of GDP) and new eco-taxes introduced on emissions of carbon dioxide, sulphur dioxide and nitrogen.

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I. FOUR FUNDAMENTALS

The changes required by this policy integration must be implemented in a way that respects the basic principles underlying modern tax systems (fairness, fiscal neutrality, administrative simplicity). Particular attention has to be paid to four issues: the earmarking of tax revenues, fiscal neutrality, revenue neutrality and fairness.

A. *Earmarking*

A number of environmental charges and taxes are already being used to finance specific programmes, such as pollution control equipment (by river-basin authorities in France; and pollution charges are used in this way in the Netherlands) or to finance special trust funds, sometimes to clean up hazardous waste sites (as in the "Super Fund" in the United States). Earmarking environmental taxes and charges has the advantage that it can build up popular support for a new environmental tax, since it makes the link between the tax and its objective explicit. More generally, earmarking may increase the reliability of funds for environment programmes, which is important when the public sector is operating under tight fiscal constraints.

But the trend in recent reforms has been to move away from earmarking tax revenues for specific purposes, in part because returning the revenue from earmarked taxes to the taxpaying polluters (in the form of subsidies, for example) weakens the incentive

1. *Taxation and Environment: Complementary Policies* (Paris: OECD Publications, forthcoming).

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for them to change their behaviour. And where environmental taxes are set high enough to provide the incentive necessary to change the polluting behaviour of firms and households, earmarking is not required.

Another disadvantage of earmarking is that, in the long run, it is likely to introduce undesirable rigidities into budgetary decisions: the desire for revenue rather than environmental effectiveness may dictate the choice of tax rates, and environmental spending may be determined simply by the availability of earmarked revenue. Experience suggests that earmarking should generally be viewed only as a second-best, transitory solution during the period when environmental taxes have not yet reached their most effective rates.

B. *Fiscal neutrality*

From a purely fiscal perspective, taxes should normally be designed exclusively to yield revenue in the most efficient and least distortive manner. That is, the design of the tax system should be influenced by fiscal considerations alone, not to induce any specific behaviour or reaction from producers and consumers. Clearly, few taxes meet these criteria, and environmental taxes, after all, are generally designed to induce polluting agents to abate their emissions and to behave in an environment-friendly manner. But the reason for not wanting the tax system to influence behaviour is that the market is generally better at ensuring economic efficiency than government is. This is clearly not the case when there is pollution as, without taxes and/or in the absence of well-defined property rights, prices do not reflect the broader costs of pollution. Nonetheless, a careful balance should be kept between the advantages of tax reforms designed to achieve fiscal neutrality and the achievement of environmental objectives.

C. *Revenue neutrality*

The revenue potential of environmental taxes is large and thus requires government to address the question of how the income should be used. To offset other taxes? To pay for additional government expenditure, either on the environment or for other purposes? To finance government deficits? Most governments favour the first option. The political acceptability of new environmental taxes will be enhanced if they are introduced as part of a revenue-neutral package with offsetting reductions in the yields from other taxes (as in the fiscal reform in Sweden). Such revenue neutrality may also be attractive from an economic standpoint if the taxes that are reduced are producing distortions in patterns of consumption or production. How far countries can achieve revenue-neutrality will in part depend upon the size of public-sector deficits and the resulting pressure on revenue to cover them. It will also depend upon whether the environmental taxes are earmarked for specific funds, thereby inhibiting any offsetting reductions in distortionary taxes.

D. *Fairness*

Environmental taxes high enough to have any real impact on the environment will also have distributive consequences for households by pushing up the cost of fuel, agricultural products and thus food, and other goods and services. Since these items consume a larger proportion of the income of poorer households, it has been claimed that these taxes are regressive and therefore unfair. Governments try to deal with these effects in a number of ways. First, they have developed compensation schemes. Second, equity issues can be dealt with by decisions on which of the existing taxes should be reduced. But it is unlikely that this would produce a distributionally neutral outcome. It is important that redistributive measures be undertaken separately (through benefit systems), not in the form of tax exemptions or reductions which would offset the environmental effect of eco-taxes in encouraging environment-friendly behaviour by reducing incentives not to pollute.

II. OPTIONS FOR GOVERNMENT

There are a number of options open to governments to improve the environment by using tax-based instruments.

A. *Emission taxes and charges*

Emission taxes and charges can make an important contribution to the reduction of a range of industrial effluents, especially where discharges can be readily observed and measured – which is not always easy. But improvements in measurement technology are increasing the number of taxable effluents where precise and continuous measurement is feasible, and where taxes can be levied in direct proportion to the amount of environmental damage from each source. Discharges of organic substances into water, for instance, or of sulphur oxides into the atmosphere from thermal power stations can be easily monitored. Although the potential revenue from emission taxes is high, present experience suggests that the actual yield has been limited because, for economic and political reasons, the rates of eco-taxes are kept relatively low, usually too low to achieve environmental objectives (hence the importance of combining taxes with regulations).

B. *Indirect taxes*

Before introducing new environmental taxes, existing fiscal measures that might have a detrimental effect on the environment should be modified or removed if they, say, encourage urban sprawl (through, for instance, the deductibility of travel as a commuting expense), or afforestation which damages wetlands or for land clearance and drainage, and so on.

Changes to the structure of the taxes on goods and services provide an alternative way of introducing incentives for pollution control into the existing system. Taxes on products which cause damage (say, pesticides) can also be effective, particularly if they are used in large quantities and are readily identifiable (if the product is highly toxic, a partial or total ban may be preferable). The higher the demand for elasticity and substitution possibilities of products, the higher the environmental effectiveness of product taxes, as consumers use less of them or turn to alternative, more readily acceptable alternatives.

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Input taxes offer another approach. They are applied to material and energy inputs that result in polluting productive processes and/or products. Reducing the energy and material intensity of production and consumption will affect all subsequent stages of production and result in reduced pollution. The approach can apply to specific raw materials (a tax on virgin – non recycled – paper, for instance) or polluting inputs (phosphates, chlorine, sulphur, and so on).

But there are limitations to the introduction of environmentally motivated changes in the existing consumption tax system: first, since not all polluting inputs can be taxed and, second, because the use of VAT systems may be inappropriate. VAT is paid on the value of products, whilst the environmental damage is usually related to quantities produced. The link may therefore be weak.

C. *Carbon taxes*

In order to combat global warming some countries are turning to a carbon tax (a tax on the carbon content of fuels, which is tantamount to an additional energy tax). These are imposed on energy sources (gas, coal, oil) in proportion to the amount of carbon dioxide given off when they are consumed. They encourage consumers to use less energy, and to switch to less carbon-intensive energy sources. Several OECD countries – Denmark, Finland, the Netherlands, Norway and Sweden – have already implemented such taxes.

The main problem with carbon taxes is that they would have to be very heavy to reduce emissions on any real scale. Stabilization of emissions at 1990 volumes in the OECD area over the period 2000-2050 would require a tax of about $ 81-88 per ton of carbon ($ 236 in Japan) by the year 2050 (at 1985 prices). That would probably result in substantial burdens on poorer households, where fuel usually accounts for a large proportion of their expenditure. To offset these undesirable effects, carbon taxes could be implemented as part of a package (for example, through reductions in other taxes to equalize the net incidence of the new tax across households and/or economic sectors).

The introduction of such heavy taxes would also produce structural changes in the economy which would influence the geographical distribution of income and employment in different sectors and international trade patterns in the energy sector. These changes would be heavily influenced by the precise way in which the revenues are used – some consumers and industries could be net gainers from a package that introduced a carbon tax and reduced other taxes.

III. QUESTIONS FOR IMPLEMENTATION

The introduction of environmental taxes and thorough integration of environmental and tax policies will require a set of simple rules and criteria to ease their implementation and strengthen their effectiveness.

Close coordination will be required between different arms of government, in particular between ministries of finance and of the environment. If revenue considerations dictate the choice of tax rates, it will make it more difficult to achieve the optimal environmental impact. And, if environmental taxes are introduced without considering their implications for the overall balance of the fiscal system, they are likely to run into administrative and political opposition that could have been avoided with better coordination.

There are important international dimensions to environmental taxes, two in particular. First, eco-taxes are bound to have an effect on the international competitiveness of domestic firms. Industry often claims, sometimes justifiably, that environmental taxes and charges introduce an additional financial burden which adversely affects its competitive position. But, relative to regulations, taxes encourage economic efficiency over the longer term and should minimize the overall cost of controlling pollution in a given country, thus improving its industrial competitive position overall in comparison to industries in a country which uses a regulatory approach.

Moreover, the additional tax burden has to be seen in the context of the implicit (sometimes explicit) subsidies that have been provided to polluting industries when environmental policies have been weak, for instance, through low emission standards or weak enforcement of regulations. Furthermore, if eco-taxes are implemented in the context of a more comprehensive reform, which decreases other taxes, the short-term additional burden may be reduced. Of course, tax reductions may affect different economic agents in different ways and thereby make it difficult to compensate completely those most adversely affected by the change. On balance, this fear of worsening the short-run competitive position of firms operating in a country which introduces a significant environmental tax is real, though perhaps occasionally exaggerated. Nevertheless, these reservations should not be used as a reason to postpone the introduction of eco-taxes if the approach is internationally coordinated and implemented in a progressive fashion, in order to alleviate potential trade distortions.

Because certain forms of environmental problems are of a regional or global scale, measures to address them will be most effective if they involve international cooperation. It can take a variety of forms. With global warming, for example, international cooperation may have to extend to a coordinated introduction of carbon taxes by all OECD countries (and preferably countries beyond the OECD area). That could require formal international agreements as well as policy dialogues in international fora, including the OECD.

The Commission of the European Community has made a formal proposal for an EC-wide carbon-energy tax, an issue actively debated at present, although unresolved. Such a tax would require the active coordination of policies and a proper integration into existing fiscal systems to achieve a revenue-neutral package and alleviate possible anti-competitive effects.

Environmental taxes will not provide the unique solution to environmental problems and will usually have to be used in combination with direct regulation of environmentally damaging activities. But they may contribute to a more efficient solution to national and international environmental problems.

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DENMARK:
TAX REFORM

Bente Møll Pedersen

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I. INTRODUCTION

Comprehensive Bills[1] providing for a tax reform were enacted by the Danish Parliament on 24 June 1993. The reform covers the taxation of individual income, business profits and companies, and as a general rule will be effective as of 1 January 1994. However, a number of the amendments apply from 19 May 1993, the date the proposals were introduced.

Contents

I. Introduction
II. Background and Objective
III. Taxation of Individuals
A. Tax rates
B. Social security contribution
C. Fringe benefits
D. Income from immovable property
IV. Taxation of Dividends
V. Taxation of Capital Gains
A. Shares
B. Immovable property
C. Goodwill
VI. Taxation of Business Profits
A. Investment funds
B. Stock valuation
C. Depreciation
D. Relief for foreign source income
E. Capital transfer duty
F. Duty on the sale of shares
VII. Measures to Prevent Tax Avoidance
A. Partnership leasing
B. Leasing activities
C. Trade in loss-making companies
D. Income from abroad
VIII. Conclusion

II. BACKGROUND AND OBJECTIVE

Danish taxation of individual income has traditionally been characterized by extremely high and progressive tax rates. Some of the problems associated with the progressive tax principle in Denmark were resolved or at least mitigated by the 1987 tax reform. However, taxation remains progressive with a tax rate of up to 68 percent on earned income.

The overall objective of the reform is to reduce the tax burden by decreasing the taxation of earned income of individuals and gradually reducing the top marginal rate from 68 to 58 percent over the five-year period from 1994 to 1998. However, the introduction of a social security contribution implies that the marginal tax rates are actually only reduced to 62 percent.

The revenue to finance the reduction of the marginal tax rates will be provided by broadening the tax base, primarily by introducing taxation of all capital gains and abolishing the inconsistent treatment of different types of income and capital gains. The new social security contribution and the new environmental taxes (i.e. duties on petrol, gas, electricity, waste disposal and water, etc.) should provide additional sources of revenue.

The 1993 tax reform is not as fundamental as the 1987 reform, but substantial changes have been made in certain areas. This article describes the key features of the tax reform.

III. TAXATION OF INDIVIDUALS

A. *Tax rates*

Effective from 1994, the computation of tax payable is amended and the following new rates apply.

1. National tax

(a) *Bottom level tax*

The current 22 percent tax, which is levied on all taxable income, is replaced by a bottom level tax of 14.5 percent in 1994, gradually reduced to 8 percent in 1998.[2]

(b) *Mid-level tax*

A new national income tax is introduced as a mid-level tax of 4.5 percent in 1994, gradually increased to 6 percent in 1998. Tax is levied on personal income, plus or

1. Bills Nos. L 283 – L 297 of 19 May 1993.
2. The bottom-level tax is levied on all taxable income regardless of the amount.

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minus capital income. The mid-level tax is only levied on income exceeding DKK 130,000 (1994).

(c) *Top-level tax*

The current 12 percent national income tax is replaced by a new top-level tax of 12.5 percent in 1994, gradually increased to 15 percent in 1998. This tax is levied on personal income plus capital income over DKK 20,000 (1994) for a single taxpayer, and DKK 40,000 for a married couple. A deduction of DKK 234,900 (1994) is allowed when determining income subject to the top level tax.

2. Municipal taxes

Ordinary taxable income is subject to municipal taxes at the rate of approximately 29.5 percent and, if applicable, church tax of approximately 0.7 percent. These rules remain unchanged.

B. *Social security contribution*

A social security contribution has been introduced. The tax is imposed on employment income, fees and business profits. The employee contribution for 1994 is set at a flat rate of 5 percent on gross employment income or personal income, increasing to 8 percent by 1997.[3] The employer contribution will not take effect until 1997, at the rate of 0.3 percent of wages, increasing to 0.6 percent by 1998.

C. *Fringe benefits*

Fringe benefits received from an employer are regarded as taxable income for an employee. Until now an employee has been taxed on the estimated value of the private use of any such benefit. However, from 1994 the employee will be taxed at an amount equalling the cost to the employer.

For certain fringe benefits, i.e. free automobile, telephone, summer cottages and pleasure boats, standard amounts apply, and new rules are fixed according to which the employer must report such benefits to the tax authorities and withhold income tax from the salary.

D. *Income from immovable property*

Owner-occupied houses are deemed to produce taxable income for the owner in an amount equal to the rental value of the property. The rental value is set by the tax authorities; currently it is 2.5 percent of the public assessment value of the property up to DKK 1,483,200 (1993) and 7.5 percent of any excess. These rates are reduced to 2 percent and 6 percent with effect from 1994.

IV. TAXATION OF DIVIDENDS

One of the primary objectives of the reform is to ensure that dividends and capital gains are taxed in the same manner. From 1991 until 19 May 1993, dividends from Danish companies were classified as a special type of income, "dividend income", which was not included in the calculation of taxable income. Dividends were taxed separately at the rate of 30 percent if the dividend did not exceed DKK 31,700, and a further tax of 15 percent was levied if the dividend exceeded DKK 31,700 per year. Under the reform dividends are taxed as "share income" (see Section V) and the tax treatment of dividends from Danish companies is more favourable than previously.

Share income below DKK 31,700 (1993) is taxed at 30 percent, and from 1996 at 25 percent. Share income exceeding DKK 31,700 (1993) is taxed at 40 percent. However, the rules do not apply to dividends of non-resident companies which are taxed as capital income (i.e. up to 58 percent in 1998).[4]

Under the reform dividends are still subject to double taxation in Denmark as follows:

	below DKK 31,700	*above DKK 31,700*
Company profits	100.0	100.0
Corporation tax	34.0	34.0
Shareholders tax (on 66)	19.8	26.4
Total tax	53.8	60.4

V. TAXATION OF CAPITAL GAINS[5]

As a general rule all capital gains are taxable under the reform. A new classification, "share income", has been introduced which is comprised of either dividends or income related to capital gains on shares held for more than three years. As stated above "dividend income" has been abolished.

The gains are taxable as general taxable income or share income. For individuals, general taxable income is taxed as personal income or capital income. For companies, general taxable income is taxed at the corporation tax rate of 34 percent.

A. *Shares*

Capital gains derived from the sale of shares are taxed as capital income if the shares are held for less than three years. Any loss may be deducted from the gain on other shares held for less than three years. These rules remain unchanged.

3. The contribution is deducted from personal income before calculating ordinary taxable income, and thus reducing the base for calculating national and municipal income taxes.
Foreign key expatriate employees and research workers who are allowed to opt for a 30% income tax rate on their gross income are also subject to the social security tax. For further details, see Bente Møll Pedersen, "Tax Status of Expatriates", 47 *Bulletin for International Fiscal Documentation* (April 1993), at 211-213. Thus the actual taxation of such expatriates will be 38% in 1997 as the tax will not be deductible from the income which is subject to 30% taxation.
4. The different treatment of dividends of non-resident companies is most likely incompatible with the EC treaty and therefore the taxation of dividends of non-resident companies may be changed.
5. Unless otherwise indicated all changes apply to both individuals and companies.

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Before the reform measures took effect on 19 May 1993, if the shares were held for more than three years, the gain was generally exempt from taxation. However, if the shareholder in question together with close relatives held more than 25 percent of the share capital or 50 percent of the voting power of the company, special rules applied, i.e. the capital gain was subject to a special income tax at a flat rate of 50 percent. However, if the shareholder held the shares for more than seven years tax was reduced to 25 percent. The taxation of capital gains on shares held by individuals for more than three years has been substantially amended by the reform. For companies, however, the rules are unchanged, and any gain is still tax-exempt if the shares are held for more than three years.

Capital gains on shares held by individuals for more than three years are taxed in the same manner as dividends from Danish companies (see above). A loss can be deducted at a maximum tax value of 40 percent. The rules apply to capital gains realized on the sale of shares in both resident and non-resident companies.

By way of exception to the general taxation of shares held by individuals for more than three years, capital gains on shares quoted on a stock exchange and of a total value not exceeding DKK 100,000 (1993) are tax exempt. If the holding exceeds DKK 100,000 the gain is taxed as share income. If the gain is taxable, a loss can be deducted from gains on other quoted shares held for more than three years.

Special rules apply to major shareholders, i.e. shareholders with more than 25 percent of the shares or 50 percent of the voting rights of a company before 19 May 1993. The taxable gain is reduced by 1 percentage point for each year the shares are held prior to 1998, but the gain may not be reduced more than 25 percent. No reduction is granted if the shares are acquired after 19 May 1993.

Capital gains on shares of certain non-resident tax-exempt investment companies are taxed as capital income. These rules also apply if a Danish holding company owns the shares of a non-resident investment company.

As a result of the uniform taxation of dividends and capital gains on shares, the special Danish holding rules for companies have been abolished.

B. *Immovable property*

Prior to the reform capital gains from the sale of property other than residential property were taxed at various rates depending on the period of ownership. If the property was held for less than three years the gains were fully taxable. Thereafter the taxable gain was reduced by 20 percent annually, and after seven years the disposal was tax-free. Under the reform, the capital gain is reduced by 5 percentage points per year for each year of ownership, subject to a maximum of 30 percent. Thus if the property is held for more than eight years 70 percent of the capital gains are taxable.

For individuals the gain will be taxed as capital income at the highest marginal tax rate of 58 percent in 1998. The effective tax rate is thus 58 percent of 70 percent, or 40 percent, if the property has been held for more than eight years.

Rollover relief is granted which permits deferral of taxation if the property is used for the owner's business and if replacement property is acquired. In such a case the gain is deducted from the purchase price.

C. *Goodwill*

Until 1982 capital gains on goodwill were taxable. Between 1982 and 19 May 1993, capital gains on goodwill were tax-exempt. However, taxation on goodwill is reintroduced by the reform – capital gains on goodwill are taxable as ordinary income and personal income for individuals. Acquired goodwill may be depreciated over ten years by 10 percent annually. The amount on which depreciation is effected and the seller's gain are calculated on a cash basis.

A special rule has been introduced to prevent related persons or companies from transferring goodwill in a year with low income (and therefore minimum taxation of a gain) to a related buyer who can depreciate on the full purchase price. If goodwill or other intangible rights are transferred between related parties goodwill can only be depreciated at an amount equal to the seller's taxable gain.

In connection with the reintroduction of the taxation of goodwill, the taxation of a number of other intangible rights which previously were taxable under the special income tax act are now taxable as general taxable income. For individuals this implies that the 50 percent flat rate special income tax no longer applies. Gains are taxable as personal income for individuals.
As a general rule, the above applies to goodwill transferred after 19 May 1993. However, if goodwill is transferred in 1993 only 25 percent of the gain is taxable, if it is transferred in 1994 50 percent of the gain is taxable, and if transferred in 1995 75 percent of the gain is taxable. The amount on the basis of which depreciation is effected is the reduced amount.

If goodwill is transferred between 19 May 1993 and 1 January 1998, and if the principles of calculating goodwill have been agreed to between the parties under a binding contract, goodwill may be tax exempt according to the old rules. However, a binding ruling must be obtained from the authorities (and filed before 1 January 1994) to the effect that a binding contract has been entered into.

VI. TAXATION OF BUSINESS PROFITS

The taxation of business profits has been amended as follows:

A. *Investment funds*

Up to 25 percent of an individual's taxable business income may be allocated to an investment fund and deducted in calculating taxable income. The investment fund must be used within six years after the year of allocation as advance depre-

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ciation of any acquired tax-depreciable assets. These rules, which have already been abolished for companies, will be abolished gradually. With effect from the income year 1998 it will no longer be possible to obtain the deduction.

B. *Stock valuation*

Stock, i.e. the taxpayer's movable property which is to be sold in the course of the taxpayer's business or to be used in the production process which will be sold as part of the taxpyer's business, can be deducted at the rate of 23 percent of the value of the stock in 1993. This deduction will be gradually abolished, and with effect from 1998 it will no longer be possible to reduce the valuation of inventory.

C. *Depreciation*

Machinery and equipment, etc. and ships may be depreciated for tax purposes at a maximum of 30 percent per annum on a pooling basis. As from 1994 the transfer sum for such assets will be calculated on a cash basis. Special rules will apply for this calculation.

D. *Relief for foreign source income*[6]

A company having foreign branches or jointly taxed foreign subsidiaries may obtain relief amounting to 50 percent of the Danish corporation tax levied on the net taxable income of the foreign branch or subsidiary. The effect of this relief is that the effective Danish tax rate may be reduced for a company having branches or jointly taxed foreign subsidiaries. This foreign relief is gradually abolished at the rate of 1/7 each year between 1994 and 1999, and totally abolished as from the year 2000.

E. *Capital transfer duty*[7]

The 1 percent capital transfer duty has been abolished.

F. *Duty on the sale of shares*

The 1 percent duty on the sale of Danish or foreign shares and similar securities (where at least the seller is resident in Denmark) is reduced to 0.5 percent as of 1 January 1995.

VII. MEASURES TO PREVENT TAX AVOIDANCE

As part of the reform several measures have been introduced to prevent tax planning and other undesirable methods of exploiting the tax system.

A. *Partnership leasing*

Income from certain types of tax-effective investments in partnerships with more than ten partners are taxed as capital income, and losses can only be offset against other income from the same partnership. These restrictions apply as from 19 May 1993 to the leasing of equipment or ships where a partner does not take an active role in the leasing business and regardless of the number of partners.

B. *Leasing activities*

To counter the increasing trade in "surplus-generating companies", the possibilities of depreciating leasing assets have been restricted with effect from 19 May 1993. No companies – not only "surplus-generating companies" – acquiring machinery and equipment are allowed a first-year depreciation on such leased assets. In the following year 60 percent may be depreciated.

C. *Trade in loss-making companies*

To prevent an increasing trade in "loss-making companies" the existing rules in respect of tax losses have been restricted. Tax losses may be carried forward for five years to be offset against taxable income. If more than 50 percent of the share capital or more than 50 percent of the voting rights of a company have been transferred to new owners, tax losses cannot be set off against income from passive investments. In the future this will also apply to leasing income. However, a loss can still be offset against income from trading activities.

D. *Income from abroad*

To counter the rising tax planning in connection with the investment of capital in foreign financial assets, a net income principle has been introduced in calculating relief under a double tax treaty or under Danish domestic rules. When avoiding international double taxation, the income entitled to relief must be calculated on a net income basis. Accordingly, expenses related to the foreign income must be deducted from the foreign income before calculating the relief.

VIII. CONCLUSION

The Government has created a new tax system which provides for more symmetrical taxation and taxation of capital gains on all assets. The gap between the taxation of earned income and capital income has also been closed. Different types of income and capital gains will be taxed in the same manner.

The Government also aimed to approximate taxation in Denmark to that of the rest of Europe, e.g. by introducing a social

6. This rule applies only to companies.
7. *Id.*

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security contribution. However, a progressive taxation of capital income and capital gains up to 58 percent in 1998 does not provide for such approximation. Furthermore, taxation of capital gains on shares at a flat rate of 40 percent without any allowance or inflation deduction and double taxation up to 60.4 percent are putting Denmark into a special class. No other country in Europe appears to have such a heavy tax burden.

Denmark is not following its Nordic neighbours, Sweden, Norway and Finland, which levy a comparatively low flat rate of tax of 25-28 percent on capital income. If Denmark is numbered among the Nordic countries, one certainly cannot speak of a Nordic model of taxation of capital income.[8]

8. For a discussion of the Finnish tax reform, see Kari S. Tikka, "Fundamental Tax Reform", 47 *Bulletin for International Fiscal Documentation* (June 1993), at 348-353.

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LIECHTENSTEIN:

PREFERENTIAL TAX TREATMENT OF HOLDING AND DOMICILIARY COMPANIES

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I. INTRODUCTION

Tax experts acquainted with the complex tax laws of most OECD countries would be amazed at the simplicity and clarity of Liechtenstein tax law. The entire tax system is clearly set forth in a mere 167 paragraphs. There exists no plethora of judgements and/or rulings on the interpretation of the various provisions and thus potential investors and businessmen are provided with a high degree of certainty as to the tax treatment of their projects.

The simple tax system which generally speaking does not know concepts such as "imputation", "deeming provisions" or "income attribution rules" nevertheless boasts low rates of personal and corporate tax, and has proven to be successful as an instrument of social and economic policy. Since the introduction of the basic tax scheme in 1923, which was overhauled by the tax law of 1961, the Liechtenstein economy has flourished. Unemployment is unknown and the government continues to balance its budget. Liechtenstein is one of the few modern states with both a highly developed social welfare system and an annual excess of state revenues over expenditures.

As mentioned above, the fundamental system of taxation was introduced through the tax law passed in 1923. Pursuant to this law, the tiny Principality adopted a system which, in providing for a universal tax on capital with only a supplementary tax on income, perceived capital as the main source of government revenue. This law was passed at a time when the economy was still land-based with many farmers producing mainly to satisfy their own needs so that only modest surpluses were transformed into cash. Thus, the administration of an income tax system was perceived to be unfair to the landless workers who, unlike the farmers, had become fully integrated into a cash economy. The administrative difficulty in introducing an income tax system in an agrarian economy was also taken into account. The system of tax on capital was intended to shelter capital growth through the imposition of very low rates.

The current tax law, introduced in 1961, is, as was its predecessor, based on a system of a general tax on capital with tax on income being treated as a supplementary source of revenue.

A tax system which is based on a universal tax on capital as opposed to income tax must by logical necessity prefer the concept of territoriality or "source", i.e. that a state is only entitled to tax those assets situated within its jurisdiction and such income as arises within its jurisdiction, to the concept of a levy on the worldwide income of its residents. This basic notion which lies at the heart of Liechtenstein tax principles has been misunderstood and led to the notion that the tax system was intentionally designed to encourage tax evasion on an international scale.

The general philosophy upon which the tax system is based has been extended in order to benefit corporate entities. The use of legal entities – whether or not wholly controlled by a single individual – is not considered tax evasion in Liechtenstein. Thus, various forms of Liechtenstein legal entities, as well as trusts, have been used to maximize estate and tax planning schemes, particularly by non-residents seeking effective tax shelters. As a result, encouraged by a preferential tax treatment, foreign-owned holding and domiciliary companies have flourished in Liechtenstein.

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Interestingly enough, holding and domiciliary companies were not originally attracted to Liechtenstein for tax reasons. After the collapse of the Austro–Hungarian Empire following the treaty of Versailles, many large enterprises were faced with a situation in which their various branches were scattered throughout the newly formed independent states. To consolidate operations they decided to transfer the company's administrative head office to a neutral state abroad.

The first such transfer was arranged on 18 January 1920 by the Liechtenstein envoy in Vienna, Prince Eduard von Liechtenstein. Seven months later the Bank of Liechtenstein, a holding company of the Anglo–Austrian bank, was opened. Through contacts maintained by this bank in Austria, many new holding and domiciliary companies were attracted to the politically stable Principality, whose monarchy had survived the collapse of all other German monarchies.

Liechtenstein provided a safe refuge from the continual threat of political instability and economic collapse which hovered over Austria in the 1920s and 1930s. The preferential tax treatment which holding and domiciliary companies enjoyed in Liechtenstein thus played little or no part in the decision to relocate. Taxation on income had been introduced as a temporary levy in most OECD countries during World War I to finance their respective military engagements.[1] The establishment of holding and domiciliary companies in Liechtenstein commenced at a time when the immutability and severity of personal/corporate income taxes was not foreseeable.

Essentially, Liechtenstein was to profit from the general shift west of the political and economic centre of gravity in Europe following World War I, and in particular the collapse of the Austro–Hungarian and Ottoman Empires, as well as the self-imposed isolation of Russia, factors which were subsequently exacerbated by the formation of the Iron Curtain.

The Liechtenstein fiscal authorities, however, soon became aware of the importance of holding and domiciliary companies, and guided by the action of some Swiss cantons to attract foreign investment, introduced tax legislation providing for the preferential treatment of holding and domiciliary companies. The tax law of 31 January 1921 was a self-declared instrument of economic policy, providing that the establishment of holding and domiciliary companies was to be encouraged, and a special flat corporate tax rate was introduced. This preferential tax treatment continues to this day.

II. HOLDING AND DOMICILIARY COMPANIES

Holding and domiciliary companies are special tax concepts and are not dependent on any particular special corporate structure as set forth in the civil law. Liechtenstein tax law distinguishes between companies which actively carry on business in Liechtenstein and domiciliary companies. The latter are only active abroad notwithstanding that their corporate headquarters are in Liechtenstein.

For tax purposes holding companies are defined as legal entities entered in the Public Register as well as non-registered foundations,[2] whose objects consist primarily or exclusively of portfolio management, the acquisition of equity participations in other corporate entities or the long-term management of other legal entities.[3] Such legal entities are exempt from property, income and capital earnings taxes. They are, however, subject to a tax on capital calculated as 0.1 percent of their paid-up capital and assets plus retained earnings or, in the alternative, less accrued losses.[4] The tax on capital may not be less than Sfr. 1,000 in each year.

To the extent that a holding company invests in operations or other assets in Liechtenstein and generates income therefrom, the holding company is subject to tax on its capital earnings as well as capital tax on the Liechtenstein assets at the same rate as legal entities which actively conduct business or hold assets exclusively in the Principality.

Domiciliary companies are defined as legal entities entered in the Public Register which merely maintain a domicile, i.e. an address with an agent for service, in Liechtenstein. Whether or not such companies maintain actual offices is irrelevant. Domiciliary companies may under no circumstances carry on business or engage in any commercial activities in Liechtenstein.

Companies which satisfy the foregoing criteria are exempt from property, income or capital earnings taxes. They are merely required to remit an annual capital tax which is calculated as 0.1 percent of the paid up capital and other assets held by the company, including retained earnings and taking into account any accrued losses. However, the tax may not be less than Sfr. 1,000 in any year.

The essential requirement that a domiciliary company refrain from any type of commercial activity in Liechtenstein is interpreted pragmatically by the tax authorities. Thus, international trading companies can maintain offices in Liechtenstein for the purpose of importing and exporting provided they do not sell, manufacture or finish any of their products in Liechtenstein, do not maintain inventory in Liechtenstein and do not solicit business there. Domiciliary companies may, however, purchase personal services, retain agents on a free-lance basis (who may only be active abroad), entertain customers from abroad and hold meetings at their Liechtenstein offices. The intent of this policy is clear: companies which benefit from preferential tax treatment may not compete with domestic companies whose tax burden is somewhat more

1. Liechtenstein maintained no army at this time so the state treasury was not confronted with exigencies similar to those of its neighbours.
2. Foundations are separate estates set up for specific purposes. The estate enjoys a distinct juridical personality. Foundations are excellent vehicles for portfolio management and estate planning. The usual purposes for which foundations are established are charitable or maintenance of one or more family members (family foundations). Foundations may not be formed for the primary purpose of undertaking any type of commercial or industrial activity.
3. Holding companies may, however, also own and administer movable and immovable property located within or outside Liechtenstein, including patents, trademarks, copyrights, models, etc.
4. The capital tax rate of 0.1% is reduced for holding companies which have considerable assets. The capital tax is reduced to 0.75% for foundations with assets in excess of Sfr. 2 million (including reserves and accumulated income), and to 0.5% for those with assets in excess of Sfr. 10 million, including reserves.

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onerous. At least one member of the board of directors of a domiciliary company must be a Liechtenstein resident and an agent must be appointed for service in Liechtenstein.

Capital tax for both holding and domiciliary enterprises is assessed and collected by the tax administration. The minimum amount of capital tax, i.e. Sfr. 1,000, is payable annually in advance according to law. If an enterprise which is required to submit its annual accounts to the tax administration has reserves that, together with its capital, amount to more than Sfr. 1,000,000, it will be subject to a tax assessment at the rate of 0.1 percent, or at a maximum, the preferential tax rate taking into account the prepayment.

Both holding and domiciliary companies must maintain fully paid-up capital at a Swiss or Liechtenstein bank of at least Sfr. 30,000 in the case of Anstalts, business trusts or foundations, or Sfr. 50,000 in the case of joint-stock companies.

It should be noted that with the exception of coupon tax (see below), Liechtenstein has no further taxes levied at source.

III. COUPON TAX

Introduced in 1966, the coupon tax is imposed on all coupons in respect of securities which have been issued by a resident company, a company having its official head office in Liechtenstein or a company which is registered in the Public Registry. The following coupons are subject to tax (when issued by residents): stocks, bonds, debts, debentures, medium term notes, annuity bonds, mortgage bonds, bills of exchange as well as discounted bills such as borrower's notes, which are issued in series for the purposes of trading.[5]

The coupon tax is levied on and is payable by the payer – thus the tax becomes due upon payment or distribution regardless of the identity or residence of the recipient.

Under Liechtenstein law it is possible to incorporate legal entities which enjoy a distinct juridical personality and whose capital is not divided into shares. Such entities (e.g. foundations) may serve as holding companies, or as in the case of Anstalts, as domiciliary companies. If the capital of an entity is not divided into shares and the right to participate in the equity is not evidenced by a certificate of title, the entity is not subject to any tax (in particular coupon tax) in respect of distributions made to beneficiaries or equity participants. Such distributions are tax-free.

From a legal perspective, the coupon tax is not a tax on profits, a tax on capital gains or a tax on income. It is the legal transaction itself which is taxed, as evidenced by the coupons described above, i.e. the transfer of monies which the issuer of the instrument of indebtedness is obliged to undertake in favour of the holder in consideration for having made capital available.

In practice the following types of distributions are relevant for coupon tax purposes:

- the distribution of dividends to shareholders by Liechtenstein joint stock companies;
- the remittance of other monetary payments by legal entities subject to Liechtenstein tax to the holder of any instrument of title which entitles the holder to participate in the equity or profits of the legal entity, or remittances to third parties closely related to the holder which are not recorded as a payment on account of dividends or profit sharing, such as the payment of a liquidation surplus, a bonus or a bonus in shares;
- interest on loans the principal balance which exceeds Sfr. 50,000, provided that one of the contracting parties is recorded in the Public Register or carries on business, and that according to its terms the loan has been made for a minimum of two years. Thus loans to or from shareholders or equity participants of a legal entity may be subject to coupon tax.

The rate of coupon tax is currently 4 percent. The amount repaid by the coupon debtor in redemption of the coupon, or a distribution on account thereof, forms the tax base for calculating the coupon tax. With respect to documents analogous to coupons, the tax is levied on the amount paid, compensated or credited (taxable distribution) as per the terms of the document.

IV. TRUSTS

Trusts, whether or not established under Liechtenstein law, which have a Liechtenstein resident trustee, are prima facie taxable in Liechtenstein. However, an exemption exists for trust property situated abroad. Trust property is subject to the same tax treatment as applies to assets held by domiciliary companies to the extent that it can be demonstrated to the tax authorities that the trust assets are situated abroad.

The concept of trust property is not defined in the tax law. The courts have extended the meaning of trust property beyond the Liechtenstein civil law concept which is an adaptation of the Anglo-Saxon concept. The courts have held that notwithstanding the absence of a definition of trust property in tax law, it must be defined in view of the provisions in the tax law concerning domiciliary companies with the result that the capital tax liability of trust estates does not depend exclusively on the civil law designation or legal construction or on a legal adjudication of the relationship between the settlor, trustee and beneficiary, but rather on the factual economic relationship. Thus, the preferential tax treatment granted to trust property has been extended to other types of separate estates which are managed on a fiduciary basis, meaning that management and control over the assets are removed from the economic ownership thereof.

5. If the securities were issued without coupons, they are considered to be replaced by such document as is required for the purposes of drawing upon, transferring, crediting or otherwise to receive dividends, interest, rents, profit participations or other income arising by virtue of title to the security in question.

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V. CONCLUSION

Austria is the only country which has entered into a double tax treaty with Liechtenstein. Assets held by holding companies abroad and income earned by domiciliary companies may be subject to taxation in other jurisdictions. Moreover, shareholders or equity participants in Liechtenstein legal entities who are resident abroad may be subject to taxation in other jurisdictions with respect to the distributions made to them. Therefore the effective tax advantages in establishing a holding or domiciliary company in Liechtenstein cannot be assessed solely on the basis of the Liechtenstein tax implications, but must also be considered in light of the tax implications arising out of the relationship of the Liechtenstein company to persons, business activities and assets in other tax jurisdictions. Fortunately, in many OECD countries withholding taxes on income earned by non-residents, as well as branch taxes, are somewhat less onerous than the personal and corporate taxes levied on residents.

Inasmuch as Liechtenstein domiciliary companies are in most instances subject to at least some taxation in those jurisdictions where they carry on business through a branch office, and in view of the fact that holding companies may be subject to tax as non-residents with respect to income earned by the assets which they hold abroad, the preferential tax treatment of Liechtenstein holding and domiciliary companies is not an incitation to the flagrant evasion of taxes, but rather the embodiment of the principle of territoriality, namely that income ought to be subject to taxation in the territory where it is earned, and capital ought to be taxed in the jurisdiction where it is situated. This philosophy seeks to avoid double taxation as well as the need to enter into endless double tax treaties.

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POSTSCRIPT TO JUNE 1993 ARTICLE ON DEVELOPMENTS IN TAX REVENUES AND FISCAL DEFICITS OF OECD COUNTRIES

Ken Messere

Since my June article, more recent estimates have become available on tax revenue developments[1] and fiscal deficits[2] in OECD Member Countries. This would not in itself justify a postscript so soon, but because a few countries considerably revised their total tax receipts to GDP ratio (TTR's) between 1990 and 1992, and because most countries have considerably revised upwards their fiscal deficits between 1992 and 1994, some of the commentary in the June article is already invalid, so I would like to make a few corrections.

Revisions of TTR's (Table 1)

It is normal that there should be some revision of TTR's for very recent years, because both tax receipts and GDP figures may have been over- or underestimated. However, most modifications of estimated TTR's for the years 1990 and 1991 have been very slight indeed, rarely exceeding 0.5 percent. Significant exceptions are flagged in Table 1 in footnotes 1 and 2. Among the G7 countries, Canada and Italy greatly overestimated their increase in TTR's for 1991 and Germany greatly underestimated it – probably due to the complications of integrating East Germany's data.

A comparison of columns (4) and (5) of Table 1, suggests that after a few years of stagnation overall TTR's are likely to be increasing in 1992 (pluses of some magnitude in Austria, Denmark, Germany, Iceland, Italy, Portugal, Spain, Switzerland and Turkey and a corresponding decline only in Japan and Sweden). This potential increase in TTR's may have more to do with sluggish growth in GDP than increased revenues but there has been no time to verify this.

Revisions of Fiscal Deficits (Table 2)

I suggested in my June article (Section IIE page 336), that recent estimates of the extent of deficits have been on the optimistic side, reflecting governmental wishes to let the world know that things are not as bad as they seem. Latest estimates for 1993 and 1994 (columns (4) and (7) of Table 2) as summarized in columns (9) and (10)) indicate a growing tendency of many governments for overoptimism. While for the most part deficits predicted for 1994 are slightly less than those for 1993 it will be interesting to see whether this remains so, when OECD Economic Outlook No. 54 is published in December 1993 and later estimates will presumably be revealed.

Revaluation of tax effort[3] of the G7 countries (Table 3)

Table 3 first reproduces my original assessment on the tax effort of the G7 countries[4] between 1989 and 1992 as given in my June article, secondly makes some revaluations to take account of revisions either to TTR, or the size of the deficit, or both, and thirdly provides an evaluation of measures so far taken in 1993. On this last there has been a notable improvement in tax effort in France, the United Kingdom and the United States, though it is doubted whether this will be sufficient greatly to reduce deficits. However, with most of the G7 in recession and the recovery rather fragile in the United Kingdom and United States, it is arguable that reducing deficits should not be given short- term priority. The increase in revenues and reduction in government expenditures guaranteed by growth could well reduce these deficits by a greater amount in the longer term, while immediate increases in TTR's could inhibit such growth.

1. Revenue Statistics of OECD Member Countries 1965-92 (Paris: OECD, August 1993).
2. OECD Economic Outlook (Paris: OECD, June 1993).
3. I recall that I am using normative 'tax effort' in the context that many governments' priorities have been to reduce their budget deficits reflected in Table 2, together with their acknowledgement that government expenditure reductions will be insufficient to achieve this aim.
4. As provided in Table 13 of the June article.

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TABLE 1 – TOTAL TAX RECEIPTS/GDP RATIOS 1990-1992

	(1) 1990 Original estimates (a)	(2) 1991 Revised estimatis (b)	(3) 1991 Original estimates (a)	(4) 1991 Revised estimates (b)	(5) 1992 Provisional estimates (b)
Australia	30.8	30.8	na	29.2	na
Austria	41.6	41.3	42.0	42.1	43.6(3)
Belgium	44.9	44.9	42.0	44.9(2)	45.4
Canada	37.1	37.0	39.4	37.3(2)	na
Denmark	48.6	48.5	48.2	48.3	48.9(3)
Finland	38.0	37.9	37.2	37.7	37.7
France	43.7	43.8	43.9	44.2	43.7
Germany	37.7	36.8(1)	36.6	39.2(2)	40.0(3)
Greece	36.5	36.1	na	38.3	na
Iceland	32.6	32.3	32.5	32.4	33.2(3)
Ireland	37.2	36.8	37.9	37.5	38.0
Italy	39.1	39.1	40.5	39.7(2)	42.4(3)
Japan	31.3	31.4	na	30.9	30.2(3)
Luxembourg	50.3	48.8(1)	na	48.5	na
Netherlands	45.2	44.6(1)	47.2	47.0	46.7
New Zealand	38.2	37.3(1)	na	36.0	na
Norway	46.3	46.3	47.0	47.1	46.7
Portugal	34.6	34.8	35.5	35.6	37.8(3)
Spain	34.4	34.4	34.6	34.7	35.9(3)
Sweden	56.9	56.9	51.7	53.2(2)	50.4(3)
Switzerland	31.7	31.5	31.4	31.0	32.2(3)
Turkey	27.8	27.8	30.0	29.4	32.1(3)
United Kingdom	36.7	36.7	36.2	36.0	35.8
United States of America	29.9	29.5	na	29.8	na
Unweighted Average	38.8	38.6	na	38.7	na

(a) From Revenue Statistics of OECD Member Countries 1965-91 Table 3, p. 75 and Table 112, p. 180.
(b) From Revenue Statistics of OECD Member Countries 1965-92 Table 3, p. 75 and Table 112, p. 178.
(1) Changes of more than 0.5 percentage points of GDP between original and revised estimates for 1990.
(2) Changes of more than 0.5 percentage points of GDP between original and revised estimates for 1991.
(3) Changes of more than 0.5 percentage points of GDP between 1991 and provisional estimates for 1992.

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TABLE 2
GENERAL GOVERNMENT FINANCIAL BALANCE (AS PERCENTAGE OF NOMINAL GDP)

SUMMARY OF REVISIONS OF ESTIMATES

	(1) 1992 early estimate (a)	(2) 1992 later estimate (b)	(3) 1992 latest estimate (c)	(4) 1993 early estimate (b)	(5) 1993 later estimate (c)	(6) 1994 early estimate	(7) 1994 later estimate (c)	(8) 1992 (difference between column (1) and (3)	(9) 1993 (difference between column (4) and (5)	(10) 1994 difference between columns (6) and (7)
United States	–3.9	–4.7	–4.7	–2.7	–3.8	–3.4	–2.9	0	+	0
Japan	+1.9	+1.3	–1.8	+1.8	+0.1	+0.5	–0.1	0	0	0
Germany	–3.4	–2.2	–2.8	–3.3	–4.1	–2.7	–4.1	0	0	+
France	–2.3	–2.8	–3.9	–2.3	–5.7	–2.9	–5.8	+	III (3%)	II
Italy	–11.3	–12.5	–9.5	–10.8	–9.5	–8.9	–8.3	–	–	0
United Kingdom	–4.6	–6.6	–6.7	–5.2	–8.3	–6.7	–7.4	II	III (3%)	0
Canada	–4.6	–5.8	–6.4	–3.2	–5.8	–3.2	–4.5	+	II	+
Australia	–4.0	–4.9	–5.0	–2.7	–3.9	–3.1	–3.4	+	+	0
Austria	–2.0	–1.9	–2.0	–2.1	–5.9	–1.4	–5.4	0	III (4%)	III (4%)
Belgium	–5.5	–6.1	–6.8	–5.0	–2.3	–4.4	–2.4	+	– –	–
Denmark	–2.1	–2.2	–2.5	–1.1	–3.8	–1.8	–5.5	0	III (5%)	III (4%)
Finland	–7.7	–9.7	–8.9	–6.3	–10.0	–5.7	–9.7	+	III (4%)	III (4%)
Greece	–14.5	–3.2	–10.6	–12.3	–10.4	–9.5	–10.1	– –		– 0
Ireland	–1.9	–2.3	–2.8	–2.5	–3.7	–2.8	–3.9	0	+	+
Netherlands	–3.4	–2.8	–3.3	–2.7	–3.6	–3.1	–3.1	0	0	0
Norway	–2.9	–3.4	–2.8	–2.8	–3.2	–2.6	–2.2	0	0	0
Spain	–4.9	–4.7	–4.8	–3.9	–5.4	–3.8	–5.7	0	+	+
Sweden	–4.1	–7.9	–7.1	–4.8	–13.0	–9.8	–11.3	III (3%)	III (8%)	+

(a) OECD Economic Outlook (June 1992) Table 8, p. 24.
(b) OECD Economic Outlook (December 1992) Table 10, p. 26.
(c) OECD Economic Outlook (June 1993) Table 1, p. 5.
(*) 0 less than 1% of GDP difference between first and subsequent estimates.
+ later estimate between 1 and 2% of GDP more than earlier estimate.
II later estimate between 2 and 3% of GDP more than earlier estimate.
III later estimate more than 3% of GDP more than earlier estimate.
– later estimate between 1 to 2% of GDP less than earlier estimate.
– – later estimate more than 2% of GDP less than earlier estimate.

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TABLE 3
TAX EFFORT TOWARDS REDUCING THE PUBLIC BORROWING SECTOR REQUIREMENT IN THE G7 COUNTRIES THROUGH INCREASES IN TOTAL TAX RATIOS (TTRs)

COUNTRY	(1) ORIGINAL ASSESSMENT* DURING THE PERIOD 1989-92(2)	(2) REVISED ASSESSMENT TO TAKE ACCOUNT OF DATA CHANGES FOR THE 1985-1992 PERIOD	(3) ASSESSMENT OF GOVERNMENT POLICIES SO TAKEN IN 1993 (AS AT 9/93)
CANADA	Good. Increases in TTR over recent years suggests that deficit is under greater control than in most countries	Bad in view of downward TTR's estimates (cols (3) and (4) of table 1 and higher budget deficit (cols (1 to 3) of table 2)	As column 2
FRANCE	Good. TTR has fallen slightly in recent years, but is appreciably higher than that of the other G7 and until very recently the deficit has remained stable and relatively small	Bad in view of much higher deficits than originally estimated (c.f. columns (1) and (3) and (4) and (5) of table 2)	Good but probably inadequate
GERMANY	Bad. TTR has fallen in recent years at a time when more revenues are needed for reunification costs as well as for the deficit	Good in view of substantial revision to 1991 TTRs (cols (3) and (4) of Table 1), but still inadequate	Good see cols (4) and (5) of table 1
ITALY	Good but inadequate. TTR has risen greatly in recent years, but not enough to reduce the very heavy deficit	As column 1	As column 1
JAPAN	Very good. Recent increases in TTR have enabled Japan to remain the only OECD country not in deficit	As column 1	Moderate as Japan is expected to join the rest of OECD in deficit and TTRs are estimated as static
UNITED KINGDOM	Very bad. TTR has consistently fallen since 1985, and since 1989 deficits have increased considerably	As column 1	Good but probably inadequate
UNITED STATES OF AMERICA	Very bad. No recent increase in TTR and budget deficit does not abate. (In 1991 has probably overtaken Turkey as the OECD country with the lowest TTR).	As column 1 except that Australia has joined Turkey and US as the lowest TTR countries. (Table 1 column 4)	Good but probably inadequate

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ASIA:
DEVELOPMENTS IN ECONOMIC INTEGRATION AND FISCAL HARMONIZATION

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Contents

I. Introduction
II. ASEAN Initiatives Towards Economic Integration
A. ASEAN Free Trade Area
B. Harmonization of tax treaties
III. Developments in Taxation Re Fiscal Harmonization
IV. Conclusion

I. INTRODUCTION

The importance of economic integration and fiscal harmonization was recognized by the countries in Asia as early as 1956. The meeting of the Economic Commission for Asia and the Far East (ECAFE which is the forerunner of the Economic Social Commission for Asia and the Pacific) in that year dealt with the establishment of intra-regional trade arrangements. The promotion of regional trade cooperation was again discussed extensively in the 1961 ECAFE meeting in India. Various forms of cooperation such as the establishment of an economic union, a customs union and free trade areas in Asia were also discussed. The meeting reviewed the structure of economic integration in Europe and Latin America in order to provide a basis for a similar structure in Asia.

The idea for economic integration was also discussed by other regional organizations such as the Asian Parliamentarians' Union (APU) in the 1970s. In the Vietnam meeting of the APU, the organization approved a study on the feasibility of an Asian payments union and schemes for regional cooperation for development and regional integration.

These initiatives, however, remained merely project proposals, and the feasibility of economic integration continued to be a topic of discussion for study groups and regional organizations. This does not indicate regional indifference towards the importance of economic integration, but rather is the product of diverse economic structures, particularly the diverse trade structures of the Asian countries. Striving for a common market when countries lack economic parity and when they have conflicting needs, priorities and problems is difficult. Further, many Asian countries have faced political problems which have adversely affected regional groupings, such as the Taxation and Customs Conference (TCCC) and the Study Group on Asian Tax Administration and Research (SGATAR).[1]

The TCCC was established in 1971 to enable member countries such as the Republic of China, Korea, the Philippines and Vietnam to discuss ways to improve customs and tax policies and practices in the region. The TCCC stopped meeting in 1975 because of the Philippines' one-China policy and the political problems in Vietnam. It is fortunate that SGATAR has survived political changes in the region, although Vietnam, Laos and the Khmer Republic have ceased participating in SGATAR meetings (Australia, New Zealand and Korea joined SGATAR in later years).

Of the other efforts to achieve a common economic direction for Asia, the most prominent is the Association of South East Asian Nations (ASEAN).

II. ASEAN INITIATIVES TOWARDS ECONOMIC INTEGRATION

ASEAN was organized on 8 August 1967 with Indonesia, Malaysia, the Philippines, Singapore and Thailand as founding members. Brunei Darussalam joined in January 1984 and Vietnam and Laos are expected to become members in 1993.[2]

The aims of ASEAN are diverse and encompass more than economic goals. For example:

1. SGATAR is one of the institutions in the Asia-Pacific region which facilitates the need of governments to cooperate with one another in the area of taxation.
2. At the time of writing, Vietnam and Laos had

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- to accelerate economic growth, social progress and cultural development in the region through joint endeavours;
- to promote regional peace and stability through abiding respect for justice and the rule of law in the relationships among countries in the region and adherence to the UN Charter;
- to promote active collaboration and mutual assistance on matters of common interest in economic, social, cultural, technical and administrative areas;
- to provide mutual assistance in the form of training and research facilities in educational, professional, technical and administrative areas;
- to collaborate more effectively for the greater utilization of agriculture and industry, expansion of trade, improvement of transportation and communication facilities and raising the standard of living;
- to promote Southeast Asian studies;
- to maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes and explore all avenues for closer cooperation among member countries.

The potential of ASEAN is very promising. As a market, it has a population of about 311 million which makes it as large as the EC. If other countries in the Asia-Pacific region are included, such as the other SGATAR member countries (Japan, Australia and New Zealand), in addition to Laos and Vietnam, the total population would increase to 563 million. ASEAN had a total GDP of US$ 300 billion in 1989 with total imports of US$ 127 billion and exports of US$ 122 billion. With these resources, ASEAN can be considered a substantial market and a major producer. It will therefore derive many benefits from economic integration.

To achieve this goal, ASEAN has made initial strides which include the establishment of ASEAN Free Trade Area (AFTA) and the harmonization of tax treaties.

A. *ASEAN Free Trade Area*

The agreement to establish AFTA (using the Common Effective Preferential Tariff scheme) was adopted by ASEAN on 28 January 1992. Within 15 years, beginning 1 January 1993, the tariff rates in ASEAN will be reduced to a final tariff structure of zero to 5 percent. A reduction from the existing tariff rates to a maximum rate of 20 percent will be accomplished within five to eight years beginning 1 January 1993, followed by a subsequent reduction to 5 percent by the year 2000. Each member state may adopt individual reduction schemes to achieve these objectives. In addition, individual member countries may exempt "sensitive" products from the tariff cuts or suspend tariff preferences if a domestic industry is threatened.

ASEAN member countries have agreed to accelerate tariff reductions on 15 product groups, i.e. vegetable oil, cement, chemicals, pharmaceuticals, fertilizer, plastics, rubber products, pulp, textiles, ceramic and glass products, gems and jewellery, copper cathodes, electronics, wooden and rattan furniture. Member countries have also agreed to reduce or eliminate non-tariff barriers to facilitate foreign trade, including the lifting of quantitative restrictions. A ministerial-level council was established in 1992 (called the AFTA Council) to supervise, coordinate and review the development of the AFTA.

B. *Harmonization of tax treaties*

For a number of years ASEAN member countries have aimed to eliminate double taxation of income and investment in ASEAN through tax treaty negotiations. Treaty provisions generally follow the OECD model, although the UN model is also used because it takes account of the needs and conditions of developing economies. For example, the definition of a permanent establishment (PE) under the UN model is much broader than the OECD definition.[3]

Some treaties between ASEAN member countries contain deviations from both the OECD and UN models; e.g. the absence of the time test for a PE in the Malaysia/Singapore treaty with respect to construction activities. In the case of the Philippines/Thailand and Philippines/Indonesia treaties, the time test is reduced from six months to three months for assembly and installation projects.

With respect to the taxation of business profits, many of the tax treaties follow the "attribution rule" in the OECD model which means that only the portion of profits attributable to the PE will be subject to tax in the source country. However, the Indonesia/Philippines and the Thailand/Indonesia treaties follow the "force of attraction" rule under the UN model, i.e. business profits which are taxable in the host country include not only the profits attributable to the PE itself but also profits derived from sales in that country of goods or merchandise of the same or similar kind as those sold through the PE, and profits derived from other business activities carried on in that country, of the same or similar kind as those effected through the PE.

The general method for allocating profits to a PE in ASEAN tax treaties is also based on the OECD and UN models, i.e. the arm's length rule, under which the profits of a PE are profits which would be earned by the PE "if it were wholly an independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and at prices prevailing in the ordinary market".

ASEAN members, however, felt the need to develop a model convention which would also address the needs and circumstances which are peculiar to ASEAN. In 1985, the "Intra-ASEAN Model Double Taxation Convention on Income"

3. It covers not only a branch, a place of management, an office, a factory, a workshop, and a mine, or any other place of extraction of natural resources, but also extends to:
- a building site, a construction assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;
- the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue within the country for a period or periods aggregating more than six months within any 12-month period.

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was developed and adopted by an Ad-Hoc Committee on the Harmonization of Tax Treaties of ASEAN countries. The model essentially follows the UN model but contains the following modifications:

- the convention does not include taxes on capital or taxes imposed by local governments;
- nationality is removed as a criterion in determining the residence of a taxpayer;
- the definition of a PE is broadened to include a farm, a plantation or any other place of extraction of natural resources including timber or forest products;[4]
- income derived by an enterprise from the operation of ships in international traffic may be taxed in the other contracting state but the tax imposed will be reduced by an amount equal to 50 percent;
- the criteria for determining taxation of a resident of a contracting state who provides services or independent personal services has been limited to specific tests such as the length of stay and the monetary test;[5]
- the purview of professional services has been broadened to include computer hardware and software engineers;
- the exemption of income derived from activities performed in a contracting state by public entertainers or athletes if their visit is substantially supported by public funds or a political subdivision or local authority;
- the exemption of payments from scholarship grants has been limited to scholarships granted by governmental institutions, research institutes or charitable organizations;
- an article regarding the exemption for teachers and researchers who are on an official fellowship or an exchange arrangement between universities.[6]

The modifications in the model were aimed towards granting ASEAN governments more power in taxing income from foreign investment. Although the model has not been formally adopted, it is considered a major step in the harmonization of tax treaties in ASEAN, particularly with respect to the rules and practices in defining income, locating source and avoiding double taxation, and is used as a guide by ASEAN members.

III. DEVELOPMENTS IN TAXATION RE FISCAL HARMONIZATION

Despite the absence of a formal mechanism to harmonize tax systems, the recent changes in taxation which have been introduced by governments in Asia all lead toward the evolution of similar tax structures. This is inevitable given the development of trade relationships among the Asian countries and the increased flow of international capital. It should also be mentioned that regional tax organizations such as SGATAR serve as "greenhouses" as well as clearing houses for the introduction of tax reforms. SGATAR conferences have provided opportunities for tax officials to learn about tax reforms in neighbouring countries. The introduction of tax reforms by one government serves as a stimulus for the introduction of similar reforms by other governments. The result is the evolution of a tax structure which is compatible with the structure of other governments in the region.

Foremost among the reforms introduced by Asian governments is the restructuring of income taxes towards lower tax rates and fewer tax brackets for individuals. The highest marginal rates, which are imposed in Indonesia, the Philippines and Malaysia, are aligned at 35 percent. The highest marginal rate in Singapore, which is 33 percent, is relatively lower. Among ASEAN countries, the highest marginal rate is imposed in Thailand at 37 percent.

There was also a marked reduction in the progressivity of the individual income tax structure because of the reduction in the number of brackets. Asian Governments followed similar trends in the adoption of wider and fewer tax brackets. Indonesia made the most radical change by replacing its 19-rate band with a 3-rate band. Other countries also undertook bold moves – Thailand and the Philippines reduced the number of taxable income bands from 11 to 5 and from 37 to 5, respectively. These measures are in response to the growing taxpayer disenchantment with tax structures that penalize productivity and growth. In addition, governments in the region had to confront problems of evasion which were bred by steeply progressive tax rates. As a safety net to the reform towards flatter rate structures, governments have increased income tax exemption levels for poor and low-income families.

Tax regimes have also moved towards the adoption of low corporate tax rates. Malaysia, Thailand, the Philippines and Singapore impose a uniform corporate tax rate with the lowest of 27 percent in Singapore and the highest rate of 34 percent in Malaysia and 35 percent in the Philippines. Thailand lowered its corporate tax rate to 30 percent in 1991. Although the highest corporate tax rate imposed in Indonesia is aligned with the rates in Malaysia and the Philippines, Indonesia maintains a three-tiered structure which is the same as the tax rates on individuals.

Reforms have also been introduced to eliminate double taxation particularly with respect to the taxation of dividends. Malaysia introduced an imputation system whereby corporate tax paid in respect of profits distributed to shareholders as dividends is creditable against the shareholder's liability. Where a credit cannot be absorbed by the tax which is due, any excess is refunded. In the Philippines, the elimination of the double taxation of dividends takes the form of the elimination of the tax on intercorporate dividends as well as the tax on dividends which are distributed to individual shareholders. In Singapore, the relief is in the form of "franked" dividends. If the corporate tax paid by the company exceeds the tax deducted from the dividends paid to the shareholders, the surplus is available for franking future dividends. Indone-

4. Under the convention, a PE also encompasses a firm which habitually secures orders wholly or almost wholly for the enterprise itself or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it.
5. The concept of a "fixed base" has been excluded from the criteria.
6. The exemption does not apply to income from research which is primarily undertaken for the private benefit of a person or firm.

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sia also exempts intercorporate dividends from taxation subject to certain limitations.

Another current initiative is the formulation of a basic framework for the taxation of leasing activities. It has been observed that there is a spectrum of tax treatment on leasing by member countries. All ASEAN member countries, except Brunei Darussalam, impose a withholding tax on rental income paid to non-resident lessors with rates ranging from 4.5 to 35 percent. New guidelines are being formulated to determine how cross-border leasing among member countries should be treated for tax purposes.

The other area where tax systems are converging is in the adoption of the value added tax (VAT). Indonesia adopted VAT in 1985, and Korea shifted to VAT in 1976. The VAT was introduced in the Philippines in 1988 and in Japan in 1989. Thailand adopted VAT in 1991 and Malaysia is seriously considering implementing VAT in the near future. VAT in the region is of the consumption type, broad-based and is computed using the tax credit method. In most cases, Asian countries have adopted a uniform rate of VAT ranging from 3 to 12.5 percent, with provision for zero-rating and the imposition of an excise tax in addition to VAT for non-essential commodities.

Similar directions can also be observed with respect to simplification of the tax system and improvement of tax administration. Deductions are being rationalized in many countries, particularly deductions which are subject to abuse. The Philippines has disallowed many expenditures including representation, entertainment, travelling and bad debts in computing the taxable income of individuals with business income. No deductions are allowed for fixed income earners. Along the same line, Malaysia disallows entertainment expenses (with certain exceptions) as a deduction for income tax purposes. The broadening of the income tax base has been accomplished in a more radical way in Indonesia where virtually all tax incentives have been withdrawn. This was a dramatic attempt to simplify the tax system and move towards the adoption of low tax rates.

Increased use of withholding tax schemes has also been noted in ASEAN especially with respect to interest income, in response to the problems of evasion and avoidance through non-reporting or under-reporting of interest income. The withholding tax rates on interest income range from 15 to 20 percent. The separate taxation of interest income from global income (e.g. the Philippines and Japan) may be indicative of the growing importance of the schedular approach to taxation.

Governments have also made major strides in computerization to enhance information flows and streamline systems and procedures. There is also a movement to enhance the image of the tax administration as a service-oriented agency. Measures to develop a closer link between taxpayers and the tax office have been introduced, such as the establishment of mobile tax centres in shopping malls, the organization of public relations offices in tax agencies, the creation of one-stop shops in tax offices and frequent dialogues with taxpayers.

IV. CONCLUSION

The development of economic integration and fiscal harmonization in Asia can be looked at from two perspectives. One can be critical and note the slow pace towards integration. However, noting the diverse culture and stages of development of the Asian countries and understanding their political and economic problems, the attempts towards integration, small as they are, can be appreciated. One major block which must be overcome is parochialism. There must be a strong desire among governments not only to work for the good of their countries but for the good of the region as well. They must identify not only with their own countries but with the whole of Asia. There also must be mutual respect between developed and developing economies in the region. More importantly, regional meetings should not be perceived as ends in themselves but rather should be springboards of ideas which prod governments into action.

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CUMULATIVE INDEX – 1993

I. ARTICLES

Australia:
Peter A. Harris:
New Fif regime: an international comparison 652

Canada:
Nathan Boidman:
Tax Developments of Interest to US Tax Advisers 389
Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Research Incentives 255

Bangladesh:
K.A. Gofran:
Salient Features of the 1993/94 Budget 601

Caribbean:
Pierre-Jean Douvier:
Tax Regime and Investment Incentives in the French Caribbean Islands (Martinique, Guadeloupe and Guyane) 122
Michael Ellis:
Financial Services in the Netherlands Antilles 147
Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116
Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109
Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107
H. E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108
Michael Riegels:
Financial Services in the British Virgin Islands 143
Bruce Zagaris:
Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129

China (People's Republic):
Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Denmark:
Bente Møll Pedersen:
Tax Status of Expatriates 211

European Community:
Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

Finland:
Kari S. Tikka:
Fundamental Tax Reform: 25 Percent Rate on Capital Income and Corporate Income 348

France:
Olivier Delattre and Clothilde Fournier:
French Income Tax Developments of Interest to US Tax Advisers 367
Pierre-Jean Douvier:
Major Measures concerning International Taxation: the Finance Act 1993 and Transfer of Assets Abroad 214

Germany:
Friedhelm Jacob:
Administrative and Legislative Developments of Interest to US Tax Advisers 383
Friedhelm Jacob:
Recent legislative developments 664
Dr Klaus Sieker and Adrian Yeeles:
New Thin Capitalization Rules 594

Hong Kong:
Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283
Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

India:
Har Govind:
Recent Court Decision Affecting Non-Residents 37
G.K. Kawatra:
1993/94 Budget 294

International:
John Azzi:
Policy Considerations in the Taxation of Foreign Source Income 547
Vicki L. Beyer:
Issues raised by International Cooperation in Revenue Enforcement: Directions for the Future 436
Sijbren Cnossen:
What Kind of Corporation Tax? 3
John Hasseldine:
How do Revenue Audits Affect Taxpayer Compliance 424
Ken Messere:
Recent Tax Revenue Developments in OECD Countries and Some Policy Implications 323
John Prebble:
100 Years of Income Tax 59
Stanley C. Ruchelman:
US Tax Considerations in International Derivative Products 235
Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

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Italy:
Simona Belletini:
Tax Treatment of Financial Instruments in Italy 502
Karl Beusch:
1993 IFA Congress in Florence 471
Augusto Fantozzi:
Italy Welcomes Further EC Harmonization 474
Bruno Gangemi:
Tax Avoidance: The Italian Experience 522
Paolo Ludovici:
The Tax on the Net Worth of Enterprises 496
Guglielmo Maisto:
Implementation of the EC Merger Directive 480
Andrea Manganelli:
Tax Treaty Developments 529
Andrea Manzitti:
Tax Incentives in Italy 516
Giuseppe Marino:
Taxation of Italian-Based Flows of Interest and Royalties in an International Context 510
Siegfried Mayr:
Implementation of the Parent-Subsidiary Directive 493

Japan:
Alum Bati:
Taxation of Dividends and Interest 202
Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Kazakhstan:
Charles E. McLure, Jr.:
Tax Foundation Signs Agreement with Kazakhstan and Russia 444

Malaysia:
Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Mexico:
Juan Pablo de la Calle Pardo:
Tax Developments of Interest to US Tax Advisers 407

New Zealand:
Michael Dirkis:
Applying a sledgehammer to foreign investment: Foreign investment fund measures 646
Andrew M.C. Smith:
Comprehensive Dividend Imputation, Neutrality and Double Taxation of Corporate Profits 568

Netherlands:
Ebel Magnin:
Proposed Tax Haven Legislation 589
Paul Sleurink:
Income Tax Developments of Interest to US Tax Advisers 371

Nigeria:
Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Russia:
Charles E. McLure, Jr.:
Tax Foundation Signs Agreement with Kazakhstan and Russia 444
James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Singapore:
Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

United Kingdom:
Eric Tomsett:
Holding Company Regimes 599
Guy Brannan:
Tax Developments in the United Kingdom of Interest to US Tax Advisers 363

United States:
Melvin S. Adess and Barbara M. Angus:
Knowledge and Technology Transfers to and from the United States – Characterization of Transfers of Computer Software 414
Stephen A. Mihaly:
How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the Best Method Rule of the New Section 482 Regulations 307
John G. Rienstra:
Entity classification guidelines for German GmbHs 638
Revenue Reconciliation Act of 1993 581
Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84
Stanley C. Ruchelman:
Transfer Pricing Regulations Issued 187
Philip H. Spector:
The 1933 US tax act will affect international transactions 630
Leif Weizman:
New Income Tax Treaty – An Analysis and Prognosis 450

United States/Netherlands:
Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175
Philip H. Spector:
Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159

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Bruce Zagaris:
The US–Netherlands Income Tax Treaty:
Tax Collection Assistance and Evidence-Gathering 342

Wim Wijnen:
The New US/Netherlands Double Tax
Convention: an Introductory Note: 74

II. REPORTS AND DOCUMENTS

International:
Peter Hann:
ASSOCHAM/IFA Conference 92

Jill C. Pagan:
Indications of Future Policy in the Latest OECD
Task Force Report 181

Report by the Committee on Fiscal Affairs on the
Proposed Regulations under Section 482 IRC:
The US Proposed Regulations Dealing with
Tax Aspects of Transfer Pricing within
Multinational Enterprises 21

Report by the Committee on Fiscal Affairs on
intercompany transfer pricing regulations under US
Section 482 temporary and proposed regulations 619

III. IFA NEWS 44, 96, 219, 254, 473, 667

IV. CONFERENCE DIARY 39, 149, 285, 347, 413, 492, 614, 670

V. BIBLIOGRAPHY

– Books 49, 100, 150, 226, 297, 354, 462, 535, 602, 671
– Loose-leaf services 51, 103, 154, 231, 302, 465, 540, 611, 680
– List of addresses of the major publishing houses appearing in the Bibliography 53

LIST OF AUTHORS – 1993

Melvin S. Adess and Barbara M. Angus:
Knowledge and Technology Transfers to and from the
United States – Characterization of Transfers of
Computer Software 414

Barbara M. Angus:
See under Melvin S. Adess and Barbara M. Angus

John Azzi:
Policy Considerations in the Taxation of Foreign
Source Income 547

Alum Bati:
Taxation of Dividends and Interest 202

Simona Belletini:
Tax Treatment of Financial Instruments in Italy 502

Vicki L. Beyer:
Issues raised by International Cooperation in Revenue
Enforcement:
Directions for the Future 436

Marius Cloete van Blerck:
New Dual Tax System 701

Nathan Boidman:
Tax Developments of Interest to US Tax Advisers 389

Guy Brannan:
Tax Developments in the United Kingdom of
Interest to US Tax Advisers 363

Juan Pablo de la Calle Pardo:
Tax Developments of Interest to US Tax Advisers 407

Sijbren Cnossen:
What Kind of Corporation Tax? 3

Olivier Delattre and Clothilde Fournier:
French Income Tax Developments of Interest to
US Tax Advisers 367

Michael Dirkis:
– Applying a Sledgehammer to Foreign Investment:
Foreign Investment Fund Measures 646
– The Last Chapter? A Review of Australia's
New Foreign Investment Fund Measures 687

Pierre-Jean Douvier:
– Major Measures concerning International Taxation:
the Finance Act 1993 and Transfer of Assets
Abroad 214
– Tax Regime and Investment Incentives in the
French Carribbean Islands (Martinique,
Guadeloupe and Guyane) 122

Michael Ellis:
Financial Services in the Netherlands Antilles 147

Professor A.C. Ezejelue:
1992 Reforms in Tax Structure and Policy 40

Augusto Fantozzi:
Italy Welcomes Further EC Harmonization 474

Clothilde Fournier:
See under Olivier Delattre and Clothilde Fournier

Bruno Gangemi:
Tax Avoidance: The Italian Experience 522

K.A. Gofran:
Salient Features of the 1993/94 Budget 601

Christine A. Gore:
Taxation of Foreign Investment in Jamaica 116

Har Govind:
Recent Court Decision Affecting Non-Residents 37

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Peter Hann:
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Ian W. Harris:
Budget 1993/94: Hong Kong Continues to Achieve Remarkable Growth 283

Peter A. Harris:
New FIF Regime: an International Comparison 652

John Hasseldine:
How do Revenue Audits Affect Taxpayer Compliance 424

Friedhelm Jacob:
– Administrative and Legislative Developments of Interest to US Tax Advisers 383
– Recent Legislative Developments 664

Annette T. Johnson:
Recent Tax and Foreign Investment Developments in the Caribbean 109

Philip T. Kaplan:
Treaty Shopping under the New US–Netherlands Treaty 175

G.K. Kawatra:
1993/94 Budget 294

Dr Willem G. Kuiper:
The First Caribbean Tax Conference 107

H.E. Mr Roland H. Laclé:
Excerpts from the Address of the Minister of Finance of Aruba 108

Lee Fook Hong:
1993 Budget: Rewards for Going Abroad and Rebates for GST At Home 278

Li Zhi Hui:
A Brief Introduction to Tianjin Port Bonded Zone 90

Paolo Ludovici:
The Tax on the Net Worth of Enterprises 496

Ebel Magnin:
Proposed Tax Haven Legislation 589

Ebel Magnin and Eero Rautalahti:
Tax Haven and Foreign Tax Credit Rules: 1992 Amendments and Their Impact on Dutch Holding Companies 286

Guglielmo Maisto:
Implementation of the EC Merger Directive 480

Andrea Manganelli:
Tax Treaty Developments 529

Andrea Manzitti:
Tax Incentives in Italy 516

Giuseppe Marino:
Taxation of Italy-Based Flows of Interest and Royalties in an International Context 510

Dr George Mavraganis:
Corporate Income Tax Harmonization in the Nineties 220

Siegfried Mayr:
Implementation of the Parent-Subsidiary Directive 493

Charles E. McLure, Jr.:
– Tax Foundation Signs Agreement with Kazakhstan and Russia 444
– See under James Riordan and Charles E. McLure, Jr.

Ken Messere:
– Recent Tax Revenue Developments in OECD Countries and Some Policy Implications 323
– International Postscript to June 1993 Article on Developments in Tax Revenues and Fiscal Deficits of OECD Countries 721

Stephen A. Mihaly:
How to Escape the Wrath of Thrasybulus' Sword and Establish Reasonable Royalty Rates in Intercompany Licensing of Intangibles under the Best Method Rule of the New Section 482 Regulations 307

Jeffrey Owens:
Environment and Taxation: Mutually Reinforcing Policies 708

Jill C. Pagan:
Indications of Future Policy in the Latest OECD Task Force Report 181

Bente Møll Pedersen:
Tax Status of Expatriates 211

John Prebble:
100 Years of Income Tax 59

Eero Rautalahti:
See under Ebel Magnin and Eero Rautalahti

Michael Riegels:
Financial Services in the British Virgin Islands 143

John G. Rienstra:
– Revenue Reconciliation Act of 1993 581
– Entity Classification Guidelines for German GmbHs 638

James Riordan and Charles E. McLure, Jr.:
Tax Aspects of Improving the Investment Climate in Russia 17

Leonard W. Rothschild, Jr. and Michael G. Schinner:
Determining Residency for Federal Income Tax Purposes 84

Stanley C. Ruchelman:
– Transfer Pricing Regulations Issued 187
– US Tax Considerations in International Derivative Products 235

Efraim Sadka and Vito Tanzi:
A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation 66

Ingrid Sapona:
The Proposed New Scientific Research and Experimental Development Rules – an Update on Research Incentives 255

Michael G. Schinner:

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See under Leonard W. Rothschild Jr. and Michael G. Schinner

Dr Norbert Seeger:
Preferential Tax Treatment of Liechtenstein Holding and Domiciliary Companies 717

Dr Klaus Sieker and Adrian Yeeles:
New Thin Capitalization Rules 594

Veerinderjeet Singh:
The 1993 Budget and Recent Developments 26

Paul Sleurink:
Income Tax Developments of Interest to US Tax Advisers 371

Andrew M.C. Smith:
Comprehensive Dividend Imputation, Neutrality and Double Taxation of Corporate Profits 568

Philip H. Spector:
- Limitations on Benefits under the New US–Netherlands Income Tax Treaty 159
- The 1993 US Tax Act Will Affect International Transactions 630
- Triangular Problem settled in US–Netherlands Treaty Protocol 698

Vito Tanzi:
See under Efraim Sadka and Vito Tanzi

Kari S. Tikka:
Fundamental Tax Reform: 25 Percent Rate on Capital Income and Corporate Income 348

Eric Tomsett:
Holding Company Regimes 599

Jefferson P. VanderWolk:
The Privy Council Wanders in the Wilderness 33

Leif Weizman:
New Income Tax Treaty – An Analysis and Prognosis 450

Wim Wijnen:
The New US–Netherlands Double Tax Convention: an Introductory Note 74

Adrian Yeeles:
See under Klaus Sieker and Adrian Yeeles

Angel Q. Yoingco:
Developments in Economic Integration and Fiscal Harmonization in Asia 725

Bruce Zagaris:
- Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options 129
- The US–Netherlands Income Tax Treaty: Tax Collection Assistance and Evidence-Gathering 342

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